Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:CTM:SEA:POR:POSTF-155944-01
JMDewey

date: November 6, 2001

to: Team Manager LMSB 1423
Attn: Revenue Agent Kelly Bowman

from: Associated Area Counsel
(CC:LM:CTM:Sea:Por)

subject: **Technical Assistance - [redacted] Synthetic Lease Arrangement**

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

INTRODUCTION

You have requested our assistance in reviewing the Synthetic Lease arrangement that [redacted], a wholly-owned subsidiary of the above-named taxpayer, entered into in [redacted] regarding [redacted] aircraft. [redacted] and [redacted] booked the transaction as a lease, but treated it as a financed purchase of the aircraft for tax purposes. We have reviewed the materials you provided and conclude, at least provisionally, that the taxpayer properly reported the arrangement as a purchase on its consolidated tax returns. However, we suggest that further factual development be done to substantiate and to obtain a better understanding of some of the details of the arrangements described in the [redacted] Commitment Letter that are either not covered or not fully explained by the Lease document dated [redacted] This should be done in order to show whether, under the contracts actually executed, the risks and duties incurred by [redacted] were those of a purchaser (owner) rather than a lessee, and whether [redacted] properly reported all the expenses incurred in a manner consistent with this characterization.

FACTUAL SUMMARY

Based on the documentation provided, the relevant facts are as follows: first obtained use of the aircraft at issue in . The aircraft were owned by and had been entered into leases with for each of the aircraft for maximum terms of -years (months plus -year extensions). Upon expiration of each lease, the equipment was to be returned in a well-defined good operating condition and with a specified maintenance record. paid rent and all insurance, tax, maintenance and repair costs. was also required to pay, or to provide letters of credit to insure the payment (if necessary) of "commitment fees" and "supplemental rent." The commitment fees were analogous to rental deposits, satisfied either by a letter of credit or by payments which were refundable when the aircraft was returned in the requisite good condition. The supplemental rent, due each quarter under the leases, varied depended on how heavily the airframe, engines and landing gear were used (measured in terms of flight hours and take-off/landing cycles). Essentially, supplemental rent was based on expected heavy maintenance costs, and if performed and paid for the required maintenance, it would not then be required to actually pay these supplemental amounts.

In fact, the aircraft were not returned to Instead, upon termination of the leases, entered into purchase agreements for the planes-- in and in . No down payments or cash investments were made by or other related entities pursuant to these initial purchase agreements. Instead, the agreements were subsequently assigned to , and this trust purchased the aircraft and became owner and lessor.

According to the Commitment Letter and the Lease document, the organization agreed to partly fund and to obtain funding for the purchase of the aircraft, by establishing the lessor Trust (Trustee, which would hold title to the equipment and lease it to The purchase price for the aircraft was $ and was funded by , its associated entities and, through the issuance of commercial paper, by other investors. The Trust executed a Note for approximately % of the "lessor's cost" (the principal paid) to the "primary lender," (owned and administered by . in turn, borrowed this amount from other sources, including (who agreed to provide a "liquidity facility" and to execute a parallel purchase commitment to directly fund up to of the principal, if required). The remaining % of the "lessor's

cost" was obtained by issuing Certificates to [redacted] and its assignees ([redacted]). The role of [redacted] was that of guarantor for the performance of the lessee, [redacted] (to be backed up by [redacted] if required). We attach as Exhibit A, a diagram which shows the complex relationship of the parties to these arrangements.

The lease and other agreements provide that the Trust would repay the Note, with interest, over a [redacted]-year "amortization period." The periodic (quarterly) payments on the Note included "interest" and principal. The "interest" portion included both (real) interest and "fees" (dealer, program, administrative, facility and [possibly] arrangement fees). The Trust was also required to make quarterly payments of "yield," over a [redacted]-year period, on the Certificates it had issued.

The maximum term of the Lease was also [redacted] years, made up of a [redacted]-year base period and [redacted]-year renewal options. The quarterly payments of rent due under the Lease (in the amount of $[redacted]) were designed to cover all the Trust's payments for interest, fees and yield, plus (by the end of [redacted] years) approximately [redacted]% of the principal. The remaining principal due upon expiration of the Lease was to be satisfied either by (1) purchase of the aircraft by [redacted] at a given "residual value" (the fixed purchase price option) or by (2) sale of the aircraft to a third party. Under the latter option, if the price received was less than the "residual value," [redacted] would have to pay the difference, but if the purchase price was greater than the "residual value", [redacted] would keep the difference. As far as we can ascertain, no option was provided, in the Lease or other documents, which would allow the aircraft to be returned to the lessor Trust at end of the Lease term.

Although the agreement between the Trust and [redacted] was in the form of a lease, the entire arrangement appears to be, in substance, a refinancing and conditional sale of the [redacted] used aircraft. The Commitment Letter states it to be the intention and agreement of the parties that the Lease would be treated as such for financial purposes, but that for tax purposes (and FAA registration), [redacted] would be considered the owner of the aircraft.

DISCUSSION

Whether a contract which is called a lease should be treated as such for tax purposes, or be classified as some other type of arrangement, such a conditional sale, depends on the substance of the transaction, and not its form. Even where such an arrangement is treated as a lease under GAAP principles, it may

not be a lease for tax purposes. See Frank Lyon Co. v. U.S., 435 U.S. 561 (1978), Swift Dodge v. Commissioner, 692 F.2d 651 (9th Cir. 1982), and many other cases; also see Rev. Proc. 75-21, 1975-1 C.B. 715 and Rev. Proc. 2001-28, 2001-19 I.R.B. 1160. Similarly, an agreement claimed to be a conditional sale may be a lease for tax purposes if the "seller" retains most of the attributes of ownership, and is, in substance, a lessor. See Swift Dodge, supra. Thus, in analyzing such an arrangement, consider whether it is the purported "lessor" that bears the burdens or may reap the benefits of asset ownership, or whether these are held by the "lessee."

Under the terms of the ████ Lease arrangement, the expenses of operating and maintaining the aircraft up to FAA standards are to be borne by ███. However, this factor is not determinative--a "triple net lease" may still be considered a lease for tax purposes. Also, whether or not an arrangement is fully leveraged, as this one appears to be, is not determinative. Although, having an initial equity interest is an indicator of ownership, it is not a requirement. See Rev. Procs. 75-21 and 2001-28.

In characterizing an arrangement for tax purposes, the most important factor to consider is which party, under the terms of the operative contract(s), bears most of the risks of loss or will reap the benefit of a subsequent increase in asset value. Under the ████ lease arrangement, ███ bears the risk of loss if the aircraft is damaged or if it diminishes in value more rapidly than was anticipated at the time the parties entered into the lease arrangement. Under the contract, the lessor (and through it, the primary lender and the Certificate holders) is entitled to receive a fixed amount (measured by the pre-set "residual value") upon termination of the lease and/or the disposal of the aircraft, If the aircraft is sold to a third party, ███ is required to make up any difference between the sales price and the "residual value."

███ will also benefit from any unexpected increase in value of the aircraft. Thus, if the aircraft were to be sold for a price greater than the "residual value" ███ would be entitled to keep the excess. Moreover, there appears to be no option under the lease (or under any of the other "operative agreements") which would allow the Trust simply to take possession of the aircraft, then operate it or sell it for its own advantage, should the value of the assets unexpectedly increase. Of course, under circumstances where ███ is in default under the contract, one remedy available to the Trust is to take possession of the aircraft. However, this type of remedy is one which would also be included in a conditional sale arrangement, or would be

accorded the lien holder in a traditional mortgaged sale of assets. Thus, its availability under default circumstances is not an indicator of ownership.

We conclude that the ████ lease arrangement here at issue, was properly treated for tax as a financed sale, with a "balloon" payment due at the end. As in any such arrangement, ████ will then have the option of selling the equipment and using the proceeds to make the final payments due under the contract.

RECOMMENDATIONS

Since the ████ leasing arrangement is not a lease for tax purposes, but is, in substance, a mortgaged, conditional sale, tax treatment for the expenses incurred by ████ in order to obtain the agreement must be consistent with this characterization. Thus, we suggest that you further develop the facts concerning the amount and nature of the different fees incurred by ████ whether paid at the outset or as part of the periodic payments due under the lease. If these amounts do not represent true interest, but rather , comprise the cost of obtaining financing and paying for administrative services, they should be capitalized.

Also, our conclusions concerning the substantive nature of this arrangement, and its proper tax treatment, are tentative. This is because we have examined only one of the "Operative Agreements" which govern the series of transactions making up the arrangement. According to the definitions attached to the Lease, the "Operative Agreements" are: the Bill of Sale, Participation Agreement, Trust Agreement, Notes, Certificates, Loan & Security Agreement, Loan Supplements, Liquidity Documents, Assignment Agreements, Guaranty Agreement, Lease, Lease Supplements, Purchase Agreements, Purchase Agreement Assignment, and Fee Letter. The taxpayer has provided you with only one of these documents (the Lease), and the Commitment Letter. Also, page ██ of the Lease, which contains the initial discussion on the end-of-term options, is missing. We think it possible that there may be provisions contained in the missing documents which might alter our analysis of this matter, and we recommend that you obtain copies of all these documents. In particular we are concerned about the derivation and tax treatment of "fees," which are fully explained, apparently, in the Fee Letter, and, also, the nature of the sales agreements, originally entered into with ████ which ████ then assigned to the Trust. We would also like to know the exact provisions, in the lease and elsewhere, which establish the end-of-term options. The Participation Agreement and the Trust Agreement, as well as the "missing" page

of the Lease, surely contain relevant information in this regard.

If you have any questions or comments about this memorandum, please call Attorney Julia Dewey at (503) 326-3100, extension 248.

JULIA M. DEWEY
Attorney (LMSB)

Attachment