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

OFFICE OF
CHIEF COUNSEL

April 23, 2002

Number: **200232003**
Release Date: 8/9/2002
CC:ITA:05
POSTF-162829-01
UILC: 61.16-03

INTERNAL REVENUE SERVICE NATIONAL OFFICE LEGAL ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL, STRATEGIC LITIGATION (CTM)
CC:LM:CTM:SLPOR

FROM: Associate Chief Counsel (Income Tax & Accounting)
CC:ITA:5

SUBJECT: Ownership of Leased Assets

This Chief Counsel Advice responds to your memorandum dated February 1, 2002. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

<u>LEGEND</u>

Taxpayer =

Subsidiary A =

Subsidiary B =

Foreign Country X =

Facility Assets =
Operator =

Finance 1 =
Finance 2 =

Consortium	=
Entity	=
Phase 1A Assets	=
Phase 1B Assets	=
Public Institution	=
Sale	=
Leaseback	=
MOA	=
Obligations	=
Cancellation	=
Lease	=
Appraiser	=
Sublease	=
Installments	=
Tax Year 1	=
Tax Year 2	=
Tax Year 3	=
Tax Year 4	=

POSTF-162829-01

a%	=	
b%	=	
c%	=	
d%	=	
e%	=	
f%	=	
g%	=	
h%	=	
i%	=	
j%	=	
Date A	=	
Date B	=	
Date C	=	
Date D	=	
Date E	=	____
Date F	=	
Date G	=	
Date H	=	
Date I	=	
Date J	=	
Date K	=	
Date L	=	

a	=
b	=
c	=
d	=
e	=
f	=
h	=
i	=
j	=
k	=
l	=
m	=
n	=
o	=
p	=
q	=
r	=
s	=
t	=
Term A years	=
Term B years	=
Term C years	=

ISSUES[1]

Viewing the substance of the transaction as that of a conditional sale rather than a lease, is the conditional purchaser Operator or Finance 2?

CONCLUSION

In our view, your office has developed the facts sufficiently so that we can agree with your approach to determining which party is the owner of the Facility Assets in this case. The expert economist involved in this case has determined that Operator has an "economic compulsion" to exercise its Lease Assignment Option under the documents to acquire the Facility Assets, thus supporting your conclusion that Operator should be considered the conditional purchaser of such assets. To the extent the documents and the facts ultimately support this conclusion, we support the determination that Operator is the owner of the Facility Assets.

FACTS

The Taxpayer, together with its subsidiaries, is a diversified international company with many operations. In Date A, Taxpayer sought to expand its overseas operations. After obtaining some concessions by the government of Foreign Country X, Taxpayer chose a location in Foreign Country X for new Facilities Assets. The parties set forth the blueprint for Facilities Assets (including the legal obligations and development plan) in a Master Agreement that was signed on Date B by the Foreign Country X government, various other public parties in Foreign Country X, and Taxpayer. Taxpayer assigned all of its rights and obligations under the Master Agreement to Subsidiary A, one of its wholly owned subsidiaries.

As contemplated by the Master Agreement, two special purpose entities were created, Operator and Finance 1. Operator was intended to be the developer and operator of Facility Assets, while Finance 1 was intended to be the nominal titleholder of the Facility Assets and the source of funds for financing the construction of the Facility Assets.

Operator is a Foreign Country X entity similar to a publicly held limited partnership. In Date C, Operator held a public offering of its equity interest with the understanding, as expressed in the Master Agreement, that more than 50 percent of

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[1] The incoming submission also requests advice concerning the relevant standard of evidence for this case and the proper characterization of the transaction in issue here. However, because there is no dispute between the Service and the taxpayer concerning these two issues, neither will be addressed in this Chief Counsel Advice.

the equity interest in Operator would be owned by residents of Foreign Country X and neighboring countries. The initial public offering ("IPO") raised FC[2] a, of which FC b was used to reimburse Taxpayer for project development costs and FC c was loaned to Finance 1. After the public offering, the Taxpayer, through Subsidiary B, a wholly owned subsidiary, held an e% equity ownership interest in Operator. Some months after Date I (i.e., after the restructuring and Sublease transactions described below), Taxpayer, through Subsidiary B, reduced its equity ownership interest in Operator to a% through certain other transactions.

Finance 1 is a Foreign Country X general partnership, owned b% percent by a Consortium and c% by Entity, a Foreign Country X entity wholly owned by another Foreign Country X entity, which in turn is wholly owned by the Taxpayer.

Pursuant to the Master Agreement, the development of Facility Assets was structured in two phases with the first phase divided into phases 1A and 1B. Phase 1A included the construction of the Phase 1A Assets. Phase 1B included the construction of the Phase 1B Assets.

To finance phase 1A, Finance 1 originally had obtained loans (collectively the "Loans") from four sources: (1) the independent Consortium, (2) Public Institution, which is a Foreign Country X public institution the board of which includes several members of the legislature of Foreign Country X, (3) certain partners, and (4) Operator, as follows:

Consortium	FC d
Public Institution	FC e (maximum)
Partner Advances	FC f
Operator Loans	FC c
Total	FC h

Finance 1's partners made the Partner Advances at below market interest rates in exchange for Foreign Country X tax benefits. To provide Finance 1's partners with Foreign Country X tax benefits, the parties structured the transaction to vest legal title to the Facility Assets in Finance 1 because under Foreign Country X's tax law, the holder of legal title, not the beneficial owner, is the party entitled to take deductions for interest and depreciation.

Operator, as developer, constructed Facility Assets and sold them to Finance 1 under the terms of a Sale Agreement, executed by Operator and Finance 1 in

[2] All monetary amounts are expressed in the currency of Foreign Country X as "FC" (for "Foreign Country") rather than in United States dollars.

Date C. The Sale allowed Operator to sell the Facility Assets to Finance 1 in anticipation of their completion. As Operator completed construction, it transferred legal title to Finance 1.

To enable Operator to operate Facility Assets, Finance 1 leased the Facility Assets back to Operator under Leaseback, the Foreign Country X equivalent of a tax-advantaged, leveraged lease. The Leaseback had a term beginning in Date D and ending on the earlier of Date G or the date on which all outstanding loans are repaid. Under the Leaseback, Operator was required to make monthly rental payments equal to the principal and interest due on the Loans ("debt service payments") and to pay for insurance, repairs, maintenance, improvements, and taxes. In addition, after Term A years and continuing thereafter, Operator had an option to purchase the Facility Assets for a purchase price equal to the then outstanding balance on the Loans plus certain costs and a nominal amount equal to FC i. Consequently, Operator's option entitled it to acquire the Facility Assets merely by repaying the outstanding debt and making a nominal additional payment.

During the early years of its existence, operation of Facility Assets did not achieve the level of revenues previously anticipated. The reasons for this ranged from the growing recession to increasing interest rates on the variable rate debt to certain misconceptions. Consequently, Operator could not meet its objective to sell certain assets and properties at profits substantial enough to pay down the debt.

To salvage Facility Assets, the Taxpayer and the creditors entered into a MOA dated Date H, which defined the terms of a financial restructuring. The financial restructuring had two primary components: reduce costs, and increase in capital, achieved, in part, as follows. First, the creditors agreed to reduce the burden of the Loans by deferring the principal on the Loans for a 3-year period and forgiving interest having a net present value of FC j. At the same time, the Taxpayer reduced certain fees it was entitled to receive with respect to the Facility Assets. Second, under the MOA, the Taxpayer and Operator agreed to raise additional capital through a public offering of rights to purchase additional shares in Operator (the "Rights Offering"). The creditors agreed to underwrite d%, and the Taxpayer agreed to purchase (through Subsidiary B) e% of the Rights Offering. The Rights Offering raised FC k, FC l of which Operator loaned to Finance 1 for the purpose of repaying a portion of the principal amount of the Loans. Third, the MOA provided that the Taxpayer agreed to purchase FC m in Obligations issued by Operator. Subsidiary B, Taxpayer's wholly owned subsidiary, bought Obligations.

In addition, the Taxpayer agreed to purchase from, and lease back to, Operator certain Facility Assets then under construction for FC n. The Taxpayer also agreed to prepay to Finance 1 a portion of Operator's rent. To accomplish these objectives, the Taxpayer created Finance 2, a Foreign Country X general partnership owned by two wholly owned subsidiaries of the Taxpayer. In essence, the Taxpayer contributed FC t to its two wholly owned subsidiaries, which in turn loaned FC t to Finance 2 at an interest rate of f% for Term C years. Of these funds, FC n was used by Finance 2 to purchase certain Facility Assets under construction from Operator and FC p was used to prepay to Finance 1 rent on its lease of the completed Facility Assets back to Operator. Finance 2 then leased Facility Assets under construction to Operator for a term of Term B years with an annual lease payment of FC o. At the end of Term B years (which occurs in Date F), Operator has an option to purchase these assets for FC n payable in Installments at an interest rate of i% per annum. Operator may exercise this option only if it exercises an option (described below) to acquire Finance 2's leasehold interest in the completed Facility Assets. Finally, the Taxpayer, Operator, and the creditors agreed to cooperate in the implementation of one or more transactions that would optimize the impact of the restructuring on the Taxpayer from a tax and accounting perspective.

Thereafter, the Taxpayer negotiated additional changes in order to optimize the restructuring. The Taxpayer proposed a new leasing structure that would replace the original Leaseback. The new leasing structure required the termination of the original Leaseback (which included Operator's purchase options) between Finance 1 and Operator. Although the Leaseback, on its face, did not provide for such termination, Operator and Finance 1 entered into a Termination, which cancelled the original Leaseback and, according to the language of that agreement,

> . . . for U.S. tax purposes . . . results in [Finance 1] recovering all the benefits and burdens related to ownership of the Installations.

See Termination. Contemporaneous with the termination of the original Leaseback, Finance 1 leased the Facility Assets to Finance 2 under "Lease." Finance 2, in turn, entered into a sublease of the Facility Assets to Operator under "Sublease." This structure is explained as follows.

Under the Lease dated Date I, Finance 1 leased the Facility Assets to Finance 2 on a net lease basis for the period beginning on Date I and ending on Date G (or the date on which all outstanding loans are repaid, if earlier). Finance 2 can terminate the Lease at any time after Date K and before Date G, however, by paying the outstanding balance of the Loans, certain costs and a nominal amount equal to FC i.[3] The Lease requires Finance 2 to make monthly rental payments that are equivalent to the debt service payments. Under the "exceptional circumstances" provision, however, Finance 2 may defer rent to the extent that the debt service payment exceeds its "available cash." If Operator does not exercise its option (described below) to purchase Finance 2's leasehold interest in the Facility Assets, Finance 2 must pay the deferred rent by Date J. Under the terms of this Lease, Finance 2 can satisfy this obligation by assigning an equal amount of outstanding rents that may be owed to it by Operator. As stated above, Finance 2 made a prepayment of rent of FC p that was, and will be, applied to reduce the rent on the completed Facility Assets at an annual amortization of FC q over Term B years.

Finance 2 has three options under the Lease (subject to the Operator's option described below). First, Finance 2 may terminate the Lease on Date J, but only if it pays Finance 1 an indemnity equal to g% of the outstanding balance on the Loans. In the event that Finance 2 terminates the Lease, Finance 1 will grant Finance 2 the authority to sell or lease the Facility Assets. Finance 2 must not offer the Facility Assets for a price that is less than 25 percent of the outstanding balance on the Loans. To the extent that the proceeds from the sale exceed the remaining balance, Finance 2 may retain the excess as its commission.

Second, pursuant to the Lease, the Finance 2 may purchase the Facility Assets at any time starting after Date J for an amount equal to the outstanding balance of the Loans, certain costs plus a nominal amount equal to FC i. The outstanding balance of the Loans was expected to approximate FC r. Appraiser estimated the fair market value of the Facility Assets as of Date F to fall within a range of 4 to 8 percent above FC r.

Third, Lease permits Finance 2 to continue the lease through its full term and purchase the Facility Assets for a nominal amount equal to FC i plus certain costs.

In addition, Finance 2 and Operator entered into Sublease dated Date I, pursuant to which Finance 2 leased the Facility Assets to Operator on a net lease basis for an irrevocable term of Term B years. Sublease does not contain any renewal provisions. Operator is required to pay Finance 2 a monthly rental payment equal to the rental payment under the Lease plus i%. Operator may defer rent to the extent that the debt service payment exceeds its "available cash." If

[3] In its response, the Taxpayer acknowledges that the FC i amount required to be paid by Finance 2 upon the exercise of the above options is a nominal amount in relation to the estimated fair market value of the Facilities Assets subject to Lease.

Operator does not exercise its option to purchase Finance 2's leasehold interest (as described below), Operator must pay the deferred rent on Date J.

Under the terms of the Sublease, Operator has the option to acquire Finance 2's leasehold interest under the Lease for FC s on Date L ("Lease Assignment Option"). Operator's Lease Assignment Option to purchase Finance 2's leasehold interest has priority over Finance 2's options to terminate the Lease or to purchase the Facility Assets itself. Consequently, if Operator chooses to exercise its Lease Assignment Option, on Date L Operator will "step into the shoes" of Finance 2 under the Lease. That is, Operator will be obligated to make the monthly rental payments equivalent to the debt service payments and will have the option to purchase the Facility Assets in Date F for the fixed price of approximately FC r or any time thereafter for an amount equal to the outstanding balance on the Loans, certain costs plus a nominal amount equal to FC i.[4]

Neither Finance 1 nor Operator has been engaged in business in the United States at any time. Therefore, they have never been required to, and have not, filed United States income tax returns. The Taxpayer reported on Forms 5471, Information Returns of U.S. Persons with Respect to Certain Foreign Corporations, that for Tax Year 1 and Tax Year 2, Finance 1 and Operator were controlled foreign corporations. In doing so, the Taxpayer was required to provide an income statement for each entity. The Taxpayer reported "depreciation not deducted elsewhere" with respect to the Facility Assets on Operator's Form 5471. Form 5471 contains Schedule C, Income Statement, requiring the Taxpayer to report all information in accordance with United States Generally Accepted Accounting Principles (GAAP). This would indicate that the Taxpayer treated Operator as the owner of the Facility Assets for United States tax purposes. But because Operator did not have any subpart F income, the Taxpayer did not claim, indirectly through Operator, any depreciation with respect to the Facility Assets for U.S. tax purposes.

The two wholly owned subsidiaries of the Taxpayer, which are partners in Finance 2, file consolidated income tax returns with the Taxpayer. On their Tax Year 3 and Tax Year 4 consolidated income tax returns, the Taxpayer and its subsidiaries claimed large deductions for depreciation and original issue discount ("OID") as distributive shares of Finance 2's income/loss. The Taxpayer argues that the Lease is not a "lease" but rather a "conditional sale" of the Facility Assets and consequently Finance 2 is the owner of the Facility Assets and is thus entitled to deductions for both depreciation and OID.

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[4] Again, we note that the Taxpayer acknowledges that the FC i amount required to be paid by Operator upon exercise of its option is a nominal amount in relation to the estimated fair market value of the Facilities Assets subject to the Sublease.

Operator files a Form 20-F, Annual Report, with the Securities Exchange Commission. In a footnote to this report for Tax Year 4, Operator describes how it adjusted its financial statements to reflect United States GAAP as follows:

> Lease and interest adjustments
>
> A majority of the Group's assets, including the Facility Assets and Phase 2 Assets, are leased under various arrangements. Under Foreign Country X GAAP, the Group has not capitalized these leases and is accounting for them as operating leases. Under U.S. GAAP, the underlying assets and liabilities and related depreciation and interest expense are reflected in the Group's financial statements.
>
> Borrowings
>
> As described in Note, the Group has not capitalized the leases of the Facility Assets and the Phase 2 Assets but has accounted for them as operating leases. Under U.S. GAAP, the leases would be capitalized.

Financial Accounting Standard 13 describes when a lease will be capitalized for U.S. GAAP purposes.

LAW AND ANALYSIS

In this case, Taxpayer's position is that for Federal income taxes, the Lease should be recharacterized as a conditional sale. Taxpayer contends that Finance 2 is the "conditional purchaser" of the Facility Assets from Finance 1 and thus their tax owner. This position enables the Taxpayer to claim depreciation and interest deductions concerning certain Facility Assets following the restructuring.

The Taxpayer supports its characterization by arguing that under the terms of the Lease, Finance 2 has the opportunity for profit should the value of the Facility Assets appreciate above the cost of exercising any of its options to acquire the Facility Assets during the term of the Lease; Finance 2 has a substantial risk of loss down to h% of the value Facility Assets should its value decline by g%; and Finance 2 has the use of the Facility Assets for their full useful life since the term of the Lease ends on Date G, which exceeds the estimated useful life of the Facility

Assets according to Appraiser (unless, of course, Finance 2 exercises one of its options to acquire Facility Assets prior to Date G).

Under the authorities, it is clear that the opportunity for profit from the appreciation in the value of property, the risk of economic loss from a decline in the value of the property, and the use of the property for its full useful life are very significant benefits and burdens of ownership. See Helvering v. F. & R. Lazarus & Co., 308 U.S. 252 (1938); Casebeer v. Commissioner, 909 F.2d 1360 (9th Cir. 1990); Larsen v. Commissioner, 89 T.C. 1229 (1987); Gefen v. Commissioner, 87 T.C. 1471 (1986); Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237 (1981); Pacific Gamble Robinson v. Commissioner, T.C. Memo 1987-915; Rochester Development Corp. v. Commissioner, T.C. Memo. 1977-307; Rev. Rul. 55-541, 1955-2 C.B. 19. Consequently, where a “lessee” holds all three under the terms of a “lease,” courts and the Service will find that the user of the property holds sufficient burdens and benefits of ownership to be treated as the tax owner of the property. Accordingly, in many cases, transactions cast in the form of a “lease” have been recharacterized as a conditional sale for Federal income tax purposes. See Swift Dodge v. Commissioner, 692 F.2d 651 (9th Cir. 1982), rev’g 76 T.C. 547 (1981); Rev. Rul. 55-540, 1955-2 C.B. 39; Rev. Rul. 55-541, 1955-2 C.B. 19; Rev. Rul. 55-542, 1955-2 C.B. 59; and Rev. Rul. 57-371, 1957-2 C.B. 214.

It is important to note that the partners of Finance 1 originally agreed to make below market rate loans in exchange for Foreign Country X tax benefits (i.e., depreciation on the Facility Assets). Since Foreign Country X’s tax law, unlike United States tax law, is form driven, the holder of mere title to assets is the one entitled to claim depreciation under Foreign Country X law. In order to preserve these tax benefits for the partners of Finance 1, it was essential that the Date E restructuring not disturb Finance 1's title to those assets. Consequently, upon implementing the Date E restructuring, there was no change in who held title to the leased assets. Both before and after that date, Finance 1 held title to the Facility Assets. Since Finance 1 only holds title to the Facility Assets, neither the Taxpayer nor your office takes the position that Finance 1 is the owner (that is, the holder of the burdens and benefits of ownership under the above precedent) of Facility Assets for United States income tax purposes. Instead, it is likely that the Lease here will be viewed as a conditional sale.

Assuming the Lease is viewed as a conditional sale, what remains at issue in this case is whether Finance 2 or Operator is the tax owner of the Facility Assets for United States tax purposes. The Taxpayer’s view is that the former is the tax owner; your office’s view is that the latter is the tax owner. For the below reasons, our office believes that the facts have been sufficiently developed to support the view of your office that Operator should be considered the tax owner of the Facility Assets.

Initially, we note that assuming that the Lease is continued after Term B years, the Lease grants either Finance 2, or Operator (if it exercises the Lease Assignment Option under the Sublease and replaces Finance 2 in the Lease), a purchase option for the Facility Assets that may be exercised over an extended period of time. During this time, either Finance 2 or Operator will be considered the “lessee” for purposes of the Lease. This option to acquire the Facility Assets may be exercised at anytime on or after Date F for an amount roughly corresponding to the declining balance of the outstanding debt. Following the date on which the debt is expected to be fully repaid, either Finance 2 or Operator will have an option to acquire the Facility assets for the nominal amount of FC i plus certain other insignificant costs. Thus, barring a virtually unrealistic decline in the value of the Facility Assets, it is essentially a foregone conclusion that either Finance 2 or Operator will become the titleholder of Facility Assets upon exercise of the purchase option in the Lease.

The Taxpayer’s argument that with respect to the Facility Assets, Finance 2 has the opportunity for appreciation, the risk of loss and the use of the property for substantially all of its useful life has significance only if Operator does not exercise its Lease Assignment Option under the Sublease. The rights and obligations that support treating the Lease as a conditional sale to Finance 2 are subordinate during the Term B years of the Lease. During these first years of the Lease, Finance 2 unconditionally ceded its rights to use and operate the Facility Assets to Operator pursuant to the Sublease. The Sublease is a net lease, and Operator has assumed all costs incident to using and operating the Facility Assets, i.e., payment of property taxes, fees, insurance etc. During the Term B years, the Lease and Sublease specifically provide that Operator may make its Sublease payments directly to Finance 1, thereby satisfying Finance 2's rent obligation under Lease.

In Date F, Finance 2's potential obligation under the termination indemnity and its potential rights under the purchase option will not materialize if Operator chooses to exercise its Lease Assignment Option. If Operator exercises its Lease Assignment Option, it will succeed to the right to acquire the Facility Assets under the above terms pursuant to the options in the Lease. Consequently, the rights and obligations that warrant treating the Lease as a conditional sale will be possessed by Operator, not Finance 2. Accordingly, the fact that Finance 2's options to purchase the Facility Assets under the Lease are essentially subordinate to, and dependent upon, Operator’s Lease Assignment Option under the Sublease would indicate that Operator’s claim to the burdens and benefits of ownership to the Facility Assets has priority over that of Finance 2. As of the inception of the Lease in Date E, it is reasonable to conclude that Operator will exercise its Lease Assignment Option by making a payment of FC s to Finance 2 and thus, it would replace Finance 2, as the lessee, under the Lease.

This view is supported by the fact that the Taxpayer and all other parties to the restructuring realized that Operator's role in this transaction is so crucial that its Lease Assignment Option received primacy over the purchase options held by Finance 2 under the Lease. This would indicate that the Taxpayer and the other parties to the restructuring considered it likely that Operator would exercise its Lease Assignment Option and replace Finance 2, as the lessee. Had the parties intended for Finance 2, and not Operator, to ultimately own the Facility Assets, then the Sublease would not have contained the Lease Assignment Option and the term of the Sublease would be closer to, or coterminous with, the term of the Lease.

In addition, we note that Operator was originally created by Taxpayer primarily to develop and operate Facility Assets. Under the Lease-Sublease restructuring, Operator uses and operates the Facility Assets, not Finance 2. There is no indication that Finance 2 is prepared to take over this role in Date F. Moreover, Sublease does not contain any renewal periods, at fair market value or otherwise. Although Taxpayer can argue that Operator's role in using and operating the Facility Assets can continue beyond the expiration of the Sublease merely by having the parties negotiate a new Sublease, this seems disingenuous since parties as sophisticated as the Taxpayer and its related entities could have easily included renewal provisions in the Sublease if that is what was intended. The absence of renewal provisions in the Sublease strongly suggests that the Taxpayer and the other parties to the restructuring contemplated exercise of the Lease Assignment Option by Operator, who would then continue its use and operation of the Facility Assets.

Moreover, Operator may have limited business purposes or acumen outside of operating Facility Assets, which, in conjunction with the other agreements involving Taxpayer and related entities, appear unique. Consequently, to lose this corporate opportunity by not exercising its Lease Assignment Option leads to the question of just what business would be conducted by Operator should it "leave the scene" on Date J. Although Operator would continue to Operate the Phase 1B Assets and other real property, the loss of an integral portion of the Facility Assets would greatly diminish the earning capacity of Operator. In that case, the public shareholders would certainly lose out on their investment, which may result in a violation of Foreign Country X's laws concerning corporate fiduciary responsibility. In order to protect its business, Operator conceivably would be compelled to exercise the Lease Assignment Option and acquire Facility Assets.

We further note that Operator must pay FC s[5] to Finance 2 in order to exercise the Lease Assignment Option. Taxpayer has argued that this amount when added to FC r, the amount of the projected outstanding Lease payments, is not insubstantial or nominal and thus its payment is not a foregone conclusion. Consequently, Taxpayer concludes that Sublease is an operating lease because it is conceivable that it would end in Date F without exercise of the Lease Assignment Option. However, we nevertheless believe that Operator is economically compelled to make this payment and thus assume the outstanding Lease payments in order to protect its business and corporate opportunity with respect to the public shareholders. Moreover, while this amount appears large, it is not substantial when compared to the potential value of the Facility Assets. Payment of this amount, therefore, is not inconsistent with the view that Operator has an economic and corporate compulsion to exercise the Lease Assignment Option and ultimately acquire ownership of the Facility Assets.

Accordingly, we are not persuaded that Finance 2 can prevail with its claim to own Facility Assets predicated on rights and obligations that during the Term B years are subservient to Operator's Lease Assignment Option, and which, if exercised, would permanently divest Finance 2 of the claimed benefits and burdens of ownership. For reasons to be discussed below, we think that the Lease Assignment Option will in all likelihood be exercised at the end of Term B years.

Your office has provided us with the conclusions of an expert/economist's report, which analyzed this transaction in order to determine the likelihood that Operator will exercise its Lease Assignment Option and ultimately become the owner of the Leased Assets. This report concludes that Operator has an economic compulsion to exercise the Lease Assignment Option and thus its exercise is very likely. The following factors support this conclusion.

First, according to this report's conclusions, as of the date of its public offering (as well as the date of the Lease) Operator's market value of equity substantially exceeded its book value of equity. This difference is attributable, in part, to the expectation of investors that, based on projections of cash flow discounted back to their present values, Operator will exercise its Lease

[5] It is possible that this FC s amount is intended to reimburse Taxpayer (by virtue of a flow through of such funds from Finance 2, a partnership of two entities wholly owned by Taxpayer) of the FC p in prepaid rent discussed above, plus a reasonable rate of return on such amount. Moreover, if the payment is prepaid rent (from which Operator benefitted through lower rent payments for Term B years) plus a reasonable rate of return, the FC s amount is relatively insubstantial since Operator, prior to the restructuring, was obligated to pay rent that included the prepaid rent.

Assignment Option and ultimately increase its net worth by acquiring the Facility Assets. If one considers the Lease Assignment Option to be the equivalent of an option with a strike price equal to FC s plus the assumption of the outstanding debt of Finance 1 (and the nominal purchase price amount of FC i), the more the Facility Assets increase in value above that sum from appreciation or from debt repayment (or a combination thereof), the greater the value to Operator of exercising this “option” (that is, the deeper this option is in-the-money). Thus, any equity value in Operator is attributable to the Facility Assets. If the Phase 1A Assets do well, then the Phase 1B assets and other assets in which Operator has a stake will also do well. If Facility Assets do not do well, then neither will these other assets. Consequently, Operator’s equity value is contingent on the success of the operation of Facility Assets, and thus its failure to exercise the Lease Assignment Option will cause Operator to lose any equity value in all of these other assets as well.

Consequently, to the extent that the value of the Facility Assets exceeds Finance 1's projected debt outstanding plus FC s, Operator would be compelled to exercise its Lease Assignment Option in order to obtain the benefit from the difference between these amounts, which would increase Operator’s net worth. Thus, any appreciation in the Facility Assets’ value would accrue to the benefit of Operator, not Finance 2, because Operator would exercise its Lease Assignment Option in order to replace Finance 2 as lessee of the Lease and ultimately acquire the Facility Assets. In the event the value of the Facility Assets declines (and the expert/economist examines four such scenarios) but remains above liquidation value, the creditors of Finance 1 (e.g., the independent Consortium) would most likely wish to avoid foreclosure and liquidation of these assets. Since Operator uses and operates the Facility Assets, both before and after the Termination and restructuring, the report suggests that it is in the best interests of the creditors to accommodate Operator in the case of any payment shortfalls or in the financing of the exercise of the Lease Assignment Option.

In addition, the report points out that if Operator does not exercise the Lease Assignment Option, it loses the value of certain below-market Loans and the partners’ advances that were used to finance the Phase 1A Assets. Moreover, even if the value of the Facility Assets declines, Operator still has an incentive to exercise the Lease Assignment Option because it will obtain the right under the Lease to acquire the Facility Assets at any time during the remaining term of the Lease for an amount that declines as the outstanding debt owed to Finance 1 is repaid (plus the nominal FC i). Thus, the value of this right increases as the amount required to be paid to acquire the Facility Assets declines assuming the value of the Facility Assets ultimately appreciates, stays level, or declines at a slower rate that the repayment of the debt. As pointed out by the report, once the value of the Facility Assets declines to a point where certain loans Operator made are worthless, Operator is playing entirely with the creditors' money (that is, it can acquire the property under the Lease merely by assigning certain of its loan receivables to Finance 1, and thus part with no additional cash).

The report also notes that Operator was established, in part, by Taxpayer and endowed with certain intangible assets, including managerial skill and certain unique expertise in the operation of Facility Assets as well as certain developmental know-how. If Operator does not exercise the Lease Assignment Option, it would severely affect the operation of the Facility Assets and could very likely lead to their liquidation. Consequently, it appears in the best interests of all concerned for Operator to continue in its role as operator of Facility Assets after Date F by exercising the Lease Assignment Option.

Finally, the report provides a convincing argument in support of the position that Operator has an economic compulsion to exercise the Lease Assignment Option. The report examines four scenarios based upon four different valuations and, in each case, concludes that Operator's best course of action is to exercise the Lease Assignment Option, which would permit it (and not Finance 2) to acquire the Facility Assets under the terms and conditions that support the conclusion that Lease is actually a conditional sale.

In our view, therefore, your office has developed the facts sufficiently with respect to determining which party is the owner of the Facility Assets in this case. The expert economist involved in this case has determined that Operator has an "economic compulsion" to exercise its Lease Assignment Option under the documents to acquire the Facility Assets, thus supporting your conclusion that Operator be considered the conditional purchaser of such assets. To the extent the documents and the facts ultimately support this conclusion, we also support the determination that Operator is the owner of the Facility Assets.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted] Finance 2 would be the holder of the burdens and benefits of ownership to the Facility Assets. For instance, under the Sublease, Operator is precluded from further subleasing or assigning its interest without the express consent of Finance 2. Certainly, it is arguable that such a restriction is inconsistent with the view that Operator is the tax owner of the Facility Assets. Sublease also contains an express provision that the parties intend that the Sublease be treated as a "true lease" for United States tax purposes. Since courts often characterize a transaction by looking to the intent of the parties as evidenced by the transaction documents and surrounding facts and circumstances, (see, e.g., Haggard v. Commissioner, 24 T.C. 1124, 1129 (1955), aff'd 241 F.2d 288 (9th Cir. 1956)), it is likely that representatives of the parties will testify that all concerned consistently intend for the Sublease to be treated as an operating lease. The Taxpayer makes the further point that exercise by Operator of the Lease Assignment Option under the Sublease would require it to make a payment to Finance 2 of FC s. This amount when added to the outstanding Lease obligations is not an insubstantial figure. In addition, a court could reject the conclusions of the report of the Service's expert/economist, or accept a contrary report that we assume would be produced by the Taxpayer's expert/economists for the Taxpayer. Therefore, it is certainly possible that a court could adopt the approach that exercise of the Lease Assignment Option held by Operator is not a foregone conclusion and instead requires a "wait-and-see" approach. Consequently, a court could find that Sublease is an operating lease.

[redacted]

Also as noted above, Operator was originally created by Taxpayer as a special purpose corporation and most likely does not have any business purpose or acumen outside of operating Facility Assets. Consequently, to lose this corporate opportunity by not exercising its Lease Assignment Option begs the question of just what business would be conducted by Operator should it "leave the scene" on Date J. [redacted]

[redacted]

[redacted] The Taxpayer may take the position that Operator was never the owner of the Facility Assets, either before or after the restructuring in Date E. In addition, it may contend that Lease is a true operating lease, and thus Sublease is also a true operating sublease. Consequently, the benefits and burdens of ownership always remains with Finance 1. Finance 1 would therefore be entitled to depreciate the Facility Assets, not Finance 2 or Operator. Note that the Ninth Circuit's reasoning in Swift Dodge has been followed, somewhat inconsistently, in later cases. Compare Transamerica Corp. v. United States, 15 Cl.Ct. 420 (Cl. Ct. 1988), 88-2 USTC ¶ 9501, aff'd 902 F.2d 1540 (Fed. Cir. 1990) (leases of title insurance plants held to be true leases despite economic compulsion on part of lessees to exercise purchase options), with Transamerica Corp v. United States, 7 Cl. Ct. 441 (1985), 85-1 USTC ¶ 9210 (1985)(leases of airplanes held to be conditional sales due to bargain purchase option).

In our view, since the Taxpayer's interest in Finance 1 amounts to only c%, it is unlikely to argue that the substance of the Lease is a true operating lease, and thus Finance 1 is the owner of the Facility Assets. Since the Taxpayer reported Operator as the owner of the assets for Federal income tax purposes in Tax Year 1 and Tax Year 2, it is doubtful that the Taxpayer would want to argue against its own reporting position. To do so would result in either equitable estoppel or a violation of a duty of consistency the Taxpayer owes the Service in its reporting. Further, if Taxpayer was right in reporting that Operator was the owner in Tax Year 1 and Tax Year 2, it must explain how the restructuring affected that ownership (so that Finance 2 can be considered the owner in Tax Year 3) rather than leaving ownership unchanged (as follows from the Government's position). [redacted]

[redacted]

[redacted]

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By: ______________________________

GEORGE BAKER
Branch Chief
CC:ITA:07