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

OFFICE OF
CHIEF COUNSEL

CC:INTL:6
UILC: 923.00-00, 924.00-00

Number:**199920019**
Release Date: 5/21/1999

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

DATE: February 12, 1999

MEMORANDUM FOR:

FROM: Elizabeth G. Beck, Senior Technician Reviewer, CC:INTL:6

SUBJECT:

This memorandum responds to your request for Field Service Advice, dated April 29, 1997, concerning leases entered into by a foreign sales corporation (FSC) subsidiary of USCorp. Our advice is limited to the "grantor trust" transaction described in your transmittal memorandum. However, many of the principles herein also apply to other, similar transactions entered into by the same taxpayer. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND

a =
b =
c =
d =
e =
f =
g =
h =
i =
j =

k =
l =
m =
n =
o =
p =
q =
r =
s =
t =
u =
v =
Bank A =
Bank B =
City A =
Date A =
Date B =
Date C =
Date D =
Date E =
Date F =
Date G =
Date H =
Entities =
FSC1 =
FSC2 =
FSC3 =
Lessee =
Manufacturer =
Manufacturer FSC =
Merchandise =
Jurisdiction =
Trust =
USCorp. =
USSub. =
Year A =
Year B =
Year C =
Year D =

ISSUE

Identification of legal theories to eliminate or ameliorate the mismatch involved in a U.S. corporation's deduction of all interest from a borrowing, the proceeds of which were contributed as equity to a foreign sales corporation (FSC) and used by the FSC to acquire Merchandise for lease to an unrelated party. The FSC obtained FSC benefits for the rental income, unreduced by interest expense, and the rental income was distributed through a trust to service the debt. In addition, the FSC claimed depreciation deductions based on its ownership of the Merchandise.

CONCLUSION

The mismatch of income and deductions may be eliminated if the Service can establish that the purchase and lease of the Merchandise in substance constitutes a financing by the FSC of a purchase of the Merchandise on the part of the putative lessee. In the alternative, the taxable income of FSC1 would be increased if the Service can demonstrate that the FSC must depreciate the Merchandise based on the entire lease term rather than the basic lease term. Even though there would be an increase in the exempt foreign trade income for FSC1, there would also be an increase in non-exempt foreign trade income, subjecting FSC1 to additional tax.

FACTS

USCorp. is a domestic corporation. In early Year A, USCorp. established three FSCs pursuant to the law of Jurisdiction: FSC1, FSC2, and FSC3. These FSCs purchased Merchandise for lease to non-U.S. entities pursuant to long-term leases. Of the three FSCs, only FSC1 is addressed in this Field Service Advice.

In Date A, USSub., a wholly-owned domestic subsidiary of USCorp. and a member of the same consolidated group, established a grantor trust, Trust, appointing Bank A as Trustee. The trust was funded with an initial capital contribution of $a. In Date B, Trust borrowed $b from the City A office of Bank B, and pledged the stock of FSC1 as security for the loan. The loan, which was without recourse to USSub., matures on Date C. The interest rate was set at c% per annum for the initial term of the loan (until Date D), at which point it is calculated based on the LIBOR rate. Pursuant to the loan agreement, Trust invested in FSC1 the original equity contribution of $a received from USCorp. as well as the $b proceeds of the Bank B loan.

FSC1 used $d of the funds obtained from Trust to purchase Merchandise from Manufacturer FSC, a foreign sales corporation and a wholly-owned subsidiary of Manufacturer. The purchase was pursuant to assignment of a pre-existing contract between Manufacturer and Lessee, an unrelated, non-U.S. entity. Lessee paid FSC1 an "assignment adjustment" of $e.

On or about Date E, FSC1 executed a f-year lease of the Merchandise to Lessee. The lease specified a "basic" term of g years and an additional, "replacement" term consisting of the remainder of the lease term. The lease contained a fixed purchase-price option at the end of h years, as well as other options whereby Lessee might acquire the Merchandise during the term of the lease. In general, at the end of the initial term, Lessee was required either to purchase the Merchandise or to provide a qualified substitute lessee which would assume the replacement lease term.

The lease requires semi-annual rent payments to FSC1. FSC1 immediately passes on these rent payments to Trust as distributions with respect to its stock (dividends or returns of capital), and Trust makes debt-service payments due on the loan from Bank B. For discrete annual periods over the total lease term, the rent payments received by FSC1 under the lease are nearly identical in amount and timing to the debt-service payments due with respect to the Bank B loan.

The lease is a net lease. That is, Lessee is responsible for insurance, maintenance, and taxes, and indemnifies FSC1 against loss of the Merchandise. The first lease payment of $i was due in Date F. The next rental payment of $j was due in Date G. Thus, total rent due in the first year was $k. Total rent due in the next year (in semi-annual payments of $l and $m) was $n. Thereafter, rent was due in annual payments on Date H of each year, as follows: Years B: $o, Year C: $p, and Years D: $q.

The following Federal income tax treatment is claimed for the transaction. FSC1 is treated as the owner of the Merchandise for U.S. tax purposes, and claims all depreciation deductions. Depreciation is based on a recovery period of approximately r years, in accordance with I.R.C. § 168(g)(3)(A).[1] We also presume that the following tax treatment is claimed. FSC1 uses the section 482 pricing method pursuant to I.R.C. § 925(a)(3), and 30% of its income is exempt, 70% is non-exempt. The depreciation deduction is allocated and apportioned between the exempt and non-exempt income of FSC1, pursuant to I.R.C. § 921(b).

USCorp., as parent of the consolidated group which includes Trust, claims 100% of the interest deductions with respect to the Bank B loan. The net non-exempt income of FSC1 is reported as Subpart F income (foreign base company shipping income as defined in I.R.C. § 954(f)) on USCorp.'s consolidated U.S. income tax return, pursuant to I.R.C. § 951(e)(2). Distributions of FSC1's non-exempt income constitute previously-taxed income, which upon repatriation to USCorp., gives rise to an adjustment pursuant to I.R.C. § 959(a).

---

[1] Because the Merchandise is leased to a "tax-exempt entity" within the meaning of I.R.C. § 168(h)(2)(A)(iii) (a foreign corporation), the recovery period may not be less than 125% of the lease term. I.R.C. § 168(g)(3)(A). In this case, FSC1 determined the recovery period by reference to the basic lease period.

Finally, USCorp. claims a 100% dividends-received deduction for dividends paid by FSC1 with respect to its exempt foreign trade income, pursuant to I.R.C. § 245(c)(1)(A).

DISCUSSION

Assuming that the necessary factual basis can be established, the income tax consequences of the transaction may be scrutinized under the following approaches:

1. Benefits and burdens analysis: if the Lessee in substance owns the Merchandise, depreciation deductions may not be available to FSC1, and rental payments and payment of the purchase-option price may be re-cast for Federal income tax purposes as principal and interest, which do not constitute "foreign trading gross receipts."

2. Adjust depreciation recovery period: assuming that FSC1 owns the Merchandise, the recovery period may be increased to reflect the full term of the lease (i.e., basic plus replacement lease terms), pursuant to I.R.C. § 168(i)(3)(A).

Issue 1: Benefits and Burdens of Ownership

Under this theory, the issue is whether the Lessee is in substance the owner of the Merchandise, and whether FSC1 is a financing entity for Federal income tax purposes. Under this view of the transaction, the Service may disregard FSC1's status as holder of title to the Merchandise and other incidents of legal ownership, in order to to disallow depreciation deductions claimed by FSC1. Moreover, the rent and purchase-option payments under the lease may be treated for Federal income tax purposes as payments of principal and interest on a loan from FSC1 to Lessee, rather than rental income. Such payments would not be entitled to FSC benefits.

As a preliminary matter, we note that Manufacturer was contractually obligated to Lessee to manufacture Merchandise containing specific equipment and features desired by Lessee. As the Merchandise neared completion, Lessee assigned the contract to FSC1, a party willing to provide long-term financing of the purchase price. Under this view of the transaction, the primary parties would be Lessee and Manufacturer. FSC1 would be viewed as a party as willing to provide long-term financing in exchange for payments under a putative lease structure.

The income tax treatment of this transaction is determined by reference to authorities in the sale-leaseback area. Whether a given transaction constitutes a sale, a lease, or a

financing arrangement is a question of fact to be ascertained from the intent of the parties, based on the written agreements and the facts and circumstances at the time of the transaction. Frank Lyon Co. v. United States, 435 U.S. 651 (1978); Haggard v. Commissioner, 24 T.C. 1124, 1129 (1955). The primary test for determining whether a transaction constitutes a sale, as opposed to a lease or a financing arrangement, is whether the purported purchaser obtained the benefits and burdens of equity ownership. Larsen v. Commissioner, 89 T.C. 1229 (1987).

The Tax Court examines the following factors as relevant to the benefits and burdens of ownership: (1) whether legal title has passed; (2) whether the parties treated the transaction as a sale; (3) whether the purchaser acquired an equity interest in the property; (4) whether the sale contract obligated the seller to execute and deliver a deed and obligated the purchaser to make payments; (5) whether the purchaser is vested with the right of possession; (6) whether the purchaser pays property taxes after the transaction; (7) whether the purchaser bears the risk of economic loss or physical damage to the property; and (8) whether the purchaser receives the profit from the property's operation, retention and sale. Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1211, 1237-38 (1981).

The following additional factors are potentially relevant in the sale-leaseback context: (1) useful life of the property in excess of the term of the lease; (2) presence of a purchase option at less than fair market value; (3) whether renewal rentals at the end of the leaseback term are set at a fair market value rate; and (4) reasonable possibility that the purported owner of the property can recoup its investment in the property, based on the income-generating potential and residual value of the property. Torres v. Commissioner, 88 T.C. 702, 720-21 (1987); Estate of Thomas v. Commissioner, 84 T.C. 412 (1985). These factors are analyzed in view of the facts and circumstances surrounding the transaction, including business setting and prevailing practices in the industry. For example, the Tax Court has held that in the net-lease context certain factors, such as responsibility for taxes and insurance, may have little importance. See Torres, 88 T.C. at 721. The Tax Court also evaluates business purpose or economic purpose in order to determine whether a sale-leaseback had any potential to generate a profit, without regard to anticipated tax consequences. Estate of Thomas, 84 T.C. at 438-39; Rice's Toyota World, Inc. v. Commissioner, 81 T.C. 184, 201-03 (1983), aff'd in part and rev'd in part on another issue, 752 F.2d 89 (4th Cir. 1985).

No single factor determines the benefits and burdens of ownership. However, if a nominal buyer obtains an equity interest in the property, a reviewing court will generally acknowledge that a valid sale has occurred. See Estate of Franklin v. Commissioner, 544 F.2d 1045, 1049 (9th Cir. 1976). In this context, equity consists of a positive differential between the fair market value of the property and the balance of any loans owed on the property. Equity may also be viewed as the amount of the purchaser's funds at risk in the property. Thus, a true owner has potential for gain or loss from increase or decrease in the market value of the property. In contrast, a mortgagee's economic return, consisting of

interest payments and return of principal, is generally fixed at the time of the initial transaction.

In applying these principles to the FSC1 lease, the relevant inquiry pertains to the economics of the lease as of the time that the parties entered into the transaction. Relevant factors include the assumptions underlying the lease, the relative probabilities of individual lease scenarios (purchase, renewal, termination, default, etc.), the likely value of the Merchandise at key dates in the lease, and the economic useful life of the underlying asset. For example, the asset's projected value at the end of the basic lease term might be substantially more than the cost of exercising the purchase option, the cost of obtaining a replacement lessee and making required termination payments, or the cost of default. In that event, the lessor would be economically compelled to exercise the purchase option. Such compulsion would support a conclusion that FSC1 had no ownership interest in the Merchandise at the start of the lease term, and would permit the transaction to be treated as a financing. Relevant information includes any analysis generated by USCorp. or Lessee with respect to appraisals and projected values of the Merchandise.

In-depth economic analyses of the lease terms and the value of the Merchandise are essential. We note the following lease terms for further analysis in this regard. Section 5(a)(i)(A) allows Lessee to terminate the lease after g years by paying about s% of the acquisition cost of $t, plus any rent payments due on that date and on the successive rent payment date. In the alternative, Section 5(a)(i)(B) permits Lessee to purchase the Merchandise in the event that a "Special Termination Event" has occurred, but no "Event of Default" has occurred. The purchase price in that event would be the "Special Termination Value," which is defined in Exhibit E of the lease agreement. These provisions are relevant with respect to the argument regarding compulsion to buy on the part of Lessee.

Assuming that g years of the lease term pass without termination or default, and assuming that no purchase option is exercised in that period, Lessee "may" secure a replacement lessee who will execute a lease with FSC1. However, if Lessee exercises neither the purchase nor the replacement-lease options, Lessee must return the Merchandise to FSC1 at the end of the initial lease term. A relevant inquiry is whether (as of the transaction date) Lessee was economically compelled to exercise one option as opposed to another. For example, if projected values for the Merchandise indicate that Lessee was compelled to exercise the purchase option at the end of the basic lease term, this would support treatment of the transaction as a financing.

Section 9(a) permits Lessee to terminate the lease under certain specified conditions. Lessee may terminate after u years, provided that its chief financial officer certifies the Merchandise as "uneconomical, obsolete, or surplus" in Lessee's operations. In that event, FSC1 "may" elect to sell the Merchandise. If it does, Lessee must assist FSC1 in obtaining bids from unrelated parties. Both parties then are entitled to review the bids received, to determine their relationship to Termination Value. At that point, Lessee may withdraw the

notice of termination (subject to limits on the total number of such notices which may be withdrawn).

If Lessee does not withdraw its notice of termination, and if FSC1 elects to go forward with the sale (it is not compelled to do so), FSC1 may sell the Merchandise to: (1) any party it chooses, provided that the excess of termination value over net sale proceeds is zero; or (2) the bidder whose bid is closest to termination value, if the termination value is greater than the net sale proceeds. Upon completion of the sale, FSC1 is entitled to the net sales proceeds, and Lessee must pay FSC1 the difference between termination value and net sales proceeds, plus all accrued rents due to FSC1. Thus, under this scenario, FSC1 is assured of obtaining at least the termination value specified in the lease or, in the alternative, retaining the Merchandise and holding Lessee to the terms of the lease. The clause apparently assigns to Lessee the risk that the Merchandise might depreciate below the specified termination value. In theory, Lessee cannot share in the excess of market value over termination value. However, this point would appear to be theoretical, as Lessee would not invoke the early-termination procedure if the Merchandise's market value substantially exceeded its termination value. Again, economic projections are important in this regard.

Another relevant inquiry in this class of transactions is identifying which party stands to recognize a profit or loss at the end of the lease term. That is, if Lessee can walk away from the lease without liability in excess of a fair rent due, the transaction may be properly characterized as a lease. In that event, FSC1 would still own the Merchandise at the end of the lease term, and it would have the risk of loss and opportunity for gain that are hallmarks of equity ownership. On the other hand, if Lessee must pay a substantial premium to terminate the lease, and the purchase option is a viable alternative, FSC1 arguably would have had no ownership interest when it executed the lease. Rather, its economic position was similar to that of a mortgagee.

In evaluating these factors, the Service should consider the potential that Lessee may intentionally breach the lease, as a means of triggering an event of default. A presumption is in effect that parties intend to comply with a binding contract. However, the Service should evaluate the default provisions of the lease to ensure that, if invoked, they do not lead to conclusions inconsistent with those under the main provisions. For example, if Lessee concludes that market conditions make rental of the Merchandise for the full term of the lease less profitable than an intentional early default, it may elect to default rather than continue to make payments under the lease. The availability of this option may affect the Service's conclusion under other provisions, for example, whether Lessee is under an economic compulsion at the time of the transaction to exercise the purchase option.

In similar leasing transactions, the lessee often deposits a substantial amount with a third-party custodian upon executing the lease. The deposit and the interest it generates act as a sinking fund which covers the payment(s) required at the end of the lease, such as the

purchase-option payment, and legally defeases the lessee's obligation. Your memorandum did not indicate whether a sinking fund was used. Another relevant inquiry is whether a sinking fund or other defeasance mechanism was used, and, if so, whether Lessee's obligations were legally defeased.

The right-of-possession factor in this case appears to be generally neutral, as the lease is a triple-net-lease. The lease generally prevents FSC1 from taking possession unless necessary to protect its rights, as in the event of default. Lessee has virtually absolute rights to possession over the lease term, with only limited inspection rights for agents of FSC1. In the event that the lease is terminated, or a sub-lease is concluded, Lessee is required to maintain custody of the Merchandise.

Under the lease terms, the risk-of-loss factor also appears to be relatively neutral, as the lease is a triple-net lease. Under Section 10 of the lease, Lessee bears all risk of loss, destruction, etc. Lessee is also responsible for obtaining insurance to protect against specified risks. Schedule 1 of Exhibit H states that the underwriters shall, with certain limited exceptions, pay to FSC1 any insurance proceeds received upon occurrence of a loss event. Upon the occurrence of an event of loss, Lessee must pay FSC1 the "stipulated loss value" or designate acceptable replacement Merchandise for the remainder of the lease term.

The remaining Grodt & McKay factors also appear to be neutral in this case. For example, it is relatively unimportant that FSC1 retained legal title to the Merchandise, as this is customary in leasing of Merchandise.

It appears that, with respect to USCorp. and FSC1, precedent of the U.S. Court of Appeals for the Third Circuit (Third Circuit) is relevant. The Third Circuit has adopted a rigorous interpretation of the benefits and burdens requirements in the sale-leaseback context. Sun Oil Co. v. Commissioner, 562 F.2d 258 (3d Cir. 1977), cert. denied, 436 U.S. 944 (1978). In that case, the Court carefully scrutinized the economic reality of the transaction, and gave little weight to the labels assigned by the parties to various elements of the transaction. A purported transfer of title and leaseback amounted to "nothing more than an elaborate financing device in which the Trust stood essentially in the position of a secured lender." Sun Oil, 562 F.2d at 261. Moreover, the parties determined the rental value of the properties not on the basis of fair market rental values or the capitalization-of-earnings method, but rather (as in the present case) by reference to the "investment alternatives" available to the putative lessor. 562 F.2d at 266. As a consequence, "the rents [had] no visible connection with the economic value of the property, but [were] evidently related to a fixed interest return on the properties." 562 F.2d at 269. Finally, liberal purchase options enabled the putative lessee to "acquire the benefits of appreciation in the property by merely paying the present value of future rents payable under the lease." 562 F.2d at 268. Based on these and other factors, the Court ultimately determined that the putative lessee had not surrendered the benefits and burdens of ownership of the properties.

One year after the decision in Sun Oil, the Supreme Court in Frank Lyon distinguished the decision on the following basis: "the form of the transaction [in Sun Oil] actually created tax advantages that, for one reason or another, could not have been enjoyed had the transaction taken another form." Frank Lyon, 435 U.S. at 583 n. 18. The Tax Court has also distinguished Sun Oil on similar grounds. E.g., Cooper v. Commissioner, 84 T.C. 84, 107 (1987). However, Sun Oil remains relevant precedent in the Third Circuit.

To summarize, under a benefits and burdens theory, the transaction may be properly characterized for Federal income tax purposes as a financing. This re-characterization would have several consequences. First, FSC1 would not be entitled to depreciation deductions, as it would not be the owner of the Merchandise for tax purposes. Second, the rent and purchase-option payments would be treated for Federal income tax purposes as payments of principal and interest on a loan from FSC1 to Lessee. Third, such payments would not be subject to FSC benefits; rather, they would constitute principal repayments and investment income effectively connected with a permanent establishment in the United States, pursuant to I.R.C. §§ 921(d)(2) and 924(f)(2). (It would be necessary for the Service to determine the character of these payments, i.e., the proportionate amounts of principal, interest, and OID (if any) reflected in each payment.) Fourth, USCorp. would be entitled to a dividends-received deduction of only 80%, rather than 100%, with respect to dividends derived from these sources. I.R.C. § 245(c)(1)(B). Fifth, USCorp. would not be required to recognize subpart F income with respect to the payments, given that 100% of the investment income would be reported on the income tax return of FSC1. I.R.C. § 952(b).

Issue 2: Ownership of Merchandise by FSC1: Adjustment of Recovery Period per I.R.C. §§ 168(g)(3), (h), and (i)

Under an alternative approach, if FSC1 "owns" the Merchandise, the Service may require FSC1 to use as the recovery period for depreciation purposes the sum of the basic plus the replacement lease terms, pursuant to I.R.C. § 168(i) and Treas. Reg. § 168(i)-2. Although the transaction would retain the basic income tax consequences intended by the parties, use of an extended recovery period would significantly reduce the depreciation deductions available to FSC1, and would thereby increase FSC1's net exempt and non-exempt income, as well as USCorp.'s subpart F income.

Currently, FSC1 calculates depreciation on a straight-line basis over an r-year recovery period. There is no dispute that the Merchandise constitutes "tax-exempt use property," as defined in I.R.C. § 168(h). Section 168(g)(2)(A) limits depreciation of such property to the straight-line method, and section 168(g)(3)(A) provides that the recovery period for such property must be at least 125% of the lease term. Section 168(i)(3)(A) provides that, in determining the term of a lease for this purpose, one must take into account options to renew, as well as successive leases which form part of the same transaction or related transactions with the original lease. In the present case, FSC1 evidently takes the

position that 125% of the basic lease term yields the correct recovery period for the Merchandise.

The recovery period for tax-exempt lease property is determined by reference to economic substance, rather than the nominal terms of the lease. Independent appraisals, projections of the Merchandise's value at specific points in the lease term, and estimates of the useful life of the Merchandise are factors to be considered. After the Service has tested these values against the applicable lease provisions, it should be able to evaluate the options available to Lessee. For example, if the lease provisions suggest that Lessee must either: (1) locate a suitable lessee for the balance of the f-year term, or (2) make a lump-sum payment to compensate FSC1 for any shortfall in economic return over the replacement term, then Lessee has effectively guaranteed FSC1's returns over the life of the lease. In that event, because FSC1 has eliminated economic risk associated with the replacement term, the correct recovery period would be based on the total lease term (i.e., basic plus replacement terms).

The Tax Reform Act of 1984 modified the rules applicable to leases of property to tax-exempt entities. This legislation, including provisions codified at I.R.C. § 168(j), reflected concerns that lessors to tax-exempt entities might manipulate recovery periods by using multiple leases, multi-part leases, or other mechanisms. In 1985, the Service issued temporary regulations under I.R.C. § 168(j). Temp. Treas. Reg. § 1.168(j)-1T. Q&A 17 to this regulation provides examples of lease terms which must be aggregated to establish the recovery period. In general, the recovery period must include the lease's stated duration, as well as additional periods within the "realistic contemplation of the parties at the time the property is first put into service." Temp. Treas. Reg. § 168(j)-1T, Q&A 17, quoting Hokanson v. Commissioner, 730 F.2d 1245, 1248 (9th Cir. 1984). Thus, for example, an informal agreement between the parties or facts indicating that the lease would be extended would mandate aggregation of lease terms.

Q&A 17 of the temporary regulations is consistent with the legislative intent of I.R.C. § 168(i)(3), as the following excerpt from the legislative history demonstrates:

> The bill leaves open the possibility, as under present law, that the term of a subsequent lease could be included in the term of the original lease if the circumstances indicate that the parties, upon executing the original lease, has informally agreed that there would be an extension of the original lease. An extension at a rental rate differing materially from the market rental rate at the time of the extension would suggest that the parties had such an informal agreement. Similarly, the committee intends that rules similar to those applied under section 46(e)(3) (relating to investment credits for non-corporate lessors) be applied in determining the lease term. See, e.g., Hokanson v. Commissioner, [citation omitted] (which applies a reasonable expectations test). Also, the bill measures the lease term by counting successive leases as

> one lease. This rule applies if the original lease and one or more successive leases are entered into contemporaneously. The successive lease rule will not apply . . . merely because the parties enter into a new lease at fair rental value (or the lessee buys the property at its fair market value) at the end of the primary lease term.

S. Rep. No. 169 (vol. 1), 98th Cong., 2d Sess. 149-50 (1984) (emphasis added). See also H. R. Rep. No. 432 (part 2), 98th Cong., 2d Sess. 1161-62 (1984).

The 1996 final regulations noted that Q&A 17 of the Temporary Regulations provided illustrative examples of factors which require aggregation of lease terms. Treas. Reg. § 1.168(i)-2(a). The 1996 final regulations, which substantially restate the Q&A 17 factors in Treas. Reg. § 1.168(i)-2(b), are applicable to leases entered into on or after April 20, 1995. The Preamble also indicated that, "[n]o inference is intended by these effective dates as to the treatment of any transaction under prior law." T.D. 8667, 1996-1 C.B. at 23. The 1996 final regulations properly express the legislative intent of the 1984 amendments to section 168 and provide additional support for the conclusion reached in this memorandum, based on the Temporary Regulations.

Hokanson, cited in the legislative history and the temporary regulations, dealt with investment tax credits rather than recovery periods. However, that decision held that an open-ended lease, which was subject to cancellation by either party based on annual reviews, should be interpreted in view of the "realistic contemplation" of the parties that the lease would be renewed indefinitely. Hokanson, 730 F.2d at 1248. The Court noted that the Tax Court traditionally utilized the period within the "realistic contemplation" of the parties, rather than the term recited in the lease. E.g., Ridder v. Commissioner, 76 T.C. 87 (1981); Bloomberg v. Commissioner, 74 T.C. 1368, 1371 (1980).

In this case, the Service may be able to demonstrate that the lease term within the "realistic contemplation" of the parties was in fact f years. In particular, if Lessee guaranteed that FSC1 would receive returns equivalent to those available under an e-year lease, or assumed, in whole or in part, FSC1's market risk with respect to the replacement term, I.R.C. § 168(i)(3) requires that the two lease terms be aggregated. The recovery period under this theory would be a minimum of v years (i.e., 125% of f).

If FSC1 is required to aggregate the lease terms for purposes of determining the recovery period, its depreciation deductions would be significantly reduced, which in turn would reduce the tax benefits flowing from the lease. The net result would be to increase the net income on the part of FSC1 (both exempt and non-exempt income) as well as subpart F income on the part of USCorp.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

____
ELIZABETH G. BECK
Senior Technician Reviewer
Branch 6
Associate Chief Counsel (International)