

Effective Date: October 17, 2003

**COORDINATED ISSUE  
ALL INDUSTRIES  
LOSSES CLAIMED AND INCOME TO BE REPORTED FROM  
LEASE IN/LEASE OUT TRANSACTIONS  
UIL 9300.07-00**

**ISSUES**

1. Whether taxpayers entering into Lease In/Lease Out (LILO) transactions are entitled to deduct currently rental expense, and to amortize transaction costs resulting from their participation in the transaction under Internal Revenue Code §162, or whether taxpayers purchased at most a future interest, as in substance dominion and control over the property remain with the Tax Exempt Entity during the period of the Sublease.
2. Whether taxpayers entering into LILO transactions are entitled to deduct interest expense resulting from their participation in the transaction under Internal Revenue Code §163, or whether the deductions are disallowed on grounds that no amount is paid for the use or forbearance of money.
3. Alternatively, whether taxpayers entering into LILO transactions should be treated under the substance over form doctrine as having entered into a financing arrangement.
4. Alternatively, if the LILO transaction results in a true lease and sublease for federal income tax purposes, how do the provisions of Internal Revenue Code § 467 apply to income and deductions reported under these leases?
5. Whether Internal Revenue Code § 6662, the Accuracy-Related Penalty, applies to LILO transactions.

**CONCLUSIONS**

1. Taxpayers entering into LILO transactions are not entitled to deduct currently rental expense, or to amortize transaction costs resulting from their participation in the transaction under § 162, because taxpayers purchased a future interest, as in substance dominion and control over the property remain with the Tax Exempt Entity during the period of the Sublease.

2. Taxpayers entering into LILO transactions are not entitled to deduct interest expense resulting from their participation in the transaction under § 163, as no amount is paid for the use or forbearance of money.
3. Alternatively, under the appropriate factual circumstances, taxpayers entering into LILO transactions are not entitled to deduct rental expense resulting from their participation in the transaction because the LILO is a financing arrangement rather than a true lease. Under this alternative, taxpayers would not be treated as having purchased a future interest.
4. Internal Revenue Code § 467 and the regulations thereunder provide complex rules relating to accounting for certain leases. Agents are advised to contact the Leasing Technical Advisors for assistance with § 467 issues. Attached as an Appendix is a background discussion of the statute and regulations.
5. Internal Revenue Code § 6662 should be asserted against taxpayers entering into LILO transactions only if the taxpayers are unable to establish reasonable cause under Internal Revenue Code § 6664(c)(1) and the applicable regulations.

## **FACTS**

### **1. Overview of a Typical LILO Transaction**

LILO transactions occur between a U.S. Taxpayer (commonly known, and referred to herein sometimes as, the Equity Investor), and a Tax Exempt Entity. In these transactions, the Tax Exempt Entity (also known as the Lessor/Sublessee) ostensibly leases the property to the Equity Investor (also known as the Lessee/Sublessor) via a Headlease. The Equity Investor immediately leases the property back to the Tax Exempt Entity through a Sublease. The Equity Investor commonly acts through a domestic Grantor Trust (the Trust) which executes all the agreements in the transaction as an agent. Because the Trust is ignored for tax purposes, the terms “U.S. Taxpayer”, “Equity Investor” and “Trust” are used interchangeably in this paper. The Headlease payment(s) by the Equity Investor is necessary to generate the rental expense deductions (and amortizations) claimed for U.S. Tax purposes.<sup>1</sup>

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<sup>1</sup> Terms such as lease and sublease are used for convenience and do not indicate that the Service respects them as such. In addition, please note that this Coordinated Issue Paper refers to the basic transaction documents by their most common titles as used in actual transactions. For example, most LILO transactions require execution of the Participation Agreement. However, each transaction may entail unique documents or retitle the basic documents noted here. All questions regarding transaction documents or the operation of a LILO should be referred to the Leasing Technical Advisors.

These transactions generally involve a foreign bank or the foreign branch of a domestic bank (Lender) and an affiliate of Lender (the Payment Undertaking Party/Deposit Taker.)<sup>2</sup> Lender is essential to the LILO transaction as it makes the nonrecourse loan used by the Equity Investor to fund the majority of the prepaid (also known as advance) Headlease rental payments made to the Tax Exempt Entity at the beginning of the transaction. The remaining amount used to make the prepayment is supplied by the Equity Investor from its funds (referred to as Equity Investment). Once the Equity Investor prepays a portion of its rental payments, as permitted by the Headlease, rental expense deductions, which comprise the majority of the tax benefits derived from the transaction, purportedly become available. Moreover, the nonrecourse loan creates the claimed interest expense deductions.

Frequently the Payment Undertaking Party/Deposit Taker is affiliated with, and often the parent of, Lender, or may be the same entity as Lender. As detailed below, Lender and the Payment Undertaking Party/Deposit Taker are necessary to generate the first circular cash flow, which removes all or almost all of the credit risk which the Equity Investor would face in a true lease transaction recognized for federal tax purposes.

Most LILO transactions include a Promoter, which often initiates the transaction. The role of the Promoter is to match the Tax Exempt Entity with an appropriate Equity Investor seeking tax deductions. Also, the Promoter usually obtains the services of one or more appraisers and law firms providing the tax opinion and/or other legal advice. In addition, the U.S. Taxpayer amortizes the transaction costs<sup>3</sup> paid directly or indirectly to the Promoter and/or these other participants in the transaction.

In other LILO transactions, the Tax Exempt Entity initiates the process by sending a package, sometimes called a mandate, to potential Promoters, one of which will be selected to represent it in a deal. Once selected, the Promoter solicits bids on behalf of the Tax Exempt Entity from Equity Investors to “buy” potential tax benefits from the Tax Exempt Entity.

Many of the Tax Exempt Entities engaging in LILOs are domestic or foreign, governmental or quasi-governmental, entities. Types of property used in these transactions include passenger railway cars, locomotives, subway cars and lines, ferry boats, airplanes, power plants, sewage treatment plants, paper manufacturing plants, energy delivery pipelines, and municipal buildings. As an integral part of the deal, the Tax Exempt Entity or its affiliate is the owner and operator of the property prior to the LILO and retains control of the

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<sup>2</sup> The functions and form of the Payment Undertaking Party/Deposit Taker are discussed below.

<sup>3</sup> In most LILOs, the Participation Agreement defines “transaction costs” as being those fees paid to the promoter, advisor, and appraiser, as well as to fees paid to attorneys who have provided various legal opinions. These “transaction costs” are usually 1-2% of the prepayment of Headlease amount (or asset value). In this document, the term “transaction costs” does not refer to the Accommodation Fee (\$14 million in RR 2002-69) paid to the Tax Exempt Entity as part of the taxpayer’s Equity Investment.

property at least during the base term and any renewal term of the Sublease. As detailed below, there may be appropriate facts and circumstances under which we would expect the Tax Exempt Entity to exercise its option under the Sublease to repurchase and retain control over its property by purchasing the remaining Headlease interest. In any event, the property returns to the Tax Exempt Entity at the expiration of the Headlease.

Part of the Equity Investment in the Headlease prepayment is used by the Tax Exempt Entity to buy high grade securities. This is generally termed the Equity Collateral. The purchase of the Equity Collateral is also essential to a LILO transaction since it constitutes the second circular flow of funds. The Equity Collateral is purchased solely with funds provided by the Equity Investor, and, in the event Tax Exempt Entity exercises the Early Buyout Option or defaults, or the Equity Investor exercises the Put Renewal Option, will essentially be returned to the Equity Investor. Note that several sections of this paper discuss the return of the Equity Collateral to the U.S. Taxpayer. In each such discussion, the Equity Collateral includes an investment return earned on that Equity Collateral for the period following the Closing Date.

On their tax returns, Equity Investors report rental income due under the sublease and claim substantial accelerated deductions of the rent prepaid under the terms of the Headlease, along with interest expense deductions, and amortized transaction costs.

## **2. Structure of a Typical LILO Transaction**

On the Closing Date of the transaction, the Trust and the Tax Exempt Entity enter into a Participation Agreement. This Agreement includes terms requiring the parties to enter into various contracts, such as the Headlease Agreement, the Lease Agreement, and the Loan and Security Agreement, in order to effectuate the LILO. Next, the Tax Exempt Entity and the Trust immediately enter into the Headlease and Lease (hereinafter referred to as the Sublease) Agreements, with the Headlease extending for a period less than the remaining useful life of the equipment. Under the Headlease, the Equity Investor generally is required to make two payments: (a) a prepayment of rent (the advance rent payment) at the beginning of the transaction, usually at the Closing Date; and (b) a post-payment of rent at the end of the Headlease term. The Sublease is a net lease, requiring the Tax Exempt Entity to maintain and repair the property, obtain insurance, pay property taxes, etc. Typically, the Sublease requires that, in the event of any loss of the property, for example due to casualty or in the event of any default by the Tax Exempt Entity, the Tax Exempt Entity makes a large Sublease Termination Value payment to the Equity Investor, funded substantially with the Payment Undertaking Agreement funds and the Equity Collateral.

The Participation Agreement also defines other rights and responsibilities of the parties, such as warranties and security interests. These security interests often include: (a) the Equity Investor holding a first priority perfected security interest in the Equity Collateral; (b)

the Loan and Security Agreement creating a perfected, first priority security interest in the Collateral, as defined in the Loan and Security Agreement rather than the Participation Agreement itself; (c) if the country in which the Tax Exempt Entity is located ceases to own at least 50.1 percent of the Tax Exempt Entity or the credit rating of the Tax Exempt Entity suffers, the Tax Exempt Entity is to provide the Equity Investor with a guarantee satisfactory to the Equity Investor or a letter of credit or a bank guarantee for the benefit of the Equity Investor; (d) the Equity Investor agreeing that it will not permit any lien to exist on any of the leased property or the Collateral; (e) the Tax Exempt Entity agreeing it shall not permit any liens to exist on the Deposit; (f) the Tax Exempt Entity agreeing, for the benefit of Lender, not to declare the Headlease in default or terminate the Headlease until the nonrecourse loan to the Equity Investor and all accrued interest is repaid in full; (g) the Equity Investor agreeing not to assign or otherwise transfer any of its right, title, or interest unless certain restrictions are met; (h) the Sublease being subject to a first priority security interest in favor of Lender and subject to a subordinate security interest in favor of the Tax Exempt Entity; (i) the Tax Exempt Entity agreeing that all basic rent payments due from it shall be paid directly to Lender until the liens of the Loan and Security Agreement have been discharged; (j) the Tax Exempt Entity agreeing it may not sublease the property without the consent of the Equity Investor or Lender, plus agreeing to certain restrictions on substitute sublessees; (k) the Tax Exempt Entity agreeing that all insurance policies are to list Lender as an insured; (l) the Tax Exempt Entity agreeing that it may not assign any of its rights, except to certain restricted assignees; (m) the Equity Investor agreeing to grant security interests in favor of Lender in all its right, title and interest in and to the Sublease, the Headlease, the Equipment, and other security given by the Tax Exempt Entity to the Equity Investor (although as discussed in more detail below the Equity Investor's interest in the Equity Collateral is typically not pledged to the Lender) and (n) the Tax Exempt Entity agreeing to assign and pledge to the Equity Investor all of its right under the Payment Undertaking Agreement to the Deposit as security for its obligations under the Sublease.

As noted above, the Equity Investor finances most of the prepaid advance rental payments allowable under the Headlease by means of a nonrecourse loan from Lender.<sup>4</sup> The Lender is also granted a security interest in all rights held by the Equity Investor, except the Equity Collateral, through the Loan and Security Agreement. For example, some LILO transactions provide that for as long as the U.S. Taxpayer's interest is subject to the liens of the Loan and Security Agreement, Lender may directly enforce the Secured Obligations in the Payment Undertaking Agreement in the case of a default. In addition, under the Payment Undertaking Agreement, the Payment Undertaking Party/Deposit Taker agrees that as long as the liens of Lender have not been terminated, it will pay each of the amounts required to be paid to the Equity Investor directly to Lender.

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<sup>4</sup>Note that some LILO transactions also include a loan from the Payment Undertaking Party /the Deposit Taker to Lender under an intercompany loan agreement. In such LILOs, this loan between the affiliated Lenders serves to close the circular flow of "borrowed funds," as the amount lent by the Payment Undertaking Party /the Deposit Taker ultimately is returned to it in the form of the Deposit.

At some point, usually the end of the Basic Term of the Sublease, the Tax Exempt Entity has an option to purchase the remaining Headlease interest from the Equity Investor (the Early Buyout Option) for a predetermined fixed price (in Rev. Rul. 2002-69, it was stated as an amount equal to 105 percent of the projected appraised fair market value of the interest). All LILO transactions include the Early Buyout Option. The Headlease terminates if the Early Buyout Option is exercised; terminating the Headlease also eliminates further sublease rental income. In addition, in those LILOs including a post-payment due from the Equity Investor to the Tax Exempt Entity, exercise of the Early Buyout Option eliminates the Equity Investor's obligation to make this post-payment. Under this option, the form of the transaction permits deduction of the advance rental payment and interest expense at the beginning of the Headlease, while eventually ending the taxable rental income stream.

If the Tax Exempt Entity fails to exercise the Early Buyout Option, the Equity Investor has two alternatives:

- a. The Equity Investor may compel the Tax Exempt Entity to continue the Sublease, but often at a higher rent than was paid during the Basic Term of the Sublease (although higher than the Sublease Basic Term rent, in Rev. Rul. 2002-69, the Sublease Renewal Term rent under this option was stated as an amount equal to 90 percent of the projected appraised fair market rental value); this option may be called the Put Renewal Option. If this option is exercised, the Tax Exempt Entity normally places the Sublease payments it would then owe the Equity Investor in an investment account. Under this option, the amount of the investment account will increase to equal the post-payment<sup>5</sup> and the account may be used only to make this post-payment to the Tax Exempt Entity. In some cases, a portion of the Equity Collateral is used to make this payment. The Equity Collateral may also fund the rent payable by the Tax Exempt Entity due the Equity Investor in the Put Renewal term. Further, if the Tax Exempt Entity does not exercise the Early Buyout Option and the U.S. Taxpayer exercises the Put Renewal Option, the U.S. Taxpayer may require the Tax Exempt Entity to purchase a letter of credit guaranteeing the Put Renewal Option term rents. The Put Renewal Option is typical for transactions beginning in late 1996.

Note that in some LILOs the Tax Exempt Entity may, in case of a Put Renewal Option exercise, find a Replacement Sublessee. However, in most LILO transactions, this option suffers from restrictions because the Replacement Sublessee must be listed in a schedule attached to the Participation Agreement or meet all the following general criteria: (1) have a net worth greater than perhaps

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<sup>5</sup> See Paragraph H. under the Future Interest section below.

\$500 million; (2) have a credit rating for long term unsecured debt obligations of perhaps Aa2 by Moody's or AA by Standard & Poor<sup>6</sup> unless the Replacement Sublessee provides a credit enhancement or provides a guarantee of its obligations satisfactory to the Equity Investor; (3) operate the subject property in its business; (4) itself not be a tax exempt entity or related to the Tax Exempt Entity for purposes of Internal Revenue Code § 168(i)(3)(A); and (5) not violate the Equity Investor's credit restrictions or guidelines. In addition, the rent due from the Replacement Sublessee (i.e. the 90 percent of projected fair market rental value) usually exceeds the amount paid by the Tax Exempt Entity during the Basic Term of the Sublease, making this option less attractive.

- b. The Equity Investor may take back the property for the remaining Headlease term (the Return Option). Although generally, the Tax Exempt Entity incurs a fee which should be less than the purchase price under the Early Buyout Option, the Tax Exempt Entity must relinquish control of the property it will still need for its daily business operation. Presumably, under this option, the Tax Exempt Entity must expend its own funds to secure replacement property (e.g. railway car, power plant) in order to continue its daily business activity. All LILO transactions include the Return Option. Please note, typically the appraisals provided in LILO transactions conclude that the Tax Exempt Entity likely will not exercise the Early Buyout Option and that the Equity Investor most likely will exercise the Return Option.

### **3. Financing of a Typical LILO Transaction: Circular Flows**

These transactions always include at least two circular flows of funds designed to eliminate all or nearly all credit risk to the U.S. Taxpayer. Due to the circular flows, the Tax Exempt Entity's payment obligations in LILOs are usually 100 percent, or nearly 100 percent, economically defeased.

Using its own funds and funds obtained through nonrecourse borrowing, the U.S. Taxpayer prepays certain Headlease rent payments to the Tax Exempt Entity.<sup>7</sup> The Tax Exempt Entity then applies the Headlease prepayment in the following manner:

- A. Amounts corresponding to the nonrecourse borrowing are deposited with one or perhaps two Payment Undertaking Parties/Deposit Takers pursuant to an agreement described below;<sup>8</sup>

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<sup>6</sup> Note that as of May 2002, Moody's ratings, from the highest quality to the lowest, were Aaa, Aa1, Aa2, Aa3, A1, A2, A3, Baa2, Baa3, Ba1, Ba2, Ba3, B1, B2, B3, Caa, Ca, and C. We understand that Standard & Poor's ratings, from the highest quality to the lowest, are AAA, AA+, AA, AA-, A, A-, BBB+, BBB, BBB-, BB+, BB, BB-, B+, B-, CCC, and D.

<sup>7</sup> In Rev. Rul. 2002-69, 2002-2 C.B. 760, the amount of this Headlease prepayment was \$89 million, consisting of \$29 million of equity and \$60 million obtained through two nonrecourse borrowings (in the amounts of \$54 million and \$6 million). A diagram of the transaction described in the ruling is attached.

- B. Part of the Equity Investment is used to purchase highly-rated securities that serve as the Equity Collateral;<sup>9</sup> and
- C. The remaining part of the Equity Investment is retained by the Tax Exempt Entity, which will be paid back only in the event of a loss of the property or default by the Sublessee.<sup>10</sup>

In addition, the U.S. Taxpayer pays transaction costs to the Promoter and others.

The first circular flow of funds is commonly referred to as the debt defeasance and is prescribed by a Payment Undertaking Agreement or Deposit.<sup>11</sup> Under this agreement, amounts are released periodically to pay the Tax Exempt Entity's rent due under the Sublease. Significantly, the amount of interest paid by the Payment Undertaking Party/Deposit Taker on the Deposit generally equals the amount of interest charged by Lender on the nonrecourse loan. Further, the timing and amount of the rent payment due to the Equity Investor generally equals the timing and amount of the loan payment amount due to Lender from the Equity Investor. Also, the nonrecourse loan from Lender generally provides for annual payments that will fully amortize the loan over the Basic Term of the Sublease. Moreover, in most cases, Lender requires the Equity Investor to assign the Sublease rent payment to it; accordingly, the Equity Investor directs the Payment Undertaking Party/Deposit Taker to make payments directly to Lender. Thus, although the parties account for periodic payments from the Payment Undertaking Party/Deposit Taker to the Tax Exempt Entity, then to the Equity Investor and finally the Lender, typically the funds flow only from the Payment Undertaking Party/Deposit Taker to the Lender.

The second circular flow of funds, involving a share of the equity portion (the Equity Collateral) of the advance Headlease rent, occurs through the Tax Exempt Entity's purchase of highly-rated securities. This Equity Collateral may be securities, certificates of deposit, zero coupon bonds, or U.S. Treasury STRIPS. The purchase of the Equity Collateral is also essential to a LILO transaction since these funds mature over a period of years to an amount equal to the Early Buyout Option price<sup>12</sup> of the residual Headlease interest, thus allowing the Tax Exempt Entity to repurchase that interest without expending

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<sup>8</sup> In Rev. Rul. 2002-69, the \$54 million and \$6 million borrowings were deposited with Lender affiliates, which served as Payment Undertaking Parties/Deposit Takers.

<sup>9</sup> In Rev. Rul. 2002-69, \$15 million of the \$29 million equity portion of the Headlease prepayment was held in such an account.

<sup>10</sup> In Rev. Rul. 2002-69, the Tax Exempt Entity retained \$14 million as its inducement for engaging in the LILO. This is referred to as an Accommodation Fee in this document.

<sup>11</sup> See discussion at paragraph E. below in the Future Interest discussion regarding the distinction between a fee structure and a deposit structure.

<sup>12</sup> Note that in some LILOs, the remainder of the Deposit, if any, is added to the Equity Collateral and used to fund the Early Buyout Option.



any of its funds and eliminating any meaningful financial risk to the U.S. Taxpayer. Normally, the Equity Collateral is pledged as security for various obligations of the Tax Exempt Entity to the U.S. Taxpayer, including its liability for Sublease rent, any Sublease Termination Value payment, and the Early Buyout Option price. Notably, however, U.S. Taxpayer does not repledge any rights it has in the Equity Collateral on its nonrecourse loan obligation.

#### **4. Offsetting Obligations in LILO Transactions**

LILO transactions generally contain these reciprocal and circular structures and/or provisions:

- a. The U.S. Taxpayer's right to use the property under that portion of the Headlease equal to the Sublease Basic Term is offset by the U.S. Taxpayer's obligation to make the property available to the Tax Exempt Entity for its use during the Basic Term of the Sublease.
- b. The U.S. Taxpayer's right to possess the property under that portion of the Headlease during the Sublease Basic Term is substantially the same as the Tax Exempt Entity's right to possession under the Basic Term of the Sublease.<sup>13</sup>
- c. The amount and timing of the loan payments due from the Equity Investor on the nonrecourse loan generally equal the amount and timing of the rent due to the Equity Investor from the Tax Exempt Entity.
- d. The U.S. Taxpayer's risk that the Tax Exempt Entity will not make its required Sublease Basic Term rental payments is substantially eliminated by the existence of the Deposit and the Payment Undertaking Agreement (the debt defeasance) and the various security arrangements noted in detail above.
- e. Under the Put Renewal Option, the U.S. Taxpayer may require the Tax Exempt Entity to purchase a letter of credit guaranteeing the Put Renewal rents. However, if the Tax Exempt Entity fails to obtain the letter of credit, it must exercise the Early Buyout Option.

## **DISCUSSION**

### **1. Future Interest Argument**

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<sup>13</sup>According to the terms of specific LILO transactions, the Basic Term of the Sublease may extend from 13.5 to 24 years.

The future interest argument is the Service's primary argument for the disallowance of tax benefits claimed in connection with LILO transactions. Although Rev. Rul. 2002-69 states that the Service will assert lack of economic substance (the argument set forth in Rev. Rul. 99-14, 1999-1 C.B. 835) in appropriate circumstances, this paper does not include the economic substance argument. Based on further study of specific transactions and knowledge of their details, we have determined that strong support exists for the future interest characterization, which is a substance over form argument.

a. Legal Analysis

The substance of a transaction, not its form, governs its tax treatment. Gregory v. Helvering, 293 U.S. 465 (1935). In Frank Lyon Co. v. United States, 435 U.S. 561, 573 (1978), the Supreme Court stated, "In applying the doctrine of substance over form, the Court has looked to the objective economic realities of a transaction rather than to the particular form the parties employed." The Court subsequently applied this analysis to recharacterize a sale and repurchase of federal securities as a loan, finding that the economic realities of the transaction did not support the form chosen by the taxpayer. Nebraska Department of Revenue v. Loewenstein, 513 U.S. 123 (1994).

Taxpayers are likely to argue that LILO transactions must be respected under Frank Lyon. There are, however, a number of material differences between a LILO transaction and the transaction at issue in Frank Lyon. Three of those differences deserve special emphasis. First, unlike the Frank Lyon facts, only a relatively small portion of the funds involved in a LILO transaction could possibly be used by the Tax Exempt Entity for operations, construction or refinancing.<sup>14</sup> In Frank Lyon, substantially all of the loan proceeds were used for construction of the lessee's new headquarters. In a typical LILO, the loan proceeds<sup>15</sup> are deposited in a defeasance account. Much of the U.S. Taxpayer's Equity Investment is similarly deposited in a defeasance account,<sup>16</sup> rather than engaged in productive activity for the Tax Exempt Entity's operations. Only the remaining portion of the U.S. Taxpayer's Equity Investment, the Accommodation Fee, is retained by the Tax Exempt Entity.<sup>17</sup>

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<sup>14</sup> In Rev. Rul. 2002-69, \$14 million of the \$89 million Headlease prepayment was retained by the tax exempt as an Accommodation Fee.

<sup>15</sup> For example, the \$54 million loan from BK1 to the taxpayer in Rev. Rul. 2002-69 was deposited by the tax exempt with an affiliate of the lender and pledged to the taxpayer.

<sup>16</sup> For example, the \$15 million equity in Rev. Rul. 2002-69 was invested in high grade securities and pledged to the taxpayer. As used throughout this document, any reference to "Equity Collateral" means the amount set aside by the Tax Exempt Entity in the defeasance of the purchase option. The remaining portion of the Equity Investment is typically viewed as the Accommodation Fee paid to the Tax Exempt Entity. Thus, with respect to the facts of Rev. Rul. 2002-69, the term refers to the \$15 million.

<sup>17</sup> For example, the \$14 million in Rev. Rul. 2002-69.

Second, in Frank Lyon the taxpayer bore the risk of the lessee's nonpayment of the rent, which could force the taxpayer to default on the recourse debt. In a LILO, the combination of defeasance and nonrecourse debt will typically render such default risks remote and, even in the case of that remote event, will not leave the U.S. Taxpayer at risk for either repaying the loan balance or forfeiting the portion of its equity investment held in a defeasance account.

Third, in Frank Lyon the taxpayer was at risk for its equity investment. The fact that the buyer/lessor is at risk for its equity investment in a sale/leaseback transaction is viewed as a key factor supporting the treatment of the transaction as one in which the benefits and burdens of ownership pass from the seller/lessee to the buyer/lessor. The buyer/lessor's equity risk is typically evident from the fact that the buyer/lessor is at risk for a loss or decline in value of the property during the leaseback term or for the residual value of the property at the conclusion of the leaseback term.<sup>18</sup> In the typical LILO transaction, much of the U.S. Taxpayer's Equity Investment is deposited in a defeasance account designed to ensure that the U.S. Taxpayer will recoup those funds through either the Tax Exempt Entity's exercise of the Early Buyout Option or the Tax Exempt Entity's payment of Sublease renewal term rent under the Put Renewal Option. As a result, a decline in the residual value of the property would have an adverse effect on the U.S. Taxpayer only if neither the Early Buyout Option nor the Put Renewal Option would be exercised at the conclusion of the initial Sublease term. If the Early Buyout Option is not exercised, the U.S. Taxpayer would elect not to exercise its Put Renewal Option only if it expected to receive more in rent from a Replacement Sublessee than from the Tax Exempt Entity under the Sublease Put Renewal Option.

Thus, a LILO is not the sort of multiparty transaction encouraged by business and regulatory realities whose form must be respected under Frank Lyon. In substance, as explained below, it is a transaction in which dominion and control over the property remain with the Tax Exempt Entity at least throughout the initial Sublease term so that the U.S. Taxpayer's interest properly is characterized as a future interest.

Where parties have in form entered into two separate transactions that result in offsetting obligations, courts have often collapsed the offsetting obligations and recharacterized the two transactions as a single transaction. For example, in Rogers v. United States, 281 F.3d 1108 (10<sup>th</sup> Cir. 2002), a part owner/shareholder of a professional baseball team organized as a Subchapter S corporation borrowed money from the S corporation. This nonrecourse loan was secured by the

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<sup>18</sup> The absence of this risk is discussed in more detail below.

shareholder's ownership interest in the corporation and his existing option to purchase the rest of the shares from the other co-owner of the team. The shareholder also granted the corporation an option to purchase both his shares and his existing option to buy the other co-owner's shares. The option price was an amount equal to the outstanding loan balance. The corporation exercised its option immediately but deferred closing until the due date of the shareholder's loan, five months later.

The Rogers court applied the substance over form doctrine to collapse the loan and the option transaction into a redemption of the shareholder's stock in exchange for cash. The shareholder had no incentive to repay the loan because any reduction in the loan balance would reduce the option price. The immediate exercise of the option prevented any attempt by the shareholder to repay the loan and keep his stock. Based on the offsetting loan and option, as well as other facts, the court held that the substance of the transaction was a sale of stock to the corporation.

In Bussing v. Commissioner, 88 T.C. 449, reconsideration denied, 89 T.C. 1050 (1987), a Swiss subsidiary of a computer leasing company (AG) purchased computer equipment in a sale/leaseback transaction involving a five-year lease. Subsequently, AG purportedly sold the equipment to a domestic corporation, which in turn purportedly sold interests in the equipment to the taxpayer and four other individual investors. The taxpayer acquired his interest in the computer equipment subject to the underlying lease via a cash payment, short-term promissory notes, and a long-term promissory note to the domestic corporation. The taxpayer then leased his interest in the equipment back to AG for nine years. The rents due the taxpayer from AG equaled the taxpayer's annual payments on the long-term promissory note for the first three years and were supposed to generate nominal annual cash flow thereafter.

The court first disregarded the domestic corporation's participation in the transactions on substance over form grounds. It then held that the taxpayer's long-term indebtedness also must be disregarded because it was completely offset by AG's rent payments in a "purported sale-leaseback pursuant to which the respective lease and debt obligations flow between only two parties." Id. at 458. The court stated,

The respective obligations between AG and [the taxpayer] cancel each other out. Any possible claim by AG with respect to the note is fully offset by AG's rental obligation to [the taxpayer]. . . . [The taxpayer] effectively, will never be required to make any payments on his debt obligation, a

feature of the transaction that we believe the parties intended to achieve.

Similarly, courts have disregarded the parties' obligations in purported installment sales where the taxpayer received an installment note that was offset by some other arrangement between the two parties, indicating that the maker of the note would not be called upon to pay the installment obligation. See Rickey v. Commissioner, 502 F.2d 748 (9<sup>th</sup> Cir. 1974), aff'g, 54 T.C. 680 (1970). Although taxpayers are entitled to arrange the terms of a sale in order to qualify for the installment method, "the arrangements must have substance and must reflect the true situation rather than being merely the formal documentation of the terms of the sale." Id. at 752-53, quoting 54 T.C. at 694. See also United States v. Ingalls, 399 F.2d 143 (5<sup>th</sup> Cir. 1968); Blue Flame Gas Co. v. Commissioner, 54 T.C. 584 (1970); Greenfield v. Commissioner, T.C. Memo. 1982-617 (notes disregarded since cash loan from buyer and taxpayer's installment note were to be paid through offsetting book entries); Big "D" Development Corp. v. Commissioner, T.C. Memo. 1971-148, aff'd per curiam, 453 F.2d 1365 (5<sup>th</sup> Cir. 1972)(cross indebtedness lacking in reality where full receipt of the total consideration merely awaited the command of the seller).

An analogous situation occurs when the conveyance of property is accompanied by the retention of some interest in the same property. If the interest retained is of substantially the same nature as the interest conveyed, only a future interest is conveyed. In McCully Ashlock v. Commissioner, 18 T.C. 405 (1952), acq., 1952-2 C.B. 1, the taxpayer had acquired property through a deed dated June 6, 1945. The seller, however, had retained the right to possession and rentals through August 15, 1947. The court found that the taxpayer had acquired only a future interest in the property because "the [sellers] not only retained the rents legally but they also retained control and benefits of ownership." Id. at 411. Consequently, rentals from the property were income to the seller. Further, as in the net leases that are a feature of LILOs, in McCulley Ashlock the seller agreed to pay property taxes, insurance, and normal maintenance items and expenses. Similarly, in Kruesel v. United States, 63-2 U.S.T.C. ¶ 9714 (D. Minn. 1963), the court concluded that the taxpayer had transferred only a future, remainder interest in property and reserved a life estate. In contrast, in Alstores Realty Corp. v. Commissioner, 46 T.C. 363 (1966), acq., 1967-2 C.B. 1, the court found a present sale of property, with the seller retaining possession pursuant to a leaseback. The court distinguished McCulley Ashlock as a case where the benefits and burdens of ownership did not presently pass to the buyer.

In the case of a LILO, the Tax Exempt Entity retains a right to possession as part of the same transaction in which it purports to transfer the right to possess. Moreover,

its Sublease rent payments, which entitle it to occupancy, are funded, in the Payment Undertaking Agreement, with the cash received in the Headlease prepayment.

b. Facts Supporting the Future Interest Argument

Although the terms of specific LILO transactions will vary, the following discussion points out terms featured in many LILOs that lend support to the future interest and other arguments set forth in this paper. It is important to note, however, that any analysis of a LILO transaction should be based on the totality of the facts and circumstances of the transaction. Although a factor-by-factor analysis is appropriate, it is very important to keep in mind the overall structure and cash flows of the transaction.

A. Offsetting Obligations of Headlease and Sublease.

Taxpayers assert that the Headlease and Sublease are separate and distinct contractual undertakings which do not constitute offsetting rights and obligations.

The Headlease and Sublease are nominally separate legal documents. Both leases, however, are executed pursuant to the comprehensive Participation Agreement, which likely provides that no party is entitled to benefits or subject to liabilities, as the case may be, under any agreement until all agreements have been executed by all participants. Thus, the Headlease and Sublease are integrated into a single legal agreement.

Although a typical sale/leaseback transaction conveys ownership rights to the buyer/lessor and tenancy rights to the seller/lessee, there are several significant differences between that transaction and a typical LILO.

First, as discussed below, the U.S. Taxpayer's claim of "ownership" in the Headlease for the period of the Sublease basic term is inconsistent with the fact that the U.S. Taxpayer's equity is not at risk in the event of default by the Tax Exempt Entity.

Second, although taxpayers may claim that the Tax Exempt Entity has conveyed a long-term possessory interest to the U.S. Taxpayer and the Tax Exempt Entity has retained only a short-term possessory interest, which do not constitute offsetting obligations, a typical LILO contains a number of terms and conditions that support a conclusion that no present possessory interest was conveyed to the U.S. Taxpayer in the first instance. Transactions may vary to some degree, but factors that support no such conveyance may include:

- (i) a provision that allows the U.S. Taxpayer to absolve itself of any maintenance or perhaps insurance obligation under the Headlease simply by entering into some type of operating agreement with the Tax Exempt Entity or an affiliate of the Tax Exempt Entity;
- (ii) a provision that creates total symmetry between an event of loss for the Headlease and an event of loss for the Sublease, thus assuring the U.S. Taxpayer of a termination value sufficient to pay off the debt and return the U.S. Taxpayer's Equity Investment; and
- (iii) a provision that allows the U.S. Taxpayer to render its post-payment obligation under the Headlease as nonrecourse and essentially a nullity by pledging its rights to Sublease rents.<sup>19</sup>

Taxpayers have claimed, and no doubt will continue to claim, that a conveyance with a retained right of possession does not sham a transaction or result in a right of offset, and that the conveyance of ownership rights in a LILO are no different than in a typical sale/leaseback. The factors listed above, however, demonstrate that there are significant differences between a LILO and a typical sale/leaseback and such factors are key in challenging these claims.

**B. The Equity Collateral portion of the Headlease prepayment made by the U.S. Taxpayer to the Tax Exempt Entity and deposited in a defeasance account is not at risk.**

As noted above, in Rev. Rul. 2002-69 the Equity Collateral portion of the taxpayer's Equity Investment was the \$15 million amount invested in high grade securities and pledged by the Tax Exempt Entity to the U.S. Taxpayer. If in the case under review it is evident that this equity component will be returned to the U.S. Taxpayer through the Tax Exempt Entity's Early Buyout Option, the Sublease Termination Value payment, or the U.S. Taxpayer's Put Renewal Option, this factor is in the Government's favor. The support for this argument is illustrated by the following example.

In a typical sale/leaseback transaction, the buyer/lessor may have purchased the subject property for a \$100 price, comprised of \$80 of nonrecourse financing and \$20 of equity. A key factor which would support a taxpayer's characterization of that transaction as a true sale/leaseback, in which the purported benefits and burdens have in fact passed to the buyer/lessor, is the risk that the buyer/lessor may lose its

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<sup>19</sup> See discussion below.

equity in the case of, for example:

- (i) destruction of the property without adequate insurance; or
- (ii) decline in the property's value and a default by the seller/lessee.

Absence of such a risk provides a strong presumption that the benefits and burdens of the property have not passed to the taxpayer in the purported sale/leaseback. The same analysis applies in a LILLO transaction where the U.S. Taxpayer is not at risk for the equity component of its Headlease prepayment that is deposited in a defeasance account.

Evidence that the U.S. Taxpayer's Equity Investment is not at risk includes:

- (i) if the Equity Collateral portion of the Headlease prepayment is not among the items of collateral pledged to the Lender in support of the nonrecourse loan to the U.S. Taxpayer;<sup>20</sup>
- (ii) if the Equity Collateral portion of the Headlease prepayment, and any investment return earned on that portion, is paid by the Tax Exempt Entity to or deposited by the Tax Exempt Entity with an Equity Payment Undertaking Party<sup>21</sup> and, thus, to a very significant degree, put beyond the reach of the Tax Exempt Entity's creditors; and/or
- (iii) if the Equity Collateral portion is designated to satisfy Sublease rent, including renewal term rent, the Early Buyout Option price, or any Sublease Termination Value payable by the Tax Exempt Entity to the U.S. Taxpayer in the event of any structured unwind of the transaction or default by the Tax Exempt Entity.

C. Defeasance – Generally; and Guarantee of the Obligations Under the Payment Undertaking Agreement Relating to Taxpayer's Borrowing.

The economic defeasance of the Sublease rent and, consequently, the U.S. Taxpayer's borrowing, typically takes place through the execution of the Payment Undertaking Agreement. Pursuant to that agreement, in exchange for a deposit made or a fee paid by the Tax Exempt Entity, the Payment Undertaking Party

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<sup>20</sup> Typically determined by review of the "Granting" clause in the Loan and Security Agreement. Language may state that certain "excluded property" or "excluded rights" are not pledged by the U.S. Taxpayer. Those exclusions may cross reference the "equity" portions of Sublease rent, purchase option price, Equity Payment Undertaking Agreement, etc.

<sup>21</sup> See discussion below.



obligates itself to service the Sublease rent payable to the U.S. Taxpayer.<sup>22</sup> The U.S. Taxpayer, in turn, instructs the Payment Undertaking Party to make those payments directly to the Lender to service the U.S. Taxpayer's loan.<sup>23</sup> The Payment Undertaking Agreement may, as noted above, require a deposit or a fee and may state that the defeased amount is no longer subject to the credit risks, including the bankruptcy risk, of the Tax Exempt Entity.

Taxpayers have argued that they are subject to the credit risks, including the risk of bankruptcy, of the Payment Undertaking Party. The bankruptcy of the Payment Undertaking Party, taxpayers argue, could result in the U.S. Taxpayer defaulting on the loan and hence forfeiting everything the U.S. Taxpayer has pledged under the loan agreement. The pledge likely would have included the U.S. Taxpayer's rights under the Sublease and the Headlease.<sup>24</sup> Although a remote bankruptcy risk would not, in and of itself, give substance to a transaction, we believe that the risk of a default by the Payment Undertaking Party may be rendered even further unlikely through a guarantee, from a well capitalized corporate affiliate, of the Payment Undertaking Party.<sup>25</sup> Thus, such a guarantee of the Payment Undertaking Party's obligations would be a factor in the Government's favor.

Although disregarding the U.S. Taxpayer's borrowing is an important element of the future interest argument, in that such disregard of the loan indicates that the U.S. Taxpayer did not purchase a present leasehold, the disregard of the loan is not essential to the future interest position. Even if, arguably, the U.S. Taxpayer is treated as having borrowed funds, the funds have not been used to acquire a present leasehold. Rather, any borrowed funds should be treated as having been deposited by the U.S. Taxpayer in an account held for the benefit of the U.S. Taxpayer with the Payment Undertaking Party or as loaned to the Tax Exempt Entity. In either case, the U.S. Taxpayer would have interest income, paid by either the Payment Undertaking Party/Deposit Taker or the Tax Exempt Entity, as the case may be, and interest expense on the nonrecourse loan.<sup>26</sup>

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<sup>22</sup> In Rev. Rul. 2002-69, the Payment Undertaking Parties were BK1 affiliate and BK2 affiliate, otherwise referred to as the deposit banks.

<sup>23</sup> Often, the Sublease rent schedule matches the debt service schedule in timing and amounts. The Loan Agreement may also direct that the Payment Undertaking Party make payment directly to the Lender so long as the loan is outstanding.

<sup>24</sup> Though, as discussed above, not the Taxpayer's Equity Investment.

<sup>25</sup> Even in the unlikely event of default, the Taxpayer would receive its Equity Investment because, as discussed elsewhere in this paper, the Equity Collateral is not pledged on the nonrecourse loan.

<sup>26</sup> Section 3. below of this paper discusses the potential recharacterization of the transaction as a Financing Arrangement. That section discusses factors which may indicate that the U.S. Taxpayer has made a loan to the Tax Exempt Entity, of an amount which may or may not include the proceeds from the U.S. Taxpayer's nonrecourse borrowing.

#### D. Single Entity and Special Purpose Corporation Transactions.

A single entity Lender/Payment Undertaking Party (the “single entity”) is certainly a factor in the Government’s favor.<sup>27</sup> As distilled to its core, this structure essentially claims:

- (i) Single entity, in its capacity as Lender, transfers an amount as a loan to the U.S. Taxpayer, which then uses the amount as part of the Headlease prepayment to the Tax Exempt Entity;
- (ii) Tax Exempt Entity transfers that amount to the single entity in the latter’s capacity as Payment Undertaking Party;
- (iii) Single entity obligates itself, again in its capacity as Payment Undertaking Party, to use the amount to make Sublease rent payments to the U.S. Taxpayer; and
- (iv) The U.S. Taxpayer instructs single entity, once again in its capacity as Payment Undertaking Party, to apply those Sublease payments to satisfy U.S. Taxpayer’s obligation to single entity in the latter’s capacity as lender.<sup>28</sup>

The circularity of the funds flow and the offsetting nature of rights and obligations of the single entity are grounds for challenging the substance of this transaction. We consider transactions involving a special purpose corporation, often set up as a direct subsidiary of the Lender, to be not substantially different from the single entity structure. In the special purpose corporation structure, the special purpose subsidiary or affiliate of the Lender may act as Payment Undertaking Party. Often, the amount paid by the Tax Exempt Entity to the special purpose corporation for acting as Payment Undertaking Party, and the special purpose corporation’s obligation to pay Sublease rent, are the only asset and liability, respectively, of the special purpose corporation.

Thus, either the single entity structure or the special purpose corporation structure should be viewed as favoring the Government, particularly where the obligations of the Payment Undertaking Party are guaranteed.<sup>29</sup>

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<sup>27</sup> Chief Counsel has indicated that the Chief Counsel is willing to designate for litigation all cases having a single entity structure. Compliance plans to request litigation of such cases. This does not rule out designating other fact situation cases for litigation, especially those involving the special purpose corporation structure discussed below.

<sup>28</sup> The Loan and Security Agreement may also direct that the Payment Undertaking Party make payment directly to the Lender so long as the loan is outstanding.

<sup>29</sup> Any affiliation of the Lender and Payment Undertaker is a positive factor for the government as compared to an instance where

E. Form of Defeasance with Respect to Borrowed Amount: Deposit Structure as Compared to Fee Structure.

The distinction between a deposit structure and a fee structure for the Payment Undertaking Agreement may generally be summarized as follows. If in the form of a deposit, the document would reflect an account held by the Payment Undertaking Party in the name of the Tax Exempt Entity, and the subject amount would presumably remain an asset of the Tax Exempt Entity. Such asset would, however, be pledged to satisfy the Tax Exempt Entity's obligation under the Sublease. If in the form of a fee, the document would reflect a fee payment by the Tax Exempt Entity to the Payment Undertaking Party in order for the latter to obligate itself to service the Sublease rent.

Defeasance of the Sublease rent and, consequently, the U.S. Taxpayer's borrowing, is itself a favorable factor for the Government. Defeasance of the Sublease rent renders the risk of default on the U.S. Taxpayer's loan more remote.<sup>30</sup> As discussed above the defeasance may take the form of a fee structure or a deposit structure in the context of the Payment Undertaking Agreement. The terms of the defeasance feature may provide a further factor in the Government's favor.

If the defeasance, which as discussed is typically embodied in a Payment Undertaking Agreement, provides for a "fee" paid by the Tax Exempt Entity to the Payment Undertaking Party rather than a "deposit" by the Tax Exempt Entity with the Payment Undertaking Party, the Government's position is enhanced. This is because, in the event of bankruptcy of the Tax Exempt Entity, a deposit with a depository bank, even if pledged to the U.S. Taxpayer, might arguably be subject to claims of the Tax Exempt Entity's creditors; whereas a fee payment, if respected under local law, would no longer be the property of the Tax Exempt Entity and thus would not be subject to such claims.

F. Form of Defeasance with Respect to Equity Collateral Portion: Deposit Structure as Compared to Fee Structure.

The absence of risk with respect to the U.S. Taxpayer's Equity Investment supports the Government's position that there was no effective transfer of rights pursuant to the Headlease. The return of that equity plus its investment yield is typically accomplished through defeasance in an Equity Payment Undertaking Agreement.

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there is no affiliation between the Lender and Payment Undertaker. It is likely that an instance of no affiliation between the Lender and Payment Undertaker can also be overcome if there is an agreement between the Lender and Payment Undertaker which effectuates the same action as that of the single entity transaction.

<sup>30</sup> See paragraph C above.

The U.S. Taxpayer's Equity Collateral portion of the Headlease prepayment will be used by the Tax Exempt Entity to fund its future obligation for Sublease renewal rent, the Early Buyout Option price, or the Sublease Termination Value.

Defeasance of these obligations of the Tax Exempt Entity is itself a favorable factor for the Government as it secures the return of the U.S. Taxpayer's equity. The terms of the defeasance feature may provide a further factor in the Government's favor.

As with respect to the discussion of the debt defeasance above, if the Equity Payment Undertaking Agreement provides for a "fee" paid by the Tax Exempt Entity to the Equity Payment Undertaking Party rather than a "deposit" by the Tax Exempt Entity with the Equity Payment Undertaking Party, the Government's position is enhanced. This is because, in the event of bankruptcy of the Tax Exempt Entity, a deposit with a depository bank, even if pledged to the U.S. Taxpayer, might arguably be subject to claims of the Tax Exempt Entity's creditors, whereas a fee payment, if respected under local law, would no longer be the property of the Tax Exempt Entity and thus would not be subject to such claims.

G. Percentage of Economic Defeasance of the Amount Borrowed by the U.S. Taxpayer.

In Rev. Rul. 2002-69, the amount of the U.S. Taxpayer's borrowing that was defeased equaled 90 percent of the borrowing. The higher the percentage, the stronger the Government's position that there was, in substance, no bona fide borrowing. A 100 percent defeasance presents the best case for the Government with respect to this factor.

H. The U.S. Taxpayer's obligation to pay the Headlease post-payment amount is either nullified or made nonrecourse by a pledge of Sublease rents.

In all LILO transactions, the U.S. Taxpayer's obligation to make the post-payment is canceled if the Tax Exempt Entity exercises its Early Buyout Option. In some LILO transactions, if the Tax Exempt Entity extends the term of the Sublease, or a Replacement Sublease with a new party is entered into by the U.S. Taxpayer, the U.S. Taxpayer has a right to be treated as having satisfied its post-payment obligation under the Headlease if it pledges certain deferred rents under the Sublease to the Tax Exempt Entity as "Post-Payment Collateral" or "Acceptable Lease Collateral". For example, if the Tax Exempt Entity renews the Sublease or if a Replacement Sublease is entered into, the Sublease Renewal or Replacement Sublease may provide that no cash payments of rent are due for the first several years of the Sublease renewal or replacement term. In that case, for the first several years, the Sublease rent would accrue, plus an interest component, but would not be

paid to the U.S. Taxpayer. In exchange for pledging the U.S. Taxpayer's right to receive those deferred rents, the Headlease may allow the U.S. Taxpayer to satisfy its post-payment obligation. This factor favors the Government. If it is apparent that the U.S. Taxpayer's purported obligation to make the post-payment under the Headlease, which can be very significant in amount, may be completely satisfied through a pledge of Sublease rights, it provides strong support for the offsetting nature of the Headlease and Sublease.<sup>31</sup>

I. Right of the Tax Exempt Entity to Share in any Debt Service Savings Resulting from Refinancings.

In some LILLO deals, if the U.S. Taxpayer refinances the debt, the Tax Exempt Entity has a right to participate in those savings attributable to the reduced financing costs by renegotiating other terms of the transaction, including the Sublease rents and the buyout option price. The Tax Exempt Entity may even have a right, at its own expense, typically set forth in a "refinancing" article in the comprehensive Participation Agreement, to require such a refinancing by the U.S. Taxpayer. In that case, there likely would be a clause in the Sublease that allows the Tax Exempt Entity to reduce the rent or Early Buyout Option price as a result of the U.S.

Taxpayer's reduced debt service payments.<sup>32</sup> This factor favors the Government because it indicates the lack of an effective transfer of rights from the Tax Exempt Entity to the U.S. Taxpayer under the Headlease. Consider that, in order to acquire the rights under the Headlease, the U.S. Taxpayer purportedly has invested capital, in the form of debt and equity. Such a refinancing provision effectively allows the Tax Exempt Entity to share in the U.S. Taxpayer's diminution of the cost of capital.

J. The nature or history of the property makes it highly unlikely that the Tax Exempt Entity will not exercise its Early Buyout Option at the end of the Sublease term.

In some instances, the nature of the property itself makes it less likely that the Tax Exempt Entity will fail to exercise the Early Buyout Option. In other instances, the history of the property rather than its nature make it highly likely that the Tax Exempt Entity will exercise its Early Buyout Option. Either of these factors would favor the Government.

K. Synchronization of the Various Principal Amounts and Cash Flows.

Many sale/leaseback transactions are structured so that the seller/lessee's rent payment equals the buyer/lessor's debt service. Such would likely be the case in a

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<sup>31</sup> This factor typically would be evidenced in a "Lease Collateral" section of the Headlease.

<sup>32</sup> As noted above, the Sublease rent schedule typically matches the debt service schedule.

LILO transaction and, in isolation, would not generally constitute a significant factor in the Government's favor. Other factors that may, however, weigh in favor of the Government when combined with this synchronization include:

- (i) where the amount defeased by the Tax Exempt Entity equals the U.S. Taxpayer's borrowing,<sup>33</sup>
- (ii) where the Equity Collateral portion of the Headlease prepayment is invested in a manner such that maturity of the investment provides the amounts on specified payment dates which match the amounts and payment dates on the Early Buyout Option, or
- (iii) where any deferred rent under the Sublease, plus the stated interest thereon, corresponds to the amount of collateral required to be pledged by the U.S. Taxpayer in order to render its post-payment obligation under the Headlease nonrecourse.

c. Purchase of Future Interest with U.S. Taxpayer's Promise to make a Future Payment

This section 1. of the paper has assumed that, if the U.S. Taxpayer should be treated as having purchased only a future interest, the U.S. Taxpayer has paid for that future interest on the Closing Date with the Equity Investment. Upon development, the facts may indicate that the U.S. Taxpayer has purchased a future interest, but has done so not with a cash payment on the Closing Date, but rather with a promise to make a future payment which would be due upon expiration of the Sublease Basic Term.

If upon development the facts support this recharacterization of the transaction, the U.S. Taxpayer would likely be treated as the owner for U.S. Tax purposes, of the Equity Collateral. The treatment of the U.S. Taxpayer as the owner of the Equity Collateral is at section 3.b. below of this paper, concerning the potential characterization of the transaction as a Financing Arrangement.

d. Summary of Future Interest Argument

Because the transfer and retransfer of the right to possess the property for the Basic Terms of the Headlease and Sublease are disregarded as negating each other, the transaction that remains is, at best, a transfer of funds from the U.S. Taxpayer to the Tax Exempt Entity in exchange for the latter's obligation to repay those funds and

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<sup>33</sup> I.e., 100 percent defeasance. See above.

provide the Equity Investor the right to begin to lease the property at the end of the Sublease Basic Term if the Tax Exempt Entity does not exercise the Early Buyout Option. Accordingly, U.S. Taxpayer's payments under the Headlease are not rent payments and the claimed rental expense deductions are not allowed under §162. In that case, the U.S. Taxpayer would not have rental income under the Sublease, as the U.S. Taxpayer would not have entered into a Headlease and Sublease as of the Closing Date. The amortization of the transaction costs are not currently deductible under §162. The Equity Investment and the transaction costs incurred by the Equity Investor will be basis in the renewal lease term or in the computation of the gain or loss if the Early Buyout Option is exercised.

As discussed elsewhere in this section on the Future Interest argument and other sections of this paper, the facts will likely, when developed, indicate that the nonrecourse loan should be disregarded.

In other cases, however, the facts may indicate that, although the U.S. Taxpayer has not entered into a Headlease and Sublease as of the Closing Date, and has purchased only a future interest, the nonrecourse loan may possibly be respected. In that case, the U.S. Taxpayer should be treated as having deposited the nonrecourse loan proceeds either with the Payment Undertaking Party/Deposit Taker or with the Tax Exempt Entity. In either case, the U.S. Taxpayer would have interest expense paid to the Lender and interest income of equal amounts<sup>34</sup>.

## 2. Internal Revenue Code § 163

### a. Legal Analysis

The nonrecourse loan<sup>35</sup> made by Lender may be disregarded because, while allegedly financing the Headlease advance rent payment, it lacks substance. In Bridges v. Commissioner, 39 T.C. 1064, aff'd, 325 F.2d 180 (4<sup>th</sup> Cir. 1963), the taxpayer "borrowed" funds from banks, used the funds to purchase Treasury notes (which the banks held as collateral), and ultimately sold these same notes to satisfy his debts. The Tax Court's rationale for disallowing the taxpayer's deductions of prepaid interest applies equally to LILOs:

[Taxpayer] at no time had the uncontrolled use of any additional money, of the bonds,

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<sup>34</sup> If the nonrecourse loan is respected, a deposit by the U.S. Taxpayer with the Payment Undertaking Party/Deposit Taker would generate interest income to the U.S. Taxpayer from that party. A deposit by the U.S. Taxpayer with the Tax Exempt Entity would generate interest income to the U.S. Taxpayer from that entity.

<sup>35</sup> Note that in many LILOs and Rev. Rul. 2002-69, two foreign lenders made nonrecourse loans to the U.S. Taxpayer. Although this document is based on a single nonrecourse loan for the sake of simplicity and because some LILOs use only one foreign lender, the reasoning and authorities cited apply equally to LILOs with multiple foreign lenders.

or of the interest on the bonds. He assumed no risk of a rise or fall in the market price of the bonds and could not take advantage of such. His payment to the bank was not for the use or forbearance of money; it was for the purchase of a rigged sales price for the bonds and for a tax deduction. [Taxpayer] incurred no genuine indebtedness, within the meaning of the statute, and as a payment of interest, this transaction was also a sham.

Id., at 1078-79.

The Tax Court further stated that § 163 presupposes that the alleged debt not be a sham or incurred in a sham transaction. Rather, “interest”, as used in the statute, has a commercial connotation; that is, regardless of any tax consequences resulting therefrom, amounts paid as interest must have commercial reality, there must be some valid commercial reason for paying interest, and the borrower must in fact receive something in the transaction itself which would warrant payment of interest. Accordingly, to be deductible, the amounts paid must constitute interest and represent compensation for the use or forbearance of money. Where the taxpayer cannot benefit economically from the transaction except through tax deductions, the amount paid is not for the use or forbearance of money. Knetsch v. United States, 364 U.S. 361, 366 (1960). The Bridges court also noted, “We doubt that the bank at any time actually had any of its money out on loan or that its portfolio of Treasury notes actually changed. The transaction merely provided the ‘facade’ of a loan.” Id. at 1077.

Nor may interest expense be deducted when it is incurred in transactions “that can not with reason be said to have purpose, substance, or utility apart from their anticipated tax consequences.” Sheldon v. Commissioner, 94 T.C. 738, 760 (1990) (quoting Goldstein v. Commissioner, 364 F.2d 734, 740 (2d Cir. 1966)). Thus, transactions merit respect and give rise to deductible interest only if there is some tax-independent purpose for the transactions. Further, the Service may disallow an interest deduction on the grounds that “transactions which do not vary control or change the flow of economic benefits are to be dismissed from consideration” if they “do not appreciably change the taxpayer’s financial position.” ACM Partnership v. Commissioner, 157 F.3d 231, 248 (3d Cir. 1998) (quoting Weller v. Commissioner, 270 F.2d 294, 297 (3d Cir. 1959)).

A seminal case interpreting § 163 is Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), aff’g, 44 T.C. 284 (1965). For the appellate court, the underlying



purpose of § 163(a) was difficult to articulate given the extreme broadness of this provision (deduction permitted for “all interest paid or accrued within the taxable year on indebtedness.”). However, the court found the statute not entirely unlimited in its application; rather, reflecting Congressional policy of encouraging only purposive activity, § 163 did not permit a deduction for interest paid or accrued in loan arrangements without purpose, substance, or utility apart from their anticipated tax consequences. Moreover, the Service need not always first label a purported loan transaction a “sham” in order to deny a deduction for interest paid in connection with the loan. See also Lee v. Commissioner, 155 F.3d 584 (2d Cir. 1998), aff’g and remanding, T.C. Memo. 1997-172, (rejecting the broader idea expressed in Rice’s Toyota World, Inc. v. Commissioner, 752 F.2d 89 (4<sup>th</sup> Cir. 1985), that whether a debt contracted in return for an expected tax benefit will support an interest deduction depends simply on whether the debt itself is genuine).

Additionally, the mere fact that a promissory note is given does not prove the existence of a loan if there was no indebtedness existing which the note evidences. Rather, the simple expedient of drawing up papers has never been recognized as controlling for tax purposes when the objective economic realities are to the contrary. Frank Lyon, 435 U.S. at 573 (quoting Commissioner v. Tower, 327 U.S. 280, 291 (1946)). In addition, even if all papers signed purport to show legitimate debt, in sham transactions such papers often are executed solely for the purpose of obtaining tax deductions. Meyer v. Commissioner, T.C. Memo. 1986-328 (no indebtedness existed in transaction with circular funding).

Moreover, in Greenfield v. Commissioner, T.C. Memo. 1982-617, the court found it significant that the parties structured the transaction so that the loan was “repaid” by mere bookkeeping entries. Further, the interest rate and monthly payment on the notes were identical. Thus, “The fact that no repayment would ultimately be necessary, due to the contemporaneous obligations incurred . . . severely undercuts [taxpayers’] characterization of the cash receipt as a loan.” See also Blue Flame Gas Co. v. Commissioner, 54 T.C. 584 (1970) (alleged loan not respected where payments took the form of bookkeeping entries, the loan was in the exact amount of the rent due under the leases, and repayment dates of the loan and rent payments were intentionally designed to coincide).

If the nonrecourse loan lacks substance, the Equity Investor is not entitled to interest deductions. Under the Future Interest argument, Equity Investor acquires, for its equity investment, only a future interest in the property. The loan has not enabled the Equity Investor to obtain either cash or the proceeds of cash. Thus, there is no use or forbearance of money.

b. Facts Supporting Disallowance of Interest Expense under § 163

Claimed interest expenses resulting from the nonrecourse loan between the U.S. Taxpayer and Lender in LILO transactions will not be recognized under § 163 because:

(1) The nonrecourse loan lacks substance because there is no meaningful credit risk to any party:

(a) Lender is not at risk as it retains total control over the nonrecourse loan funds due to the Payment Undertaking Agreement and the Loan and Security Agreement. In addition, the Tax Exempt Entity agrees not to terminate the Headlease until Lender is paid in full, the Sublease provides for direct payment of the Tax Exempt Entity's rent to Lender, and Lender may take action against the Payment Undertaking Party /the Deposit Taker<sup>36</sup>;

(b) the U.S. Taxpayer is not at risk due to the defeasance structure, it holds a first priority perfected interest in the Equity Collateral, and the Tax Exempt Entity must provide a satisfactory guarantee or letter of credit to the U.S. Taxpayer should its credit rating dip, the country in which it is located ceases to own a majority interest in the Tax Exempt Entity, or it does not exercise the Early Buyout Option. Further, the Tax Exempt Entity's obligation to pay rent is absolute, and it may not sublease the property or assign any of its rights without the Equity Investor's approval; and

(c) the Tax Exempt Entity is protected through receipt of all the funds needed to make its rent payments at the beginning of the transaction.

(2) Neither the U.S. Taxpayer nor the Tax Exempt Entity obtains use of the funds. Upon receipt of funds from the Equity Investor, the Tax Exempt Entity immediately deposits the full amount of the nonrecourse loan with Lender's affiliate via the Payment Undertaking Agreement. The Deposit is then used only to make the Tax Exempt Entity's rent payments to the U.S. Taxpayer, which in turn immediately forwards the full amount of the rent received to Lender. In fact, the nonrecourse loan might be satisfied through direct payments from the Payment Undertaking Party/Deposit Taker to Lender or, in other cases, such as those involving a single entity acting in both capacities, by means of bookkeeping entries. In addition, the various security arrangements noted

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<sup>36</sup> Where a single entity serves as both Lender and Payment Undertaking Party/Deposit Taker, the obligation to the lender is presumably satisfied through bookkeeping entries, and there is no need for any "action" to enforce the obligation to make payment. See discussion of single entity transactions as a factor supporting the future interest argument (paragraph "D" above).

above ensure that Lender never loses control of the nonrecourse loan funds. See Bridges v. Commissioner, *supra*.

- (3) As discussed above, the U.S. Taxpayer's right to use the property under the Headlease during the Sublease Basic Term is offset by the U.S. Taxpayer's obligation to make the property available to the Tax Exempt Entity for its use during the Basic Term of the Sublease.<sup>37</sup> The offset of the U.S. Taxpayer's rights under the Headlease with its obligation under the Sublease is discussed in Rev. Rul. 2002-69. For those reasons, the nonrecourse loan should be disregarded as the purported leasehold it financed is not valid.
- (4) The nonrecourse loan is to be paid with the rent due the U.S. Taxpayer under the Sublease, which lacks substance. Under the Headlease and Sublease, the amount of rent to be paid by the Tax Exempt Entity exactly equals the amount of the U.S. Taxpayer's loan payment to Lender. The Deposit and Payment Undertaking Agreement with Lender's affiliate thus ensure that the Equity Investor need not expend any of its own funds to make the interest payment. In addition, the amount of interest charged by Lender on the nonrecourse loan exactly equals the amount of interest paid by its affiliate on the Deposit. The Tax Exempt Entity's economic position does not change under the Sublease, other than to benefit from the Accommodation Fee paid to it by the U.S. Taxpayer to induce the Tax Exempt Entity to enter into the LILO.

Finally, as noted above, the Future Interest argument, i.e., that the U.S. Taxpayer acquires no present leasehold by virtue of the LILO transaction, does not depend on a showing that no borrowing occurred in a given LILO transaction.

### **3. Substance Over Form/Financing Arrangement: Alternative Argument**

Under Rev. Rul. 2002-69, the Service will, in the appropriate factual circumstances, disallow tax benefits claimed from entering into LILO transactions on the alternative ground that the substance over form doctrine requires that all or some portion of the transaction be recharacterized as a financing arrangement.

#### **a. Substance Over Form Authority**

The Future Interest (section 1.) and Code §163 (section 2.) discussions above provide an analysis of various substance over form authorities. Those authorities may be considered in the development of the following alternative arguments.

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<sup>37</sup> Paragraph A. above in the Future Interest discussion provides factors which support that offset.

b. Discussion

The Future Interest argument provides factors which may determine that the U.S. Taxpayer has, with its Equity Investment,<sup>38</sup> purchased a right to a future leasehold interest. Upon development of the facts, the alternative argument may be that the U.S. Taxpayer should be treated as not having purchased a future interest, but rather as having acted as a lender in a financing transaction. Under this argument and characterization of the LILO transaction, the “proceeds” of the loan would in most cases equal (i) only the U.S. Taxpayer’s Equity Investment<sup>39</sup> or, alternatively, (ii) the U.S. Taxpayer’s Equity Investment plus the nonrecourse loan amount.

A. Financing Characterization: Treatment of Equity Investment as a Loan

Before discussing the analysis of this alternative characterization of the transaction, it would be useful to review certain factors discussed above. As noted, the amount of the U.S. Taxpayer’s Equity Investment which constitutes the Equity Collateral<sup>40</sup> is either (i) invested by the Tax Exempt Entity in high grade securities, or (ii) transferred by the Tax Exempt Entity to the Equity Payment Undertaking Party for investment by that party pursuant to the Equity Payment Undertaking Agreement. In either case, the funds defease the Early Buyout Option or the Sublease Renewal Term Rent.

Upon development, the facts and circumstances may indicate that the U.S. Taxpayer has loaned an amount equal to the amount of the Equity Investment to the Tax Exempt Entity, which then itself purchased the high grade securities or transferred the amount to the Equity Payment Undertaking Party.

Thus, the U.S. Taxpayer would be treated as having interest income received from the Tax Exempt Entity, which entity would be treated as a borrower. In certain cases, that the transaction is a financing will be evidenced further by the likelihood that the Tax Exempt Entity will exercise the Early Buyout Option so that the Equity Investor never obtains the property and instead simply obtains a fixed return on its investment.

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<sup>38</sup> In Rev. Rul. 2002-69, the equity investment was \$29 million.

<sup>39</sup> It is possible that, upon development, the amount of the loan by the U.S. Taxpayer to the Tax Exempt Entity would include only the Equity Collateral (\$15 million in Rev. Rul. 2002-69), rather than the full amount of the U.S. Taxpayer’s Equity Investment (\$29 million in that ruling).

<sup>40</sup> In Rev. Rul. 2002-69, this amount was \$15 million.

Accordingly, the U.S. Taxpayer has, in reality, made a loan to the Tax Exempt Entity, which will be repaid after expiration of the Sublease Basic Term, through exercise of the Early Buyout Option Price, the Put Renewal Option rent, or the Sublease Termination Value payment. Therefore, the rent expense deductions may be disallowed under § 162 because the LILLO is merely an investment or a loan of an amount equal to the U.S. Taxpayer's Equity Investment. The transaction costs are to be amortized over the life of the "loan" under this alternative financing.

At the same time, upon development the facts and circumstances may indicate that the nonrecourse loan from the Lender to the U. S. Taxpayer should be disregarded. See, however, the discussion at paragraph 3.b.C. below.

B. Retention of Ownership Characterization: Treatment of Equity Collateral as a Loan

Alternatively upon development, the facts and circumstances may indicate that the U.S. Taxpayer should be treated as holding the benefits and burdens of ownership in either the high grade securities or the funds in the Equity Payment Undertaking Agreement, as the case may be. In that case, the U.S. Taxpayer should be treated as deriving interest income on the Equity Collateral portfolio. Section 1.c. above of this paper considers the characterization that the U.S. Taxpayer may have purchased a future interest not with a cash payment on the Closing Date, but rather with a promise to make a future payment at the expiration of the Sublease Basic Term. This characterization of the transaction would likely include treating the U. S. Taxpayer as the owner of the Equity Collateral portfolio, as provided in this paragraph B.

C. Financing Characterization: Treatment of Nonrecourse Loan Proceeds Plus Equity Investment as a Loan

As discussed in section 2.b. of this paper, development of the facts will likely support that the nonrecourse loan from the Lender to U.S. Taxpayer should be disregarded. In other cases, development of the facts may indicate that it is possible to respect the nonrecourse loan.<sup>41</sup> In that case, the proper characterization of the transaction may still be a financing transaction pursuant to which the U.S. Taxpayer acts as lender. The U.S. Taxpayer

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<sup>41</sup> In Rev. Rul. 2002-69, the two nonrecourse loans equaled \$54 million and \$6 million. See discussion at section 1.c. above that the disregard of the nonrecourse loan is helpful, but by no means essential, to the development of the Future Interest argument.

should be treated as having borrowed the amount of the nonrecourse loan from the Lender and then loaned the amount to the Payment Undertaking Party or the Tax Exempt Entity. In either case, the U.S. Taxpayer would derive interest income equal to its interest expense on the nonrecourse loan.

In addition, the U.S. Taxpayer would still be treated as having engaged in a financing transaction, with a loan of the Equity Investment, under the same analysis as set forth in paragraph 3.b.A. above.

c. Interest Income/Original Issue Discount Income.

Under the alternative Financing Arrangement argument the U.S. Taxpayer may be required to report original issue discount income. See Internal Revenue Code §§ 1271-1275. This argument would be based on the determination that the U.S. Taxpayer has made a loan to the Tax Exempt Entity or the Payment Undertaking Party in the amount of the Equity Investment and that this amount, plus accrued but unpaid interest, is returned to the U.S. Taxpayer when the Early Buyout Option is exercised or Put Renewal sublease rent is paid. Agents should raise this issue only after contacting the Leasing Technical Advisors to determine whether an OID argument is appropriate and the amount of any possible adjustment to tax.

**4. Internal Revenue Code § 467**

The attached Appendix provides a background discussion of section 467 and its regulations. Agents should contact the Leasing Technical Advisors for assistance in raising section 467 issues.

**5. Internal Revenue Code § 6662**

Whether penalties apply to underpayments attributable to the disallowance of losses and deductions claimed from participating in a LILO transaction must be determined on a case-by-case basis, depending on the specific facts and circumstances of each case. The application of a penalty must be based upon a comparison of the facts developed with the legal standard for the application of the penalty.

**a. The Accuracy-Related Penalty**

I.R.C. § 6662 imposes an accuracy-related penalty in an amount equal to 20 percent of the portion of an underpayment attributable to, among other things: (1) negligence or disregard of rules or regulations or (2) any substantial understatement of income tax. See Treas. Reg. §§ 1.6662-1 through 1.6662-4. Treas. Reg. § 1.6662-2(c) provides that there is no stacking of the accuracy-related penalty components. Thus, the maximum

accuracy-related penalty imposed on any portion of an underpayment is 20 percent, even if that portion of the underpayment is attributable to more than one type of misconduct (e.g., negligence and substantial understatement); See DHL Corporation v. Commissioner, T.C. Memo. 1998-461.

#### **b. Negligence or Disregard of Rules or Regulations**

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 a tax return. See I.R.C. § 6662(c) and Treas. Reg. § 1.6662-3(b)(1). Negligence also includes the failure to do what a reasonable and ordinarily prudent person would do under the same circumstances. See Marcello v. Commissioner, 380 F.2d 499, 506 (5th Cir. 1967); Neely v. Commissioner, 85 T.C. 934, 947 (1985). A return position that has a reasonable basis is not attributable to negligence. A reasonable basis is a relatively high standard of tax reporting, one significantly higher than not frivolous or not patently improper. Thus, the reasonable basis standard is not satisfied by a return position that is merely arguable or colorable. Conversely, under Treas. Reg. § 1.6662-3(b)(3), a return position generally is considered reasonable where based on one or more of the authorities listed in Treas. Reg. § 1.6662-4(d)(3)(iii), taking into account the relevance and persuasiveness of the authorities and subsequent developments, even if the position does not satisfy the substantial authority standard defined in Treas. Reg. § 1.6662-4(d)(2). Moreover, the reasonable cause and good faith exception in Treas. Reg. § 1.6664-4 may relieve the taxpayer from liability from the negligence penalty, even if the return position does not satisfy the reasonable basis standard. See Treas. Reg. § 1.6662-3(b)(3). Treas. Reg. § 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 and prudent person to be ‘too good to be true’ under the circumstances.” If the facts establish that a taxpayer reported losses from a transaction in which it merely purchased a future interest, then the accuracy-related penalty attributable to negligence may be applicable if the taxpayer failed to make a reasonable attempt to ascertain the correctness of the claimed deductions.

The phrase “disregard of rules and regulations” includes any careless, reckless, or intentional disregard of rules and regulations. A disregard of rules or regulations is “careless” if the taxpayer does not exercise reasonable diligence in determining the correctness of a position taken on its return that is contrary to the rule or regulation. A disregard is “reckless” if the taxpayer makes little or no effort to determine whether a rule or regulation exists, under circumstances demonstrating a substantial deviation from the standard of conduct observed by a reasonable person. Additionally, disregard of the rules and regulations is “intentional” where the taxpayer knows of the rule or regulation that it disregards. Treas. Reg. § 1.6662-3(b)(2).

The term "rules and regulations" includes the provisions of the Internal Revenue Code, Treasury regulations, and revenue rulings or notices issued by the Internal Revenue Service and published in the Internal Revenue Bulletin. Treas. Reg. § 1.6662-3(b)(2). Therefore, if the facts indicate that a taxpayer took a return position contrary to any published notice or revenue ruling, the taxpayer may be subject to the accuracy-related penalty for an underpayment attributable to disregard of rules and regulations, if the return position was taken subsequent to the issuance of such notice or revenue ruling. However, a taxpayer who takes a position contrary to a revenue ruling or a notice has not disregarded the ruling or notice if the contrary position has a realistic possibility of being sustained on its merits. Treas. Reg. § 1.6662-3(b)(2).

### **c. Substantial Understatement of Income Tax**

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 (\$10,000 in the case of corporations other than S corporations or personal holding companies). I.R.C. § 6662(d)(1). If a corporate taxpayer has a substantial understatement that is attributable to a tax shelter item, the accuracy-related penalty applies to the understatement unless the reasonable cause and good faith exception applies. If the facts establish that an understatement attributable to the disallowance of deductions exceeds the greater of 10 percent of the tax required to be shown on the return or \$5,000 (\$10,000 in the case of corporations other than S corporations or personal holding companies), a substantial understatement penalty may be applicable.

### **d. The Reasonable Cause Exception**

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. I.R.C. § 6664(c)(1). The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances. Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability. Treas. Reg. § 1.6664-4(b)(1).

Taxpayers may argue they are not liable for the accuracy-related penalty because they relied on the advice of professional tax advisors. However, reliance on the advice of a professional tax advisor does not necessarily demonstrate reasonable cause and good faith. Reliance on professional advice constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith. Treas. Reg. § 1.6664-4(b)(1); see also *United States v. Boyle*, 469 U.S. 241 (1985). In no event will a taxpayer be considered to have reasonably relied in good faith on advice unless all the requirements of Treas. Reg. § 1.6664-4(c)(i) are satisfied. In addition, the



fact that the taxpayer satisfies the regulation will not necessarily establish that the taxpayer reasonably relied on the advice of a professional tax advisor or other advisor in good faith. For example, if the taxpayer knew, or should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law, reliance may not be reasonable or in good faith. Treas. Reg. § 1.6664-4(c)(1).

For a taxpayer's reliance on advice to be sufficiently reasonable so as possibly to negate liability for the accuracy-related penalty, the Tax Court has stated that a taxpayer has to satisfy the following three-prong test: (1) the advisor was a competent professional who had sufficient expertise to justify reliance, (2) the taxpayer gave to the advisor the necessary and accurate information, and (3) the taxpayer actually relied in good faith on the advisor's judgment. Neonatology Associates P.A. v. Commissioner, 115 T.C. 43 (2000), aff'd, 299 F.3d 221 (3d Cir. 2002).

Moreover, the advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances. For example, the advice must take into account the taxpayer's purpose (and the relative weight of such purposes) for entering into a transaction and for structuring a transaction in a particular manner. Treas. Reg. § 1.6664-4(c)(1)(i). The advice must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person. Treas. Reg. § 1.6664-4(c)(1)(ii). Further, where a tax benefit depends on nontax factors, the taxpayer also has a duty to investigate such underlying factors. The taxpayer cannot simply rely on statements by another person, such as a promoter. See Novinger v. Commissioner, T.C. Memo. 1991-289. Moreover, if the tax advisor is not versed in these nontax factors, mere reliance on the tax advisor does not suffice. See Addington v. United States, 205 F.3d 54 (2d Cir. 2000); Freytag v. Commissioner, 89 T.C. 849 (1987), aff'd, 904 F.2d 1011 (5th Cir. 1990), aff'd on other issues, 501 U.S. 868 (1991); Collins v. Commissioner, 857 F.2d 1383 (9th Cir. 1988).

The determination of whether a corporation acted with reasonable cause and good faith is based on all pertinent facts and circumstances. Treas. Reg. § 1.6664-4(e)(1). A corporation's legal justification may be taken into account, as appropriate, in establishing that the corporation acted with reasonable cause and in good faith in its treatment of a tax shelter item, but only if there is substantial authority within the meaning of Treas. Reg. § 1.6662-4(d) for the treatment of the item and the corporation reasonably believed, when the return was filed, that such treatment was more likely than not the proper treatment. Treas. Reg. § 1.6664-4(e)(2)(i). Under section 1.6664-4(e)(2)(i), a failure to satisfy these minimum requirements will preclude a finding of reasonable cause and good faith based (in whole or in part) on a corporation's legal justification.

The regulations provide that in meeting the requirement of reasonably believing that the treatment of the tax shelter item was more likely than not the proper treatment, the corporation may reasonably rely in good faith on the opinion of a professional tax advisor if the opinion is based on the tax advisor's analysis of the pertinent facts and authorities in the manner described in Treas. Reg. § 1.6662-4(d)(3)(ii). The latter regulation provides that the weight accorded an authority depends on its relevance, persuasiveness, and the type of document providing the authority. That is, a case or revenue ruling or other authority having only some facts in common with the tax treatment at issue is not particularly relevant if the authority may be materially distinguished on its facts or is otherwise inapplicable to the tax treatment in issue. For example, an authority that merely states a conclusion ordinarily is less persuasive than one that reaches its conclusion by cogently applying the pertinent law to the facts.

In addition to the above, Treas. Reg. § 1.6664-4(e)(2)(i)(B)(2) requires that the opinion unambiguously state that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Service. Therefore, wherever possible, the tax advisor's opinion should be obtained to determine whether these requirements are met. Taxpayers not providing the advice on which they relied cannot meet the requirements of Treas. Reg. § 1.6664-4(e)(2)(i)(B)(2).

## **Appendix – Section 467: Background and Possible Issues**

If the arrangements involved in a LILO transaction qualify as true leases for federal income tax purposes, the proper application of § 467 to such leases must be considered.

### Internal Revenue Code § 467, Certain Payments for the Use of Property or Services

Section 467, which applies to § 467 rental agreements, was added to the Internal Revenue Code by section 92(a) of the Tax Reform Act of 1984 (P.L. 98-369). Section 467(d)(1) defines a “section 467 rental agreement” as any rental agreement for the use of tangible property that provides for increasing or deferred rents. For this purpose deferred rent means rent allocable to the use of property for a calendar year not payable by the close of the succeeding calendar year. In addition, the final § 467 regulations apply § 467 to rental agreements for the use of tangible property that provide for decreasing rents or prepaid rent. For this purpose prepaid rent means rent paid in a calendar year that is allocable to the use of property following the close of the succeeding calendar year. Section 467 does not apply to rental agreements that do not provide for more than \$250,000 of rent.

Treas. Reg. § 1.467-1(a) (4) states that no inference should be drawn from any final regulation provision regarding whether an arrangement constitutes a lease for federal tax purposes. Treas. Reg. § 1.467-1(a)(5) also provides that notwithstanding § 467 and the pertinent regulations, other authorities such as the substance over form doctrine may be applied by the Service to determine § 467 rental agreement income and expense.

Congress enacted § 467 as an anti-abuse provision. The accounting methods required by § 467 have three primary purposes: (1) to match the income and deductions of lessor and lessee by requiring accrual accounting for § 467 rental agreements, (2) to adjust rents in appropriate circumstances to take into account the time value of money, and (3) to prevent tax avoidance.

To achieve these objectives § 467 provides for one of three different accrual accounting methods depending on the circumstances: (1) allocation of rent in accordance with the rental agreement, (2) the proportional rental method which adjusts rents for the time value of money, and (3) the constant rental method which prevents tax avoidance. The first method requires taking rents into account as allocated pursuant to the rental agreement. The § 467 regulations provide for rent to be allocated in one of two ways: (1) by means of a specific allocation, and (2) in the absence of a specific allocation, according to the rent payment schedule.

A rental agreement specifically allocates fixed rent if it unambiguously specifies, for periods no longer than a year, a fixed amount of rent for which the lessee becomes liable

on account of the use of the property during that period. To qualify as a specific allocation, the total amount of fixed rent allocated must equal the total amount of fixed rent payable under the lease. Treas. Reg. § 1.467-1(c)(ii)(2). Rent may be specifically allocated in a manner different from when it is payable. In the absence of a specific allocation of rent the amount of rent payable during a rental period<sup>42</sup> is allocable to that rental period. Rent payable prior to the beginning of the lease term is allocable to the first rental period of the lease. Rent payable after the end of the lease term is allocable to the last rental period of the lease. Treas. Reg. § 1.467-1(c)(2)(ii)(2).

A § 467 rental agreement that specifically allocates fixed rent may provide for deferred or prepaid rent, as defined in § 467 and the associated regulations. If the rental agreement does this but fails to provide adequate interest, within the meaning of Treas. Reg. § 1.467-2, on the deferred or prepaid fixed rent, the § 467 regulations require the deferred or prepaid fixed rent to be adjusted to take into account the time value of money. The regulations do this by requiring the proportional rental amount to be taken into account rather than the allocated rent. To determine the proportional rental amount, the amount of fixed rent allocated to any rental period during the lease term must be multiplied by the proportional rental fraction. The fraction's numerator equals the sum of the present values of the amounts payable as fixed rent and interest thereon under the rental agreement. The fraction's denominator equals the sum of the present values of the fixed rent allocated to each rental period under the rental agreement. Treas. Reg. § 1.467-2(c).

A net deferral of rent makes the proportional rental fraction less than 1 causing the fixed rent to be taken into account for any rental period to be less than the amount of fixed rent allocated to that rental period. A net prepayment of rent makes the proportional rental fraction greater than 1 causing the fixed rent to be taken into account for any rental period to be greater than the amount of fixed rent allocated to that rental period. The proportional rental method requires the lessor and the lessee to take interest on deferred or prepaid fixed rent into account as it accrues.

Section 467 does not apply to rental agreements having only decreasing or prepaid rents prior to the appropriate effective dates of the § 467 regulations. However, even in the absence of implementing regulations, § 467(a)(2) requires interest to be taken into account on deferred rent. Section 467(b)(1)(B) requires deferred rent to be taken into account at present value if the rental agreement fails to provide adequate interest on such rent.

Finally, to prevent allocations of either increasing or decreasing rents from resulting in tax avoidance, in the case of certain leasebacks or long-term agreements the § 467 regulations allow the Commissioner to require parties to a § 467 rental agreement to take

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<sup>42</sup> To determine rental period length see Treas. Reg. § 1.467-1(j)(5).

rent into account using the constant rental method. Treas. Reg. § 1.467-3(a) does not allow parties to a § 467 rental agreement to unilaterally adopt constant rental accrual based on tax avoidance. The Commissioner must determine that constant rental accrual is required to prevent tax avoidance. Under the constant rental method the parties must take into account a constant amount of rent, adjusted for the length of the rental period, for each rental period of the lease. The present value of the sum of the constant rental amounts equals the sum of the present values of the amounts payable under the lease as rent or interest.

Constant rental accrual applies in the case of disqualified leasebacks and long-term agreements. If the term of a rental agreement is in excess of 75 percent of the statutory recovery period of the leased property, the rental agreement qualifies as a long-term agreement. § 467(b)(4)(A). Treas. Reg. § 1.467-3(b)(2) defines a § 467 rental agreement as a leaseback if the lessee (or a related person) had any interest in the property (other than a de minimis interest) at any time during the two-year period ending on the agreement date. For this purpose, interests in property include options and agreements to purchase the property and, in the case of subleased property, any interest as a sublessor.

Most or perhaps all LILO Headleases qualify as long-term agreements. Likewise, a LILO Sublease always qualifies as a leaseback within the meaning of § 467. Disqualified status attaches to a leaseback or long-term agreement if a principal purpose for providing increasing or decreasing rents is tax avoidance. The details of how the § 467 regulations determine whether a principal purpose of a lease's rent allocation is tax avoidance need not be set forth here. Suffice it to say that the U.S. Taxpayer pays United States income taxes and the Tax-Exempt Entity pays no United States income taxes associated with a LILO. Because a LILO Headlease invariably provides for decreasing rents, absent extraordinary circumstances the Head Lease will qualify as a tax avoidance lease subject to constant rental accrual unless the Headlease rent allocation satisfies certain safe harbors. Likewise, if the Sublease provides for increasing rents its rent allocation must also satisfy these same safe harbors to avoid constant rental accrual.

Because one or more of the leases involved in a LILO will have either increasing or decreasing fixed rents, to avoid constant rental accrual such leases will generally have to allocate rents in a manner that satisfies one of the uneven rent tests of Treas. Reg. § 1.467-3(c)(4). These are the 90/110 test for personal property and the 85/115 test for certain leased real estate. Leases of personal property satisfy the 90/110 test if the rent allocated to each calendar year during the lease term does not vary by more than 10 percent from the average rent allocated to all calendar years during the lease term (with special rules for annualizing rent in the case of periods of less than a calendar year). The 85/115 test for certain real estate leases operates in a similar fashion. For further details of how these tests operate see Treas. Reg. § 1.467-3(c)(4).

The § 467 regulations generally apply to disqualified leasebacks and long-term agreements entered into after June 3, 1996. For rental agreements that are not disqualified leasebacks or long-term agreements, the § 467 regulations generally apply to rental agreements entered into after May 18, 1999. Prior to the amendment of the § 467 regulations on January 4, 2001, the regulations provided a safe harbor from constant rental accrual for rental agreements providing for \$2,000,000 or less of rent. Among other things, the 2001 amendments to the § 467 regulations removed the \$2,000,000 or less safe harbor for § 467 rental agreements entered into on or after July 19, 1999. For further information relating to effective dates see Treas. Reg. § 1.467-9.

### Application

Various arguments are available under § 467 for reducing the tax benefits flowing from a LILO transaction. For example, if a Headlease that is a long-term agreement is treated as extending only through the expected exercise of the buyout option, it will fail the uneven rent test, and the U.S. taxpayer can be required to use the constant rental accrual method to determine its rent deductions. Alternatively, if the main Sublease term is aggregated with the term of a renewal sublease, the resulting lease will fail the uneven rent test, and the U.S. taxpayer must include sublease rent based on the constant rental accrual method. Agents should contact the Leasing Technical Advisors in order to develop these and other arguments based on § 467.