

Part I

Section 162.-Trade or Business Expenses

26 CFR 1.162-11: Rentals.
(Also § 163; 1.163-1.)

Rev. Rul. 99-14

ISSUE

May a taxpayer deduct, under §§ 162 and 163 of the Internal Revenue Code, rent and interest paid or incurred in connection with a "lease-in/lease-out" ("LILO") transaction?

FACTS

X is a U.S. corporation. FM is a foreign municipality that has historically owned and used certain property having a remaining useful life of 50 years and a fair market value of \$100 million. BK1 and BK2 are banks. None of the parties is related.

On January 1, 1997, X and FM entered into a LILO transaction under which FM leased the property to X under a "Headlease," and X immediately leased the property back to FM under a "Sublease." The term of the Headlease is 34 years. The "primary" term of the Sublease is 20 years. Moreover, as described below, the Sublease may also have a "put renewal" term of 10 years.

The Headlease requires X to make two rental payments to FM during its 34-year term: (1) an \$89 million "prepayment" at the beginning of year 1; and (2) a "postpayment" at the end of year 34 that has a discounted present value of \$8 million. For federal income tax purposes, X and FM allocate the prepayment ratably to the first 6 years of the Headlease and the future

value of the postpayment ratably to the remaining 28 years of the Headlease.

The Sublease requires FM to make fixed, annual rental payments over both the primary term and, if exercised, the put renewal term. The fixed, annual payments during the put renewal term are substantially higher than those for the primary term. Nevertheless, the fixed, annual payments during the put renewal term are projected (as of January 1, 1997) to equal only 90 percent of the fair market value rental amounts for that term.

At the end of the Sublease primary term, FM has a "fixed-payment option" to purchase from X the Headlease residual (the right to use the property beyond the Sublease primary term subject to the obligation to make the rent postpayment) for a fixed amount that is projected (as of January 1, 1997) to be equal to the fair market value of the Headlease residual. If FM exercises the option, the transaction is terminated at that point and X is not required to make any portion of the postpayment due under the Headlease. If FM does not exercise the option, X may elect to (1) use the property itself for the remaining term of the Headlease, (2) lease the property to another person for the remaining term of the Headlease, or (3) compel FM to lease the property for the 10-year put renewal term of the Sublease. If FM does not exercise the fixed-payment option and X exercises its put renewal option, X can require FM to purchase a letter of credit guaranteeing the put renewal rents. If FM does not obtain the letter of credit, FM must exercise the fixed-payment option.

To partially fund the \$89 million Headlease prepayment, X borrows \$54 million from BK1 and \$6 million from BK2. Both loans are nonrecourse, have fixed interest rates, and provide for annual debt service payments that fully amortize the loans over the 20-year primary term of the Sublease. The amount and timing of the debt service payments mirror the amount and timing of the Sublease payments due during the primary term of the Sublease.

Upon receiving the \$89 million Headlease prepayment, FM deposits \$54 million into a deposit account with an affiliate of BK1 and \$6 million into a deposit account with an affiliate of BK2. The deposits with the affiliates of BK1 and BK2 earn interest at the same rates as the loans from BK1 and BK2. FM directs the affiliate of BK1 to pay BK1 annual amounts equal to 90 percent of FM's annual rent obligation under the Sublease (that is, amounts sufficient to satisfy X's debt service obligation to BK1). The parties treat these amounts as having been paid from the affiliate to FM, then from FM to X as rental payments, and finally from X to BK1 as debt service payments. In addition, FM pledges the deposit account to X as security for FM's obligations under the Sublease, while X, in turn, pledges its interest in FM's pledge to BK1 as security for X's obligations under the loan from BK1. Similarly, FM directs the affiliate of BK2 to pay BK2 annual amounts equal to 10 percent of FM's annual rent obligation under the Sublease (that is, amounts sufficient to satisfy X's debt service obligation to BK2). The parties treat these amounts as having been paid from the

affiliate to FM, then from FM to X as rental payments, and finally from X to BK2 as debt service payments. Although this deposit account is not pledged, the parties understand that FM will use the account to pay the remaining 10 percent of FM's annual rent obligation under the Sublease.

X requires FM to invest \$15 million of the Headlease prepayment in highly-rated debt securities that will mature in an amount sufficient to fund the fixed amount due under the fixed-payment option, and to pledge these debt securities to X. Having economically defeased both its rental obligations under the Sublease and its fixed payment under the fixed-payment option, FM keeps the remaining portion of the Headlease prepayment as its return on the transaction.

For tax purposes, X claims deductions for interest on the loans and for the allocated rents on the Headlease. X includes in gross income the rents received on the Sublease and, if and when exercised, the payment received on the fixed payment option. By accounting for each element of the transaction separately, X purports to generate a stream of substantial net deductions in the early years of the transaction followed by net income inclusions on or after the conclusion of the Sublease primary term. As a result, X anticipates a substantial net after-tax return from the transaction. X also anticipates a positive pre-tax economic return from the transaction. However, this pre-tax return is insignificant in relation to the net after-tax return.

LAW AND ANALYSIS

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

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

value of the bond. Thus, the bond and the taxpayer's borrowings constituted offsetting obligations. As a result, the taxpayer could never derive any significant benefit from the bond. The Supreme Court found the transaction to be a sham, as it produced no significant economic effect and had been structured only to provide the taxpayer with interest deductions.

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

In ACM Partnership, the taxpayer entered into a near-simultaneous purchase and sale of debt instruments. Taken together, the purchase and sale "had only nominal, incidental effects on [the taxpayer's] net economic position." ACM

Partnership at 250. The taxpayer claimed that, despite the minimal net economic effect, the transaction had a large tax effect resulting from the application of the installment sale rules to the sale. The court held that transactions that do not “appreciably” affect a taxpayer’s beneficial interest, except to reduce tax, are devoid of substance and are not respected for tax purposes. ACM Partnership at 248. The court denied the taxpayer the purported tax benefits of the transaction because the transaction lacked any significant economic consequences other than the creation of tax benefits.

Viewed as a whole, the objective facts of the LILLO transaction indicate that the transaction lacks the potential for any significant economic consequences other than the creation of tax benefits. During the 20-year primary term of the Sublease, X’s obligation to make the property available under the Sublease is completely offset by X’s right to use the property under the Headlease. X’s obligation to make debt service payments on the loans from BK1 and BK2 is completely offset by X’s right to receive Sublease rentals from FM. Moreover, X’s exposure to the risk that FM will not make the rent payments is further limited by the arrangements with the affiliates of BK1 and BK2. In the case of the loan from BK1, X’s economic risk is completely eliminated through the defeasance arrangement. In the case of the smaller loan from BK2, X’s economic risk, although not completely eliminated, is substantially reduced through the deposit arrangement. As a result, neither bank requires an

independent source of funds to make the loans, or bears significant risk of nonpayment. In short, during the Sublease primary term, the offsetting and circular nature of the obligations eliminate any significant economic consequences of the transaction.

At the end of the 20-year Sublease primary term, X will have either the proceeds of the fixed-payment option or a Headlease residual that has a fair market value approximately equal to the proceeds of the fixed payment option. If, at the end of the 20-year Sublease primary term, the Headlease residual is worth more than the payment required on the fixed-payment option, FM will capture this excess value by exercising the fixed payment option, leaving X with only the proceeds of the option. Conversely, if, at the end of the 20-year Sublease primary term, the Headlease residual is worth significantly less than the payment required on the fixed-payment option, X will put the property back to FM under the put renewal option at rents, that while initially projected to be at only 90 percent of estimated fair market value, are (because of the decline in the value of the property) greater than fair market value. Thus, the fixed payment option and put renewal option operate to "collar" the value of the Headlease residual during the primary term, limiting much of the economic consequence of the Headlease residual.

In addition, facts indicate that there is little economic consequence from X's nominal exposure to FM's credit under the fixed-payment option and, if exercised, the put renewal term. At

the inception of the transaction, FM was required to use a portion of the Headlease prepayment to purchase highly-rated debt securities that were pledged to X, ensuring FM's ability to make the payment under the fixed-payment option. If FM does not exercise the fixed-payment option and X exercises the put renewal option, X can require FM to purchase a letter of credit guaranteeing FM's obligation to make the put renewal rent payments. If FM does not obtain the letter of credit, FM must exercise the fixed-payment option. Thus, as a practical matter, the transaction is structured so that X is never subject to FM's credit.

The conclusion that X is insulated from any significant economic consequence of the Headlease residual is further supported by several factors indicating that the parties expect FM to exercise the fixed-payment option. First, FM has historically used the property. Second, because the fixed payment obligation is fully defeased, FM need not draw on other sources of capital to exercise the option. However, if FM does not exercise the fixed payment option and X exercises the put renewal option, FM would be required to draw on other sources of capital to satisfy its put renewal rental obligations.

In sum, the LIL0 transaction lacks the potential for significant economic consequences other than the creation of tax benefits. During the primary term of the Sublease, X's obligations to provide property are completely offset by its right to use property. X's obligations to make debt service

payments on the loans are completely offset by X's right to receive rent on the Sublease. These cash flows are further assured by the deposit arrangements with the affiliates of BK1 and BK2. Finally, X's economic exposure to the Headlease residual is rendered insignificant by the option structure and the pledge of the securities that defeases FM's option payment. Thus, the only real economic consequence of the LILO transaction during the 20-year primary term of the Sublease is X's pre-tax return. This pre-tax return is too insignificant, when compared to X's after-tax yield, to support a finding that the transaction has significant economic consequences other than the creation of tax benefits.

Some of the features of the LILO transaction discussed above are present in transactions that the Service will respect for federal income tax purposes. For example, an arrangement for "in-substance defeasance" of an outstanding debt was respected in Rev. Rul. 85-42, 1985-1 C.B. 36. By contrast, in the LILO transaction, the deposit arrangement exists from the inception of the transaction, eliminating any need by BK1 and BK2 for an independent source of funds. Similarly, other features of the LILO transaction, such as nonrecourse financing and fixed-payment options, are respected in other contexts. However, when these and other features are viewed as a whole in the context of the LILO transaction, these features indicate the transaction should not be respected for tax purposes.

As a result of the transaction lacking economic substance, X

may not deduct interest or rent paid or incurred in connection with the transaction.

The Service will scrutinize LILO transactions for lack of economic substance and/or, in appropriate cases, recharacterize transactions for federal income tax purposes based on their substance. See, e.g., Gregory v. Helvering 293 U.S. 495 (1935), Bussing v. Commissioner, 88 T.C. 449 (1987), Supplemental Opinion, 89 T.C. 1050 (1987). Use of terms such as "loan," "lease," "Headlease," and "Sublease" in this revenue ruling should not be interpreted to indicate the Service's acceptance of X's characterization of the LILO transaction described above.

HOLDING

A taxpayer may not deduct, under §§ 162 and 163, rent and interest paid or incurred in connection with a LILO transaction that lacks economic substance.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 85-42 is distinguished.

DRAFTING INFORMATION

The principal author of this revenue ruling is John Aramburu of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling contact Mr. Aramburu on (202) 622-4960 (not a toll-free call).