

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:RFP:SLATL: POSTF 147880-01
KAPalmerino

date: November 27, 2001

to: Ron Pendergrass, Team Manager
Freddi Aliffi, Team Coordinator
Joseph Mastracchio, Revenue Agent

from: Associate Area Counsel Strategic Litigation
LMSB

subject:

Taxable Years [REDACTED]

This is in response to your request that we confirm our previous oral advice that rent and interest expense paid or incurred in connection with a lease-in lease-out transaction ("LILO") should be disallowed under I.R.C § 162.² This memorandum should not be cited as precedent.

Facts

The LILO transaction was brought to [REDACTED]

(the [REDACTED]) by [REDACTED]

in [REDACTED].

[REDACTED] (the [REDACTED]) is a domestic corporation filing a consolidated federal income tax return. The [REDACTED] operates as a [REDACTED].

[REDACTED] ("Equity Investor or [REDACTED]") is a [REDACTED] member. [REDACTED]

[REDACTED] (" [REDACTED] or "Head Lessor") is a body corporate

¹ The case was controlled under the name of [REDACTED], which acquired [REDACTED] in [REDACTED].

² There are four LILO transactions which essentially mirror each other. This advice focuses on the [REDACTED] transaction.

and politic created and existing under and by virtue of a compact between the State of [REDACTED]

[REDACTED],³

[REDACTED] ("the TRUST" or Sublessor") is a business trust formed pursuant to a Trust Agreement⁴ between the Equity Investor with the [REDACTED] a Delaware [REDACTED] corporation. [REDACTED] is the TRUST beneficiary. [REDACTED] is the Trustee of the TRUST for the benefit of the Equity Investor and acts also as Custodian of certain [REDACTED] for parties to the transaction. A Certificate of Trust was filed by [REDACTED] with the State of Delaware on [REDACTED].⁵

[REDACTED] ("the Lender") and [REDACTED] ("the Debt Payment Undertaker") are wholly owned [REDACTED] subsidiaries of the [REDACTED], a domestic corporation filing a U.S. consolidated return. [REDACTED] (the Equity Payment Undertaker) is a [REDACTED] corporation which is wholly owned by [REDACTED].

[REDACTED] is an accommodating or agent [REDACTED] in which the parties to the LILO transaction maintained various accounts which were used to effect transfers of certain funds.

[REDACTED], a [REDACTED] insurance company is a surety for [REDACTED].

On [REDACTED] a number of documents were executed between and among the aforementioned companies in closing the LILO transaction. The principal operational documents of the LILO transaction are:

The Participation Agreement⁶ among [REDACTED] as Head Lessor and Sublessee, [REDACTED] as Equity Investor, [REDACTED] as Lender, [REDACTED]

³ Tab [REDACTED], Acknowledgement Pursuant to 49 C.F.R. § 1177.3

⁴ Tab [REDACTED]

⁵ Tab [REDACTED]

⁶ Tab [REDACTED]

██████████ as Payment Undertaker, the TRUST, as Head Lessee and Sublessor and the ██████████

The Lease Agreement ("the Head Lease") and a Lease Supplement dated ██████████ between ██████████ as owner of ██████████ and the TRUST as Head Lessee under which ██████████ leased the ██████████ to the Head Lessee.⁷ The term of the Head Lease was from ██████████ to ██████████⁸

The Sublease Agreement between the TRUST as Sublessor and ██████████ as Sublessee under which Sublessor as owner of a leasehold interest under the Head Lease, subleased the ██████████ to ██████████.⁹ The Sublease Term ran from ██████████ to ██████████ and the Sublease Renewal Term ran from ██████████ to ██████████.¹⁰ The Sublease is subject to a first priority security interest in favor of the Lender under the Loan and Security Agreement.

The Loan and Security Agreement¹¹ between the TRUST and ██████████ as the Lender under which the Lender loaned \$ ██████████ in exchange for a Loan Certificate (a note) issued by the TRUST, the principal and interest on which was to be repaid according to a schedule attached as Annex ██████████ to the Loan Certificate.¹²

The Tax Indemnification Agreement¹³ between ██████████ and ██████████ which requires ██████████ to make certain payments to ██████████ should the actions of ██████████ cause ██████████

⁷ Tabs ██████████ Lease and Lease Supplement

⁸ Tab ██████████ Section ██████████ Participation Agreement, Appendix ██████████ Tab ██████████
██████████

⁹ Tab ██████████ Sublease and Sublease Supplement

¹⁰ Tab ██████████ Sublease, Section ██████████ Participation Agreement, Appendix ██████████ Tab ██████████ "Definitions and Rules of Usage Relating to the Operative Documents"

¹¹ Tab ██████████

¹² Tab ██████████

¹³ Tab ██████████

██████████ to lose its anticipated tax benefits from the LILLO.

The Equipment Mortgage and Pledge Agreement¹⁴ between ██████████ as Mortgagor and the TRUST as Mortgagee the purpose of which is provide collateral to secure performance by ██████████ its obligations under the Head Lease.

The Debt Payment Undertaking Agreement¹⁵ among ██████████ ██████████ as Debt Payment Undertaker, the TRUST as Sublessor and ██████████ as Sublessee under which ██████████ upon payment of a fee to the Debt Payment Undertaker arranges for the Debt Payment Undertaker to make the payments to the Sublessor or to the Lender (provided the Debt Payment Undertaking Agreement is pledged and collaterally assigned to the Lender pursuant to the Loan Agreement) the amounts denominated as "Payment Amounts" as set forth in in Schedule ██████████

The Guarantee of ██████████¹⁶ in favor of ██████████ as Sublessee and the TRUST by which ██████████ guarantees all obligations of the Debt Payment Undertaker under the Debt Payment Undertaking Agreement.

The Equity Payment Agreement¹⁷ among ██████████ ██████████ and the TRUST under which ██████████, agreed to make the schedule of payments contained in Article ██████████ in consideration of its receipt of payment of the Equity Undertaking Fee of \$ ██████████

The Guarantee of ██████████¹⁸ in favor of ██████████ as Sublessee and the TRUST by which ██████████ guarantees all obligations of the Equity Payment Undertaker under the Equity Payment Undertaking Agreement.

The Account Pledge and Security Agreement¹⁹ from ██████████, as Pledgor, to the TRUST as Pledgee whereby ██████████ pledges

¹⁴ Tab ██████████

¹⁵ Tab ██████████

¹⁶ Tab ██████████

¹⁷ Tab ██████████

¹⁸ Tab ██████████

¹⁹ Tab ██████████

collateral as security for all of Pledgor's obligations and liabilities to the Pledgee under the Equity Payment Agreement, all payment obligations and liabilities of [REDACTED] (a member of the U.S. consolidated group), (" [REDACTED] ") to the Pledgee under the [REDACTED] Letter of Credit, and certain of the Pledgor's obligations.

The Custody Agreement²⁰ among [REDACTED] the TRUST and the [REDACTED] under which [REDACTED] has agreed to deposit certain collateral and to grant a first priority security interest in the Account in order to secure [REDACTED]'s obligations under the Equity Payment Agreement and the obligations of [REDACTED] under the Letter of Credit Agreement.

The Standby Letter of Credit and Reimbursement Agreement²¹ between [REDACTED] and [REDACTED] under which [REDACTED] issues the Letter of Credit in favor of the Letter of Credit Beneficiary, the TRUST or to any transferee beneficiary under the Letter of Credit in accordance with Section [REDACTED]

The Letter of Credit issued at the request of [REDACTED] by [REDACTED] in favor of the TRUST as beneficiary.²²

The Guarantee of [REDACTED]²³ in favor of the TRUST by which [REDACTED] guarantees all obligations of [REDACTED] under the Standby Letter of Credit Agreement.

The Insurance and Indemnity Agreement²⁴ between [REDACTED] a [REDACTED] insurance company, and [REDACTED] in which [REDACTED] agrees to insure all [REDACTED]'s payments under the Sublease through the issuance of the Financial Guarantee Insurance Policy.²⁵

²⁰ Tab [REDACTED]
²¹ Tab [REDACTED]
²² Tab [REDACTED]
²³ Tab [REDACTED]
²⁴ Tab [REDACTED]
²⁵ Tab [REDACTED]

On [redacted] acting through the TRUST entered into a Head Lease and Lease Supplement to lease [redacted] with a fair market value of \$ [redacted].²⁶ The term of the Head Lease was from [redacted] to [redacted].²⁷

Under the Head Lease, [redacted] was required to make an Advance Rent Payment on the closing date of \$ [redacted] and to make a Deferred Rent Payment due [redacted] years after the expiration of the Head Lease.²⁹ The Head Lessee's liability for the Advanced Rent Payment is limited under section [redacted] of the Head Lease to amounts the TRUST receives from the Equity Investor as the Equity Investor's Commitment and the amount received by the TRUST from the Lender as the Lender's Commitment.³⁰

The origin of the funds used to make the Advanced Rent Payment came from two sources: [redacted] made an Equity Investor Commitment (contribution) of \$ [redacted] and [redacted] through the TRUST borrowed \$ [redacted] from the Lender, who maintained an account at [redacted]. The sums were deposited in the TRUST'S account which was also maintained with [redacted]. Then the funds were transferred as directed by [redacted].

The loan was repayable beginning [redacted]. Neither principal nor interest payments were required between [redacted] and [redacted]; interest accrued and was added to principal during this period. Payments were required each year on [redacted] between [redacted] and [redacted]. Between [redacted] and [redacted] no interest or principal was due, interest merely accrued and was added to principal. The outstanding balance was scheduled

²⁶ Tabs [redacted]

²⁷ Tab [redacted] page [redacted] -- "[redacted]"

²⁸ Tab [redacted], Letter from [redacted] to [redacted] instructing [redacted] to transfer \$ [redacted] from the account of the TRUST as directed by [redacted].

²⁹ Head lease, Tab [redacted] Schedule [redacted]

³⁰ Id.

to be repaid on [REDACTED].³¹

[REDACTED] was protected from risk of loss for its Equity Commitment Amount because as a condition for [REDACTED] and the TRUST entering into the Participation Agreement, [REDACTED] was required to procure a letter of credit in favor of the TRUST to cover all of the TRUST's obligations to [REDACTED] under all of the operative documents. Also, under the Equity Payment Agreement (see below) [REDACTED] was guaranteed a return of its equity investment plus interest.

As collateral for the loan the Lender was granted a first security interest in certain rights and property owned by the TRUST or acquired and subjected to the Sublease in addition to all of the TRUST'S rights in any of the Operative Documents including the TRUST'S right to receive any moneys thereunder.³²

The \$ [REDACTED] was directed by [REDACTED], pursuant to the Debt Payment Undertaking Agreement between [REDACTED] and [REDACTED] and the Equity Payment Undertaking Agreement between [REDACTED] and [REDACTED] to be transferred in two tranches to the account of [REDACTED] (maintained by [REDACTED] in the amount of \$ [REDACTED] and to the account of [REDACTED] (also maintained by [REDACTED] in the amount of \$ [REDACTED].³³

On [REDACTED], of the \$ [REDACTED] received by [REDACTED], \$ [REDACTED] was utilized by [REDACTED] to purchase U.S. Treasury Strips in the face amount of \$ [REDACTED] (Series D dated [REDACTED]) in accordance with the Equity Payment Agreement and the Custody Agreement.³⁴ The balance, \$ [REDACTED] was returned to [REDACTED] as amounts of excess funds.³⁵

³¹ Tab [REDACTED] Annex [REDACTED] to Loan Certificate.

³² Tab [REDACTED] Loan and Security Agreement, "Granting Clause."

³³ Tab [REDACTED], Letter from [REDACTED] ([REDACTED]) to [REDACTED] dated [REDACTED].

³⁴ Tab [REDACTED], [REDACTED] - [REDACTED] Closing Script

³⁵ See attachment to fax dated [REDACTED] from [REDACTED] to [REDACTED] of [REDACTED].

Under the Equity Payment Agreement upon receipt of payment of the Equity Undertaking Fee of \$ [REDACTED] from [REDACTED] [REDACTED] agreed to make certain payments to the TRUST. [REDACTED] agreed to pay to [REDACTED] either the Termination Amount³⁶ or the amounts as reflected in Schedule [REDACTED] to the Equity Payment Agreement. The Schedule [REDACTED] amounts were due and payable for [REDACTED] successive quarters with the first payment due on [REDACTED] [REDACTED], a date which coincides with the end of the Basic Sublease Term and the beginning of the Sublease Renewal Term. The total of such amounts equal the \$ [REDACTED] that was utilized by [REDACTED] to purchase U.S. Treasury Strips in the face amount of \$ [REDACTED] plus the interest earned on those securities between their purchase date and [REDACTED]. As a result, [REDACTED] is guaranteed, in one form or another, to recover its initial equity investment³⁷ plus the interest earned on that investment.

Under the Debt Payment Undertaking Agreement between [REDACTED] [REDACTED] and the TRUST, the TRUST assigned its interest in the Debt Payment Undertaking Agreement to the Lender, [REDACTED] which in turn obtained a security interest in that interest as security for the loan made by the Lender to the TRUST. In essence, the funds that originated as a loan from the Lender, under the Loan and Security Agreement circuitously flowed back to the Lender, thereby eliminating the Lender's risk.

Under the Sublease, [REDACTED] has the option to purchase the Head Lessee's rights under the Head lease at the end of the Basic Sublease Term. In the event of failure of the [REDACTED] to exercise that option, [REDACTED] has three options: (1) to cause the Sublease to be extended for the Sublease Renewal Term, (2) to cause a Successor Lessee to enter into a Successor Sublease in respect of the Equipment, or, (3) to cause the Sublessee to deliver all of the Equipment.³⁸

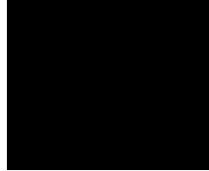
The purchase option price is equal to the following percentages of the fair market value of the lease property

³⁶ Tab [REDACTED], Equity Payment Agreement, Article [REDACTED] Definitions

³⁷ Minus the \$ [REDACTED] participation fee retained by [REDACTED].

³⁸ Tab [REDACTED], Sublease, Section [REDACTED]

payable on the following dates:³⁹



These amounts and the payment dates coincide with the amounts and the payment dates that [REDACTED] is required to pay to [REDACTED] as reflected in Schedule [REDACTED] to the Equity Payment Agreement.⁴⁰

Under the Equity Payment Undertaking Agreement, [REDACTED] is required to pay to [REDACTED] either the Termination Amount⁴¹ or the amounts as reflected in Schedule [REDACTED] to the Equity Payment Agreement. The amounts reflected in Schedule [REDACTED] to the Equity payment Undertaking Agreement are designed to cover the purchase option amounts due under the Sublease Purchase Option should [REDACTED] exercise its Purchase Option under the Sublease. If the Sublease Purchase Option is exercised, [REDACTED]'s Deferred Rent obligation under the Head Lease is extinguished.

[REDACTED] has received outside legal advice from different law firms under the laws of the [REDACTED] and of [REDACTED] that [REDACTED] has the legal right and power to enter into and to perform each of its duties and obligations under the Operative Documents.⁴² Each of those opinions, is identical and is qualified with the exact same language:

Our opinions in paragraph 2 are further

³⁹ Tab [REDACTED] Sublease, Exhibit [REDACTED]

⁴⁰ The additional \$ [REDACTED] required to be paid to the Taxpayer on [REDACTED] which is not a part of the purchase option schedule of payments is the difference between the value of the Treasury Strips purchased for \$ [REDACTED] on [REDACTED] and their value on [REDACTED]. After the payment of the \$ [REDACTED], the remaining value of the Treasury Strips is equal to the equivalent of \$ [REDACTED] paid each quarter beginning [REDACTED] through [REDACTED].

⁴¹ Tab [REDACTED], Equity Payment Agreement, Article [REDACTED], Definitions

⁴² Tabs [REDACTED], [REDACTED]

subject to qualification that certain rights, remedies, waivers and other provisions of the [REDACTED] documents may not be enforceable...

Additionally, the [REDACTED] approved this LILO on the condition that with respect to the [REDACTED] subject to the LILO transaction, that "[REDACTED] will be able to assure continued use of the equipment in [REDACTED] during the Lease Term as required by the [REDACTED]"

CONCLUSION

The LILO transaction lacks economic substance and should not be respected for federal income tax purposes. Accordingly, the deductions taken by [REDACTED] under I.R.C. §§ 162 and 467 with respect to lease payments incurred and the interest deductions taken pursuant to I.R.C. § 163 in connection with the loan incurred to prepay the lease payments under the LILO should be disallowed.

LAW AND ANALYSIS

1. Economic Substance

To be respected, a transaction must have economic substance separate and distinct from the economic benefit achieved solely by tax reduction. If a taxpayer seeks to claim tax benefits, which were not intended by Congress, by means of transactions that serve no economic purpose other than tax savings, the doctrine of economic substance is applicable. United States v. Wexler, 31 F.3d 117,132, 124 (3d Cir. 1994); Yosha v. Commissioner, 861 F. 2d 494, 498-499 (7th Cir. 1988), aff'g Glass v. Commissioner, 87 T.C. 1087 (1986); Goldstein v. Commissioner, 364 F.2d 734 (2nd Cir.1966), aff'g 44 T.C. 284 (1965); Weller v. Commissioner, 31 T.C. 33 (1958), aff'd, 270 F.2d 294 (3d Cir. 1959); ACM Partnership v. Commissioner, T.C. Memo. 1997-115, aff'd in part and rev'd in part, 157 F.3d 231 (3d Cir. 1998).

Whether a transaction has economic substance is a factual determination. United States v. Cumberland Pub. Serv. Co., 338 U.S. 451, 456 (1950). This determination turns on whether the transaction is rationally related to a useful non-tax purpose that is plausible in light of taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions. The utility of the stated purpose and the rationality of the means

chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry. Cherin v. Commissioner, 89 T.C. 986 993-94 (1987); ACM Partnership, supra. A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the non-tax benefits would be at least commensurate with the transaction costs. Yosha, supra; ACM Partnership, supra.

In determining whether a transaction has economic substance so as to be respected for tax purposes, both the objective economic substance of the transaction and the subjective business motivation must be determined. ACM Partnership, 157 F.3d at 247; Horn v. Commissioner, 968 F. 2d 1229, 1237 (D.C.Cir. 1992), Casebeer v. Commissioner, 909 F.2d 1363 (9th Cir.1990). The two inquiries are not separate prongs, but are interrelated factors used to analyze whether the transaction had sufficient substance apart from its tax consequences, to be respected for tax purposes. ACM Partnership, 157 F.3d at 247; Casebeer, 909 F.2d at 1363.

Courts have recognized that offsetting legal obligations, or circular cash flows, may effectively eliminate any real economic significance of the transaction. Knetsch v. United States, 364 U.S. 361 (1960). In Knetsch, the taxpayer repeatedly borrowed against increases in the cash value of a bond. Thus the bond and the taxpayer's loans constituted offsetting obligations. As a result, the taxpayer could never derive any significant benefit from the bond. The Supreme Court found the transaction to be a sham, as it produced no significant economic effect and had been structured only to provide the taxpayer with interest deductions.

In Sheldon v. Commissioner, 94 T.C. 738 (1990), the Tax Court denied the taxpayer the tax benefits of a series of Treasury bill sale-repurchase transactions because they lacked economic substance. In the transactions, the taxpayer bought Treasury bills that matured shortly after the end of the tax year and funded the purchase by borrowing against the Treasury bills. The taxpayer accrued the majority of its interest deduction on the borrowings in the first year while deferring the inclusion of its economically offsetting interest income from the Treasury bills until the second year. The transactions lacked economic substance because the economic consequence of holding the Treasury bills was largely offset by the economic cost of the borrowings. The taxpayer was denied the tax benefit of the transactions because the real economic impact of the transactions was "infinitesimally nominal and vastly insignificant when considered in comparison with the

claimed deductions." Sheldon, 94 T.C. at 768.

In ACM Partnership v. Commissioner, 157 F.3d 231 (3rd Cir. 1998) the taxpayer entered into a nearly simultaneous purchase and sale of debt instruments. Taken together, the purchase and sale "had only nominal, incidental effects on [the taxpayer's] net economic position." ACM Partnership, 157 F.3d at 250. The taxpayer claimed that, despite the minimal net economic effect, the transaction had economic substance. The court held that the transactions that do not "appreciably" affect a taxpayer's beneficial interest, except to reduce tax, are devoid of substance and are not respected for tax purposes. ACM Partnership, 157 F.3d at 248. The court denied the taxpayer the purported tax benefits of the transaction because the transaction lacked any significant economic consequences other than the creation of tax benefits.

In other leasing transactions, leases have been respected despite the presence of credit support for their payment, such as third-party rent guarantees. See Torres v. Commissioner, 88 T.C. 702 (1997); Cooper v. Commissioner, 88 T.C. 84 (1987); Gefen v. Commissioner, 87 T.C. 1471 (1986). On the other hand, a fully defeased lease arguably is not "compelled or encouraged by business and regulatory realities" as required by Frank Lyon v. Commissioner, 435 U.S. 561, 583 (1978).

Moreover, claims of pre-tax profit are not dispositive. There is some precedent that economic substance for a lease transaction will be satisfied if there is "some modicum" of economic substance, which may mean "some modicum" of pre-tax profit. See Rice's Toyota World, Inc. v. Commissioner, 81 T.C. 184 203 n.17 (1983) aff'd in part and rev'd in part on other grounds., 752 E.2d 89 (4th Cir. 1985). See Estate of Thomas v. Commissioner, 84 T.C. 412, 440 n.52 (1985). In Hines v. Commissioner, 912 F.2d 736 (4th Cir. 1990) the Fourth Circuit found that a leasing transaction was a sham. In doing so, it described a \$17,000 profit potential as "minimal" on an eight-year investment of \$130,000. The court found evidence of tax motivation in the offsetting obligation to pay rent and debt service. The transaction also involved the use of related parties to avoid section 465. Under these facts, the court found that "the tax tail began to wag the dog." Hines, 912 F.2d at 741. Thus, small profits on a lease transaction may be overlooked when tax considerations have taken over the transactions. See also Pacheco v. Commissioner, T.C. Memo 1989-296.

2. Application to LILO Transaction

A LILO transaction that lacks economic substance will be

recharacterized for federal income tax purposes based on the substance of the transaction. Rev. Rul. 99-14, 1999-13, I.R.B. 3, citing Gregory v. Helvering, 293 U.S. 465 (1935).

Under the facts of this transaction, it is our view that the transaction lacks economic substance because the transaction lacks the potential for any significant economic consequences other than the creation of the tax benefits.

There are no significant economic consequences to the Taxpayer. When one boils away the stream of purported transactions, in substance what has happened is that the Taxpayer has incurred an up front expense, consisting of certain fees and the payment of the present value amount to [REDACTED], in exchange for the tax benefits which it has derived from this transaction.

There is little or no financial exposure to [REDACTED]. [REDACTED] is protected from risk of loss with respect to its initial investment of funds because [REDACTED] is required to maintain a letter of credit in favor of the TRUST for the aggregate amount of obligations of [REDACTED] to the TRUST under all of the Operative Documents. On the closing date, [REDACTED], the Lessor/Sublessee, was required to deposit \$ [REDACTED] of the amount it received under the advanced rent payment to [REDACTED]. [REDACTED] was the Custodian of those funds and was to act as required by the party signatories to the Operative Documents of the Participation Agreement, who are the same parties to the LILO transaction.

Under the Equity Payment Agreement upon receipt of payment of the Equity Undertaking Fee of \$ [REDACTED] from [REDACTED] [REDACTED] agreed to make certain payments to the TRUST. [REDACTED] agreed to pay to [REDACTED] either the Termination Amount or the amounts as reflected in Schedule [REDACTED] to the Equity Payment Agreement. The Schedule [REDACTED] amounts were due and payable for [REDACTED] successive quarters with the first payment due on [REDACTED], a date which coincides with the end of the Basic Head Lease Term and the beginning of the Sublease Renewal Term. The total of such amounts equal the \$ [REDACTED] that was utilized by [REDACTED] to purchase U.S. Treasury Strips plus the interest earned on those securities between their purchase date and [REDACTED]. As a result, [REDACTED] is guaranteed, in one form or another, to recover its initial equity investment plus the interest earned on that investment.

This series of transactions had no appreciable financial

risk to any of the other parties.⁴³ The flow of funds, including the loan by ██████████ to the TRUST for the benefit of ██████████, the payment by the TRUST to ██████████ under the Head Lease, the payments by ██████████ under the Sublease and the payments by the TRUST under the loan represent a circular cash flow. The TRUST borrows from ██████████ controlled companies, which send the funds to ██████████ which in turn deposits the funds at the ██████████ controlled companies. The ██████████ controlled companies then make payments on behalf of ██████████ to the TRUST equal to the obligation of ██████████ to the TRUST under the Sublease. The ██████████ controlled companies then take the funds received on behalf of the TRUST from ██████████ and pay the obligation of the TRUST to itself under the loan.

██████████'s rights under the Payment Undertaking Agreement are assigned to the Lender as security for the loan obtained by the TRUST from ██████████. The Payment Undertaking Agreement provides no additional security to the Lender in connection with the loan. The Lender already has a security interest in the Head Lease, the Sublease and all of rights of ██████████ under the Operative Documents.

The economic reality of this series of interrelated transactions is that all amounts are, at all times, under the control of ██████████ controlled companies and are being used to fund the payments of ██████████ to the TRUST under the Sublease and the payments of the TRUST to the Lender under the loan. Under Paragraph ██████████ of the Loan and Security Agreement Granting Clause the Sublessor assigned the rent payments due to it from ██████████ to the Lender under the Sublease, and, under Section ██████████ of the Loan and Security Agreement payments on the loan were to be made solely from the collateral which consisted of the rents received by ██████████ under the Sublease. Thus the Lender is paying to itself amounts due under the loan. This negates any contention that the Lender is at risk for amounts loaned to the TRUST.

The amounts deposited with ██████████ and invested in U.S. Treasury securities also "defeased" the Sublessee's (██████████s) obligations as and when such obligations must be paid pursuant the terms of the various Operative Documents

The different options presented at the end of the Sublease do not present real economic risk to any of the parties. If the buyout option is exercised by ██████████, ██████████ purchases

⁴³ To the contrary, the Lender, and the various ██████████ companies received fees for their services and ██████████ in essence, was paid in excess of \$ ██████████ for sale of the tax benefits.

██████████'s interest in the Head Lease at the predetermined price set as of ██████████ the closing date of the transaction. The purchase price is equal to the amount of funds already designated in the Custodial Account to satisfy this purpose. The TRUST's Deferred Rent obligation under the Head Lease disappears. The fact is that under this option, neither party to the transaction is required to pay any additional funds.

If the buyout option is not exercised, ██████████ has three options: (1) to require ██████████ to renew the Sublease; (2) to find a third party to sublease the Equipment at then prevailing market rents for the Sublease Renewal Term or (3) to require the Sublessee to deliver the undivided interest in the ██████████ to the Sublessor (the Return Option).

In making a decision to exercise or not to exercise the buyout option, ██████████ would have to considered the alternatives, including a financial analysis of the cost of the various alternatives. Under the first option in which ██████████ is required to renew the Sublease, Section ██████████ of the Sublease articulates the obligations of ██████████. In summary, the Sublease Renewal Option appears to merely be an extension of the existing arrangement and imposes no additional economic burden on ██████████ because the sublease rent obligations are non-existent⁴⁴ and ██████████ is provided another opportunity to exercise its purchase option. Therefore, there appears to be little substance to this option, in the sense that it does not provide a meaningful alternative.

The liklihood of finding a Third-Party sublessee or of returning the equipment to ██████████ as opposed to the buyout option being exercised is unlikely. The feasibility of either of these options is questionable, especially in light of the requirements imposed by the ██████████ regarding the operation of the equipment. In fact, based on statements given by ██████████ personnel in an interview,⁴⁵ we are confident that neither of these options was viable.

Nor for that matter, had ██████████ done any "homework" on the feasibility of either of these options other than to have received the legal opinion that the actions called for in the operative documents were legal and did not violate ██████████'s Charter. No financial analysis was done as to the potential

⁴⁴ Tab ██████████ Lease, Schedule ██████████ Debt Service Amounts

⁴⁵ ██████████ at ██████████'s offices, ██████████


cost to [REDACTED] of any of the options, no consideration was given to the projected fair market values of the [REDACTED] at the end of either the Headlease or the Sublease term, and no thought was given to the feasibility of turning the [REDACTED] over to the Taxpayer. The bottom line was that [REDACTED] knew that it would receive a sum up front for participating in this LILLO. It was protected from any financial risk and from any risk of violating its covenants with the federal government resulting from the federal financing of the [REDACTED]. Through its ability to exercise the purchase option, which would not require any out-of-pocket cost, the status quo would be maintained, i.e., [REDACTED] would continue to own and operate the [REDACTED] as though nothing had changed.

Accordingly, under the principles of Rev. Rul. 99-14 and the legal and factual analysis, above, we conclude the LILLO lacks economic substance and should not be given effect for federal income tax purposes. No deductions for expenses arising out of the transaction including the Advanced Rents are deductible by [REDACTED] under I.R.C. §§ 162 and 467. And no interest deduction is permissible under I.R.C. § 163 with respect to interest paid by [REDACTED] to the Lender with respect to the loan.

Please do not hesitate to contact the undersigned at (404)338-7852 if we can be of further assistance.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for or views.

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