OFFICE OF
CHIEF COUNSEL

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

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

Number: **200106019**
Release Date: 2/9/2001
UILC: 167.15-00
TL-N-1436-99/CC:INTL:6

DATED: November 3, 2000

MEMORANDUM FOR Associate Area Counsel
CC:LM:CTM:SF
Attention: Michelle Korbas, Attorney

FROM: ELIZABETH G. BECK
Senior Technical Reviewer
CC:INTL:6

SUBJECT:

This memorandum responds to your request for Field Service Advice dated May 31, 2000. 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

Parties
Advisor =
Appraiser =
Corporation A =
Investment Bank 1 =
Investment Bank 2 =
Manufacturer =
Operator 1 =
Operator 2 =
Promoter =
Seller/Lessee =
Parent of Seller/Lessee =
Special Purpose Sub =
Special Purpose FSC =
Taxpayer =
Taxpayer Sub =
Trust =
Trust Company =

Amounts

a	=
b	=
c	=
d	=
e	=
f	=
g	=
h	=
i	=
j	=
k	=
l	=
m	=
n	=
o	=
p	=
q	=
r	=
s	=
t	=
u	=
v	=
w	=
x	=
y	=
z	=
aa	=
bb	=
cc	=

Dates

Date A	=
Date B	=
Date C	=
Date D	=
Date E	=
Date F	=
Date G	=
Date H	=
Date I	=
Date J	=
Date K	=
Date L	=

Date M	=	
Date N	=	
Date O	=	
Date P	=	
Date Q	=	
Date R	=	
Date S	=	
Date T	=	
Year A	=	
Year B	=	

Other

Business	=	
Event A	=	
Event B	=	
Format A	=	
Format B	=	
Individual	=	
Location	=	
Model	=	
Period A	=	
Satellite A	=	
Satellite B	=	
Sector	=	

ISSUE

Whether Taxpayer, the corporate parent of alleged purchasers/lessors engaged in a purported sale/leaseback of transponders located on a communications satellite, is entitled to depreciation deductions on the transponders.

CONCLUSION

Taxpayer is not entitled to depreciation deductions associated with the transponders subject to the sale/leaseback, because Taxpayer did not possess the benefits and burdens of ownership.

FACTS

This transaction involves an alleged purchase by subsidiaries of Taxpayer of certain transponders on Satellite A, and a leaseback of the transponders to the purported seller/lessee. Seller/Lessee is a party unrelated to Taxpayer, and part of an affiliated group of domestic corporations, the parent of which is Corporation A. Also in the Corporation A affiliated group are: the (immediate) corporate Parent of Seller/Lessee and the Manufacturer and Operator 1 of Satellite A. Parent of Seller/Lessee, an affiliate of Manufacturer and Operator 1, contracted for construction of Satellite A. Seller/ Lessee applied for and obtained the FCC license to construct and operate Satellite A. After launch, Operator 1 provided ground services for the Seller/Lessee satellite network, which was targeted primarily to Sector.

Taxpayer is engaged primarily in Business. Taxpayer is not engaged in the business of manufacturing, selling, or leasing of communications satellites, transponders, or other telecommunications equipment.

Background

A transponder is a transmission/relay device. When mounted on a communications satellite, a transponder receives radio-magnetic signals, which it processes, amplifies, and re-transmits to the Earth's surface.

The operator of a communications satellite must obtain a Federal Communications Commission (FCC) license for the satellite to occupy a particular orbital "slot" and to operate on particular radio frequencies.[1] Licensing is mandatory because the number of orbital slots is limited, and because frequencies must be allocated to reduce potential interference with ground-based communications. FCC licenses generally have ten-year terms, with temporary renewal possible if the satellite remains operational at the end of the initial term.

The Satellite A Transaction

The sale/leaseback and related financing were part of a complex, multi-party transaction.[2] This memorandum addresses only those aspects of the transaction that are essential to an understanding of the issue presented.

Generally, satellites are replaced on a periodic basis as they reach the end of their useful lives, or as newer models with more advanced features become available.

---

[1] In addition, FCC permission is necessary to build a communications satellite, due to the long-lead times for construction, the substantial capital costs involved, and uncertainty regarding the availability of a license for the desired orbital slot when the satellite is ready for launch.

[2] We rely primarily upon Area Counsel's description of the facts in the referral memorandum, as supplemented. We have not independently examined the underlying documents.

In Year A, Seller/Lessee applied to the FCC for a license to build Satellite A and to operate it in an orbital slot allowing service to the continental United States. The application estimated the total construction and operating costs for Satellite A (including the transponders) at $a. This estimate included construction, pre-operating expenses, launch vehicle services, launch insurance, cost of modifications to Seller/Lessee's control facilities and ground stations, and other operating expenses.

Satellite A (a Model) was to be placed in geostationary orbit 22,000 miles above the Earth, and was authorized to operate b transponders on Formats A and B (c per Format). Because Satellite A used analog rather than digital technology, it could not perform digital signal-compression.[3]

In Date A, Seller/Lessee devised a plan to obtain outside financing of Satellite A. In general, the plan called for Parent of Seller/Lessee to purchase Satellite A from Manufacturer, sell some of the transponders to an unrelated third party, lease them back, and then sublease some or all the transponder capacity to users, primarily in the Sector business. Parent of Seller/Lessee thereby sought to generate funds to purchase Satellite A from Manufacturer, and working capital necessary to operate the satellite over its projected life.

Seller/Lessee hired Promoter as the equity underwriter. Promoter targeted investors who might be willing to accept a lower than usual rate of return on their investment, in exchange for certain income tax benefits. Promoter first created l Special Purpose Subs, each of which owned stock in l Special Purpose FSCs. Each Special Purpose Sub was in turn the grantor of a corresponding grantor trust (Trust). Seller/Lessee then sold d or more transponders to each of the l Trusts. Of the b transponders on Satellite A, e were eventually sold, for subsequent leaseback to Seller/Lessee.

This advice deals with k of the Special Purpose Subs, which held d, f, and d Satellite A transponders, respectively (i.e., a total of g transponders). In the interest of simplicity, this memorandum will refer to these entities collectively as the "Special Purpose Subs," unless the context clearly indicates otherwise.

In Date B, Special Purpose Subs, along with Trust Company as Indenture-Trustee, Investment Bank 1 as Owner-Trustee of Trusts, and Seller/Lessee, entered into several Participation Agreements which would govern the sale and leaseback of Satellite A transponders. Under the Participation Agreements, the Trusts' initial purchase of transponders was 100% financed by Parent of Seller/Lessee. Total funding provided by Parent of Seller/Lessee, covering e Satellite A transponders, as well as other transponders not at issue herein, was $h.

---

[3] Digital signal-compression permits a transponder to process simultaneously multiple video signals or data-streams, substantially increasing its capacity.

Next, on Date C, Seller/Lessee's Board of Directors authorized the corporation to execute and deliver various documents, including leases, Purchase Agreements, Bills of Sale, Trust Agreements, Participation Agreements, and Tax Indemnification Agreements. Seller/Lessee engaged Advisor and Investment Bank 2 to advise it in connection with the transaction. Investment Bank 2, acting as the debt underwriter, sought to arrange long-term debt financing for the transaction. Promoter's role, as equity underwriter, was to enlist "Owner-Participants" for the Satellite A transponder transaction.

Seller/Lessee then sold the e transponders to Trusts, in exchange for notes totaling $h. Parent of Seller/Lessee provided the funds for these notes. Trust Company issued limited-recourse promissory notes, "Series A Notes," exclusively in its capacity as Owner-Trustee. As Owner-Trustee, it took title to the transponders pursuant to the Transponder Purchase Agreement. The purchase price, which was subject to adjustment after Satellite A had been launched and placed in orbit, was defined as fair market value of the transponders, as determined by an appraisal. (The purchase price was finally determined on Date D.)

On Date E, the closing date of the purported sale, Special Purpose Subs, as Owner-Participants, made no equity investments. Rather, the Trusts bought the transponders from Seller/Lessee, which would later notify the Owner-Participants of the date on which their equity investments were required. The deferred equity amount was loaned to the Owner-Participants until Satellite A was in its assigned orbit and functioning properly, and until the long-term debt financing was in place. In exchange for cash from Seller/Lessee, Trust Company transferred to it certain of the Series A Notes. Under the Participation Agreement, Parent of Seller/Lessee would be reimbursed for its $h advance when the mandatory refinancing of the Series A Notes took place.

Next, on Date F, Satellite A was successfully launched from Location, and reached its assigned orbit.

After launch, on Date H, the Series A Notes were refinanced. The notes were partially paid off by interim loans, evidenced by Series G Notes and an advance from Seller/Lessee. In addition, the parties borrowed $i from two foreign banks. The remaining balance of $j on the Series A Notes was paid by Trusts, as Owner-Participants.

Thereafter, on Date I, one day before Satellite A was to be placed in service, Taxpayer Sub, a wholly-owned domestic subsidiary of Taxpayer, purchased from Promoter stock in k of the l Special Purpose Subs, which in turn owned all the stock of corresponding Special Purpose FSCs.

On Date D, Satellite A began to transmit signals to its designated service area.

On that date, Taxpayer, through Taxpayer Sub and Special Purpose Subs, paid the initial equity installments to the corresponding Trusts that held the transponders. On the same date, Investment Bank 1 leased the transponders back to Seller/Lessee.

The deferred equity amounts were thus paid in two instalments, on Date D, the placed-in-service date, and Date G, approximately six month later, the date on which Investment Bank 2 finalized the long-term financing.

In Date J, about the time the final equity installment was paid, Investment Bank 2, acting on behalf of Corporation A, completed a private-placement of pass-through trust certificates pursuant to Rule 144A of the Securities Act. The assets of the pass-through trust consisted primarily of the Secured B Notes. The total amount obtained from the offering was $m. The proceeds of this offering, together with the final equity investments from the putative owners, were used to retire interim-financing debt.

With final financing arrangements in place, approximately six months after Satellite A began operations, the parties calculated the lease term, the rent payments, and other terms. Under various agreements, the transponders' purchase prices and the Early Buyout Option (EBO) amounts were calculated to yield a specified after-tax return to the purported owners.

Transaction Document Details

Below, we discuss certain additional details regarding selected transaction documents.

Purchase Agreement: Pursuant to the Date C Purchase Agreement, Seller/Lessee transferred title of the transponders on the closing date. Transfer of title was evidenced by an executed bill of sale. Under the Agreement, from the closing date to the date immediately before the placed-in-service date, all risk of loss or damage to the transponders was borne by Seller/Lessee. In addition, once the transponders were leased back, the buyer's obligation and rights were assumed by Seller/Lessee.

The purchase price of each transponder was "fair market value," based on an initial appraisal. The purchase price of each transponder was subject to adjustment on the in-service date, based on an in-service appraisal by Appraiser. On the in-service date (Date D), Appraiser estimated the fair market value (equipment cost) of the g transponders purchased by Special Purpose Subs at $n.

Lease Agreement: Seller/Lessee and Investment Bank 1 entered into l identical lease agreements, each relating to an individual transponder group. Semi-annual rent payments were assigned by the Owner-Trustee to be paid directly to the Indenture-Trustee. The Indenture-Trustee was required to provide all funds necessary to pay principal and interest due from the Owner-Trustee on the notes issued under the

Indenture, on the corresponding interest payment dates thereunder. The first rent payment was due on Date G.

The Interim Term of the lease is from the Execution Date to and including Date K, unless terminated earlier. The Basic Term began on the day immediately following the end of the Interim Term and ran for o years, to expire on Date L, unless earlier terminated pursuant to the terms. The total lease term was p years from the in-service date (Date D to Date L).

The periodic rent payments for each transponder group were set to equal or exceed the total principal, Premium Amount (if any), and interest due on the Notes that corresponded to the individual transponder group. Under some circumstances, rent could be adjusted, but in no case could rent be less than the total principal and accrued interest payable on a given date with respect to the Notes corresponding to the transponders subject to that lease.

The leases were “net leases.” That is, Seller/Lessee bore all costs of operating Satellite A and the transponders. Special Purpose Sub paid a flat fee to Operator 1 for “maintenance.” All other costs of operation were borne by Seller/Lessee. Under the agreement, the lessee could use, sublease, and assign its interest in the transponders. Seller/Lessee was also required to pay insurance, expenses, etc.

During the lease term, Special Purpose Sub could not sell the transponders to any party outside the Corporation A group.

Most key lease terms were calculated after the long-term debt financing was in place. The agreement set forth “Fixed Pricing Assumptions” and “Variable Pricing Assumptions.” Fixed assumptions included tax rates, depreciation, and debt /equity composition. Variable assumptions included the in-service date, lease-commencement date, EBO dates, lease-end dates, and lessor’s cost. Rent, EBO, debt amortization, termination values, and stipulated loss values were calculated to six decimal places, as percentages of lessor’s acquisition cost. None of these amounts could be calculated until the debt financing was complete and the interest rates, principal, and amortization schedules had been determined. Thus, although the lease began on Date D, the final equity investments due were not calculated until Date G.

Purchase option: Seller/Lessee held an option (EBO) to purchase the transponders for their fair market value on the date of exercise. This option could be exercised on specified dates beginning on Date M (which was approximately five years after Date G). Further, if it exercised the option, Seller/Lessee could elect to assume the debt and the obligations to pay interest and principal, rather than retiring the debt on the option date.

Subsequent Events During Lease Term

On Date N, Satellite B experienced Event A. In Date O, Satellite A experienced Event B. On Date P, Operator 2[4] gave notice of its intent to exercise the EBO with respect to certain of the transponders. On Date Q, Operator 2 exercised the EBO with respect to a number of (but not all) the transponders, for approximately $q.

Tax Consequences to Taxpayer

Special Purpose Sub claimed Federal income tax deductions for depreciation on the transponders, which generated taxable losses in the first several years of the transaction. These losses were reported on the consolidated Federal income tax returns filed by Taxpayer. In subsequent years, when the transaction could yield taxable income to Special Purpose Subs, Special Purpose FSCs would activate to reduce the amount of income reportable on the U.S. tax return. The principal balance for purchase of the transponders would be repaid no earlier than the EBO date under the leases, i.e., Date Q.

Throughout the lease term, the rent to be paid by Seller/Lessee corresponds closely to the periodic interest and principal due on the underlying secured Series B Notes held by the pass-through trust. That is, aside from their initial equity investments, no Special Purpose Sub was out-of-pocket to any significant extent. Special Purpose Subs' income tax savings, which resulted from deductions for depreciation, and eventually from FSC-commission deductions, were indirectly passed on to Seller/Lessee and its affiliates through a below-market interest rate. Indeed, after r months, through Federal income tax benefits, Special Purpose Subs would fully recoup their initial "equity" investment in the transponders.

According to Exam's calculations, the return to Taxpayer at the EBO date, exclusive of tax benefits, would be s%. In contrast, if tax benefits were taken into account, the return would be t%.

For Period A, Taxpayer claimed a total of $u in depreciation deductions with respect to the transponders. In each of these years, Special Purpose Subs reported taxable losses, primarily due to these depreciation deductions. Special Purpose FSCs were not active in Period A.

LAW AND ANALYSIS

---

[4] Due to intervening reorganizations in Year B, Seller/Lessee's interest in Satellite A was assumed by Operator 2.

This case turns on whether Taxpayer is properly classified as the owner of the transponders for income tax purposes. The owner of satellite transponders, as the owner of any tangible property, is entitled to a deduction for depreciation.[5] I.R.C. § 167(a) generally allows as a depreciation deduction a reasonable amount for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) of: (1) property used in a trade or business, or (2) property held for the production of income.

I.R.C. §§ 1011 and 1012 provide that the basis of property for purposes of depreciation is generally the cost of such property. Determining who is the owner of property, entitled to the tax benefits of ownership, focuses on the economic substance of a transaction, rather than its legal form. Thus, if a transaction purports to be a lease, the entity claiming ownership for income tax purposes must show that it has sufficient economic indicia of ownership.

The classification of a transaction as a sale, lease, or financing is a question of fact, which is ascertained from the parties' intent, as evidenced by written agreements, read in light of the facts and circumstances. Haggard v. Commissioner, 24 T.C. 1124, 1129 (1955), aff'd, 241 F.2d 288 (9th Cir. 1956). The primary test in this regard is whether the benefits and burdens of ownership of the property pass to the purported purchaser. Larsen v. Commissioner, 89 T.C. 1229 (1987), rev'd on other grounds sub nom. Casebeer v. Commissioner, 909 F.2d 1360 (9th Cir. 1990). The Tax Court has examined the following factors: (1) whether legal title 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. 1221, 1237-38 (1981).

When examining a sale/leaseback, the Tax Court also examines the following: (1) whether the useful life of the property exceeds the leaseback term; (2) whether the lease provides a purchase option at less than fair market value; (3) whether renewal

---

[5] Pursuant to I.R.C. § 168(e)(3)(B)(iv), satellite transponders are 5-year property and § 168(c) provides that the applicable recovery period is five years. Rev. Proc. 87-56, section 48.37 provides that TOCSC-Satellite space segment property is five-year property for depreciation purposes. TOCSC-Satellite space segment property includes satellites and equipment used for telemetry, tracking, control, and monitoring when used in satellite communications.

rentals at the end of the leaseback term are at a fair market value; and (4) whether a reasonable possibility exists for the purported owner of the property to recoup its investment from the property's income-producing potential and any residual value. Torres v. Commissioner, 88 T.C. 702, 720-21 (1987); Estate of Thomas v. Commissioner, 84 T.C. 412 (1985).

Thus, all facts and circumstances are relevant. The nature of the transaction may affect the relative importance afforded to a particular factor. For example, in Torres, which involved a sale/leaseback and a net lease, the Tax Court noted that certain of the factors had less significance than others:

> Because net leases are common in commercial settings, it is less relevant that petitioner was not responsible for the payment of property taxes or that petitioner bears less of a risk of loss or damage to the property because the lessee is required to maintain insurance on the property. Similarly, a lessor is normally not vested with the right to possession during the term of the lease and, therefore, the relevant consideration in this regard is whether the useful life of the property extends beyond the term of the lease so as to give the purchaser a meaningful possessor right to the property. Also, in a leaseback transaction it is normal for the lessee to receive profits from the operation of the property while the lessor's receipt of payments is less dependent upon the operation of the property.

88 T.C. at 721.

This question, then, is highly factual. In general, based on the information provided, we agree with the analysis in the referral memorandum. The following discussion is based on that analysis and on the factors identified in Grodt & McKay Realty and Torres.

1. Did legal title pass?

On Date E, Seller/Lessee transferred title of the transponders to Trusts, as trustees for Special Purpose Subs. From the closing date to the day before the in-service date, any risk of loss or damage to the transponders was borne by Seller/Lessee, the seller. In addition, over the lease term, the buyer's obligation and rights are exercised and performed by Seller/Lessee. These factors suggest that passage of title was a matter of form, rather than substance. Nonetheless, legal title to the transponders passed. Accordingly, this factor favors Taxpayer.

2. Did the parties treat the transaction as a sale?

Taxpayer Sub and Purpose Subs reported the transaction consistent with its form: assignment of rights from Seller/Lessee to Special Purpose Subs, (as grantors of Trusts), sale from Seller/Lessee to Special Purpose Subs, and leaseback from Special Purpose Subs to Seller/Lessee. This treatment of the transaction as a sale for tax purposes supports Taxpayer's position.

On the other hand, the substance of a transaction, rather than its form, controls for Federal income tax purposes. Helvering v. Lazarus & Co., 308 U.S. 252 (1939). The facts presented suggest that the economic substance of the transaction was a financing arrangement. The transaction was structured to provide a fixed rate of return, and Special Purpose Subs held none of the traditional indicia of ownership of property, aside from bare legal title. In particular, Special Purpose Subs were not likely to have a meaningful residual interest in the transponders at the end of the lease term.

3. Did the lessor acquire an equity interest in the property?

Equity is generally defined as the difference between the fair market value of property and the outstanding debt on it. In other words, equity interest refers to the amount the owner/purchaser has invested in the property, assuming that the amount is actually at risk and has upside (gain) potential and downside (loss) risk.

When the transponders were sold on Date E, Special Purpose Subs provided no equity funds. Parent of Seller/Lessee initially financed 100% of the purchase price of the transponders, by issuing Series A notes. The equity investors provided funds on a later date. That is, Parent of Seller/Lessee loaned the Owner-Participants the "deferred equity amount" until the satellite was in orbit and functioning, and permanent financing was in place. Taxpayer's investment thus took place only after the most significant risks, e.g., the risk of catastrophic launch failure, physical damage to the satellite during launch, or incorrect orbital placement of the satellite, had been eliminated.

In addition, Corporation A guaranteed Seller/Lessee's rent payments over the lease term, eliminating most risks associated with failure of Satellite A or the leased transponders. Under these circumstances, Special Purpose Subs' capital was not truly at risk. Its investments were more in the nature of loans than equity investments, as Special Purpose Subs were ensured of fixed returns on their investment, regardless of the circumstances under which the lease ended. This factor supports the view that Taxpayer did not own the property.

4. Did the sales contract obligate the seller to execute and deliver a deed and obligate Special Purpose Subs to make payments?

Seller/Lessee executed bills of sale to Trust. Because Special Purpose Subs were the grantors of Trusts, Special Purpose Subs were entitled to claim tax benefits from purported ownership of the transponders. However, over the lease term, the amount of alleged rent due from Seller/Lessee for each semi-annual period corresponds closely to the amount of interest and principal due on the secured Series B Notes for the particular period. Overall, this factor is neutral.

5. Did the lessor have a right of possession?

This factor is of relatively minor importance, given that the transponders were subject to net leases. However, we note that Taxpayer had no realistic right of possession. Rather, this right resided with Seller/Lessee.

In this regard, we believe that an unusual factor is present here. In most sale/ leaseback cases, the nominal owner of the property is entitled to regain possession in the event of default by the lessee. For example, in the case of real estate, if the lessee defaults, the lessor can regain possession of the property and re-lease it (or use it itself). In the case of personal property, such as an airplane or a vessel, default may allow the lessor to seize the asset. In the present case, the leased transponders would remain beyond the reach of the purported owner under virtually any set of facts, as they were located on a satellite that was owned by the lessee's parent. That is, assuming that repossession of the transponders was possible, a Special Purpose Sub could not change the position of Satellite A (which was controlled entirely by Seller/Lessee and its affiliates), nor could it operate the transponders (which only Seller/Lessee held the FCC license to operate).[6] Thus, Special Purpose Subs' right of possession in this case was apparently illusory. This factor favors the Service.

6. Who was obligated to pay property taxes?

This factor has little importance here because the property was purportedly subject to a net lease. Special Purpose Subs were not, in any event, required to pay property taxes because, pursuant to the sale and leaseback, this obligation resided with Seller/Lessee. Because this was a net lease, this factor is neutral.

7. Who bore the risk of economic loss or physical damage to the property?

This factor has little importance because the property was subject to a net lease. Special Purpose Subs had essentially no risk of economic loss or physical damage to the property because, pursuant to the sale and leaseback, this risk resided with the

[6] At least one of the transaction documents advised potential investors that it was uncertain whether security interests in the orbiting transponders could be perfected.

lessee. Once again, the existence of a net lease renders this factor relatively unimportant.[7]

As noted above, Corporation A, the ultimate parent of Seller/Lessee, guaranteed the rent payments over the lease term. Thus, if the satellite were damaged or destroyed, or if the subleasing income-potential of the transponders were otherwise diminished, Taxpayer would nonetheless obtain the predicted return on its investment.

8. Who received the profit from the property's operation, retention and sale?

This inquiry concerns whether Special Purpose Subs were likely to receive a profit from the operation, retention and sale of the transponders. Courts have consistently found that the potential for profit or loss on the sale or re-lease of property constitutes a key burden or benefit of owning property. Gefen v. Commissioner, 87 T.C. 1471, 1492 (1986); Illinois Power Co. v. Commissioner, 87 T.C. 1417 (1986).

Exam calculated the Taxpayer's projected profit, with and without tax benefits, as of both the EBO date and the end of the lease. According to this analysis, at the EBO date the economic profit earned by Special Purpose Subs, exclusive of tax benefits, would translate into an average rate of return of only s%. We agree with the conclusion that a prudent investor would probably not enter into a transaction with such a low rate of return.

If tax benefits are taken into account, however, Taxpayer's effective rate of return would increase to t% at the EBO date. The discrepancy between pre-tax and after-tax rates of return -- several orders of magnitude, on a percentage basis -- supports the view that Taxpayer entered into the transaction primarily to obtain tax benefits (depreciation deductions) from alleged ownership of the transponders. Exam's calculation of Taxpayer's rate of return over the entire lease term was v% without tax benefits and w% with tax benefits, again, a significant discrepancy. The discrepancy between these two percentages, although less dramatic than at the EBO date, also supports the view that tax considerations factored heavily in the transaction.

Additional factors that may be relevant include the following.

---

[7] In the net-lease context, these factors are neutral and generally do not support denying tax benefits to the alleged owner. However, they may support the conclusion that Taxpayer had no profit interest or potential for loss, because the nominal lessee was obligated to pay all taxes and operating expenses, and also incurred the risk of economic loss on the property.

1. Useful life in excess of the leaseback term.

This inquiry asks whether the projected useful life of the asset exceeds the term of the lease. That is, when the transponders are returned at lease-end, will they have any residual value? The useful life of the transponders depends on several factors, not least of which is the operational life of the satellite. We understand that a fully-functional transponder would have a rental value of zero if the satellite on which it was located ceased to operate (or if the FCC license to operate the satellite expired). Stated differently, if a transponder can function for twenty years, but the satellite on which it is mounted functions for only five, the transponder will have rental value for only five years. We believe that calculation of a transponder's useful life should take account of this basic consideration.

The lease term for the transponders in this case was p years from the in-service date, and the projected operational life of the satellite was x years, which is less than the lease term. FCC licenses are valid for ten years (although temporary renewals are possible). In addition, prior experience with communications satellites suggested that Satellite A's useful life might be less than x, due to obsolescence of the satellite or the transponders, or both. We think that these factors support the view that the transponders were not likely to have any residual value at expiration of the lease term.

In addition, the Purchase Agreement allowed Seller/Lessee to dispose of Satellite A at the earliest of the following: (i) when the remaining fuel on board was less than y% of the initial fuel mass at launch; (ii) when fewer than z transponders remained capable of meeting performance specifications; or (iii) aa years after the in-service date. On the earliest of the above dates, Seller/Lessee could remove the satellite from orbit, and would have no further obligations to Special Purpose Subs. With respect to one of these events, Exam obtained an internal memorandum prepared by Individual, which stated that the fuel weight at launch was bb lbs. Based on this information, and assuming normal station-keeping activities, Exam estimated that remaining fuel would amount to y% of the bb lbs. at x years. Again, the resulting date would be before the end of the useful life estimate per the lease.

When Seller/Lessee disposed of the satellite at lease-end, it could regain possession of the transponders without any additional obligation to the Taxpayer. This would be appropriate, as all debt relating to the transponders would be retired prior to that time (at o years), and Taxpayer would have received its bargained-for net economic return. Accordingly, the transponders' residual value at that point would be zero. [redacted]

Appraiser estimated that Satellite A would outlast its cc-year design life. However, the evidence on this issue is mostly to the contrary. According to the Area Counsel memorandum, the satellites in question generally have useful lives of less than cc years, because each successive generation of satellite has increased transponder capacity, higher transmission power, and increased reliability, which renders obsolete prior-generation satellites.

Moreover, we understand that, as Satellite A was being prepared for launch, digital technology was beginning to render obsolete analog transponders. If true, this may have undermined the accuracy of the parties' projection of the useful life of Satellite A. That is, if the parties could reasonably contemplate that Satellite A was unlikely to operate more than p years in any event, on account of impending technological obsolescence, and that it would cease operations less than p years from the in-service date, the lease term would exceed the projected useful life of the transponders. This would be strong evidence of a financing, as opposed to a valid sale and leaseback.

2. Purchase option at less than fair market value.

The lease specified seven potential EBO dates. The exercise or purchase amounts for each EBO date were stated as a percentage of the lessor's acquisition cost. However, the Participation Agreement states that, "Notwithstanding anything to the contrary in the Lease or the Participation Agreement, the EBO amount, together with any other rent, other than excepted Payments, due on the EBO Date and payable to Lessor, for any Transponder shall be under any circumstances and in any event, not less than the sum sufficient to pay the aggregate principal amount of the Notes outstanding together with accrued and unpaid interest thereon." Accordingly, the purchase option price bears no relation to the fair market value of a particular transponder, but instead relates to the unamortized balance on the Series B Notes relating to that transponder group. Just as all rents over the lease term are geared to debt-service on the notes, so too the EBO amounts ensure that the option-exercise price is sufficient to retire the underlying debt, regardless when the option is exercised.

3. Renewal rentals at end of the leaseback at less than fair market value.

The transponders' useful would apparently end when Satellite A ceased operations in its assigned orbital slot, which in this case could occur before the end of the stated lease term. Also, there was no provision for replacement transponders at the end of the lease. Accordingly, there would be no replacement lease or replacement lease rents. This factor is either neutral or supports the conclusion that Taxpayer did not own the transponders.

4. Reasonable possibility that the purported owner of the property can recoup its investment in the property from the income-producing potential and residual value of the property.

In this case, from the outset, no reasonable possibility existed for Taxpayer to recoup its investment based on the income-producing potential and residual value of the transponders, without regard to tax benefits. Again, according to Exam and per the discussion of factor 8 above, the profit earned by Taxpayer, when Federal income tax benefits are discounted, would be negligible.

Based on the facts provided to us, as analyzed under the Grodt & McKay Realty factors and the additional factors identified in Torres as relevant to sale/leasebacks, we believe, as does the Office of the Associate Chief Counsel (Income Tax & Accounting) (CC:ITA), that the transaction in this case should be re-characterized as a financing. The leaseback placed on Seller/Lessee substantially all burdens, risks, and responsibilities associated with ownership of the transponders, under every possible set of circumstances.

To summarize, although no single factor determines which party holds the benefits and burdens of ownership of property, the transfer of an equity interest in the property is significant evidence that a sale has taken place. See Estate of Franklin v. Commissioner, 544 F.2d 1045, 1048 (9th Cir. 1976). A taxpayer that acquires no equity interest in the property has no cognizable interest, but instead merely purports to acquire tax benefits associated with ownership. Houchins v. Commissioner, 79 T.C. 570, 602 (1982). An equity interest is distinguishable from a mortgagee's security interest in that an equity owner has the potential for: (1) gain from any appreciation in the value of the property; and (2) loss from a decline in the value of the property. In contrast, a mortgagee's return (i.e., interest) from a transaction is generally fixed, at least within certain parameters, when the parties enter into the transaction.

In this case, Taxpayer's investment was characterized as an equity investment. However, unless Taxpayer had the potential for gain if the value of the transponders appreciated and the risk of loss if the value declined, the investment should not be equated to an equity investment. We believe that, in this case, Special Purpose Subs' risk was more akin to risk of loss of principal on a loan, rather than risk of fluctuation in the value of the underlying asset. Thus, Taxpayer was in the position of a lender rather than an owner, as Seller/Lessee effectively bore all risk of appreciation and economic (as opposed to tax) depreciation of the transponders.

In our view and that of CC:ITA, Taxpayer's economic return from the transaction, when evaluated without regard to tax consequences, was effectively fixed when it entered into the transaction, and there was no upside or downside potential. In our views, based on the factors in Grodt & McKay Realty, discussed above, the burdens and benefits of ownership did not pass to Taxpayer.

Additional Considerations

An additional case that may be relevant is Frank Lyon Co. v. United States, 435 U.S. 561 (1978). In that case, the U.S. Supreme Court overturned the Commissioner's determination that a sale/leaseback should be disregarded for tax purposes. That case involved the construction of a new building by taxpayer, a regulated banking organization. Because banking regulations and capital requirements precluded the bank from actually owning the building, the bank found an investor to take title to the property and lease it back to the bank for 25 years. At trial, the government acknowledged the regulatory requirement, and conceded that more than mere tax avoidance was behind the form of the transaction. The Court held that:

> Where, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.

435 U.S. at 583-84.

We believe that the present case is distinguishable from Frank Lyon. None of Taxpayer's funds were truly at risk in this transaction, as compared to the banks' $500,000 investment that the court in Frank Lyon found was actually at risk. Moreover, it does not appear to us that valid, tax-independent considerations of the type in Frank Lyon required the parties to structure the transaction as they did. Rather, the transaction appears intended to provide Corporation A financing at below-market interest rates, in part by transferring the income tax benefits of "ownership" of the transponders to unrelated investors outside the Corporation A group.

Finally, all transactions, including sale/leasebacks, must meet the threshold requirements of business purpose and economic substance, in order to be respected for Federal income tax purposes. E.g., Rice's Toyota World, Inc. v. Commissioner, 81 T.C. 184, 209 (1983), aff'd in part, rev'd in part, 752 F.2d 89 (4th Cir. 1985). In most cases, the relevant inquiry is whether a realistic opportunity for economic profit exists, in an amount sufficient to justify the transaction. 81 T.C. at 203.

In Rice's Toyota World, the Tax Court analyzed an alleged sale/leaseback of computer equipment. The court held that no non-tax considerations supported the owner-lessor's entering into the purchase-leaseback transaction. Thus, the transaction was not motivated by a business purpose, and it lacked economic substance. The taxpayer in Rice's Toyota World (a car dealer) knew little about the subject matter of the lease (computer equipment), and it had relied primarily on the promoter's representations as to income-potential and residual value. Similarly, when it entered into this transaction, Taxpayer apparently had no independent knowledge regarding the highly-specialized market for transponders. Taxpayer had no knowledge regarding the transponders' true value or their capacity to generate rental income over the lease term, apart from the representations made by Promoter.

In this case, the tax benefits were significant, and the potential for profit without regard to tax benefits was minimal. The incentives that Seller/Lessee provided for investors to participate in the transaction were Federal income tax benefits. These factors, together with a Tax Indemnification Agreement, strongly suggest the primary importance of tax considerations in this transaction.

In summary, we believe that, based on the facts provided to us, Taxpayer did not have the benefits and burdens of ownership of the transponders. Accordingly, Taxpayer's claimed depreciation deductions should be denied.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

This memorandum discussed certain subsequent events, including the lessee's exercise of the EBO at a relatively early date, when the transponders' income-producing potential had apparently been reduced. Other facts, not discussed herein, suggest that the "migration" of Satellite A to a back-up role in another orbit might have been planned well in advance of the exercise of the EBOs. These facts tend to corroborate the view that Corporation A (and its successors) did not intend to part with ownership of the transponders, but merely engaged in a complex financing. However, it bears emphasis that only the facts and circumstances as of the time the parties enter into the transaction, rather than subsequent events during the lease term, are relevant and subject to analysis.

We recognize that Frank Lyon presents a hazard of litigation. Although that case also involved a multiple-party financing transaction involving a physical asset, we think that it is readily distinguishable. In Frank Lyon, the bank had substantial non-tax reasons (i.e., compliance with banking regulations) to seek an independent investor to take title to the property. In contrast, it does not appear that any substantial non-tax considerations underlie the transponder transaction. [redacted]

[redacted]

An important factor supporting our conclusion is the Taxpayer's lack of any meaningful residual interest in the transponders at the end of the lease, i.e., the lease term approximated (or was longer than) the projected useful life of the transponders. [redacted]

In view of our resolution of the benefits and burdens issue, we have not addressed the alternative issue regarding the correct depreciation for the transponders. We would be glad to provide assistance on this matter, should it become necessary at a later date.

If you have any questions or need further assistance, please contact Branch 6 at (202) 874-1490.

ELIZABETH G. BECK
Senior Technical Reviewer
Branch 6
Office of Associate Chief Counsel
(International)