Office of Chief Counsel
Internal Revenue Service
Memorandum

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to: Director, Financial Services
(Large & Mid-Size Business)

from: Associate Chief Counsel
(Financial Institutions and Products)

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subject: Lease-In/Lease-Out ("LILO") and Sale-In/Lease-Out ("SILO") Exit Strategy

This memorandum sets forth a legal analysis that you may wish to consider during your examination of a strategy that taxpayers used to exit from LILO and SILO transactions. This strategy is known as the Lease Residual Management Strategy ("LRMS"). Please note that it is not the only legal analysis that may be used in addressing this strategy and that it is based on the assumption that the arrangements styled by the taxpayers as options are appropriately characterized as options for federal income tax purposes. In appropriate cases, you may wish to challenge this characterization. Furthermore, the memorandum assumes that the underlying LILO and SILO transactions, and their constituent steps, have substance and will be respected, which also is subject to challenge.[1]

ISSUE

Whether a payment of cash made by the grantor of a call option to settle the grantor's obligations under the option is a sale or exchange of the option by the holder for purposes of section 954(c)(1)(B)(iii).

CONCLUSION

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[1] See note 2 and discussion under Other Considerations.

A payment of cash made by the grantor of a call option to settle the grantor's obligations under the option is a sale or exchange of the option by the holder under section 954(c)(1)(B)(iii).

FACTS

X, a U.S. taxpayer, purports to acquire either a leasehold interest (LILO transaction) or an ownership interest (SILO transaction) in property owned by Y, a tax-exempt entity.[2] X then leases the property back to Y for a term that expires before the expiration of the leasehold or ownership interest held by X. Thus, X could take possession of the property at the end of Y's lease. Y, however, also acquires from X the right to purchase, immediately after Y's lease ends, X's remaining interest in the property. This right is known as the Purchase Option. At the time X acquires the interest from Y, Y sets aside sufficient funds received from X to exercise its rights under the Purchase Option. It is highly likely that Y will exercise the Purchase Option and thus preclude X from taking possession of the property at the end of the lease term.

In a later taxable year, X engages in an LRMS transaction. In this transaction, X enters into an arrangement, styled as an option, with a controlled foreign corporation (CFC) that is subject to low foreign tax rates. This option, known as the LRMS Option, gives the CFC the right to purchase from X the same property that is the subject of the Purchase Option. The CFC has been advised by the promoter that it needs to hold the property in a fashion that satisfies section 1231. We have substantial doubt that this will happen, but we have assumed that it will for purposes of this memorandum. If Y exercises the Purchase Option as anticipated, X must deliver the property to Y. If the CFC also exercises its LRMS Option, then X will have no property to deliver to the CFC. The LRMS Option, however, allows X to make a "damages" payment to the CFC instead of delivering the specified property. Materials prepared by the promoter of the LRMS transaction characterize this "damages" payment as both a termination fee and a cash payment that settles the LRMS Option. The payment terminates the CFC's rights and satisfies X's obligation under the LRMS Option, and it equals or approximates the built-in gain in the LRMS Option. According to the promoter's materials, it also offsets, at least in part, the gain recognized by X when Y exercises the Purchase Option because it creates a deduction for X in the U.S. and a corresponding amount of income

[2] It is the Service's position that a taxpayer who engages in a LILO or SILO transaction does not thereby acquire a current leasehold or ownership interest in property. Rev. Rul. 2002-69, 2002-2 C.B. 760; Notice 2005-13, 2005-1 C.B. 630. This position has been ratified in the case of LILOs by the only court to have considered the issue. BB&T Corp. v. United States, No. 1:04CV00941, 2007 WL 37798 (M.D.N.C. Jan. 4, 2007). This memorandum assumes the correctness of taxpayers' claim that the transactions confer property interests, but only for the purpose of assessing the efficacy of the LRMS transaction as a means of reducing taxable income deferred by a LILO or SILO transaction.

for the CFC in the foreign jurisdiction. This income is subject to a lower rate of tax in the foreign jurisdiction than it would have been had it been subject to tax in the U.S.

LAW AND ANALYSIS

Pursuant to section 951(a)(1)(A)(i), a U.S. shareholder of a CFC includes in gross income its pro rata share of the CFC's subpart F income for the CFC taxable year which ends with or within such taxable year of the shareholder. Section 952(a)(2) defines the term "subpart F income" to mean, in part, foreign base company income (as defined under section 954). Section 954(a)(1) defines "foreign base company income" to include foreign personal holding company income (FPHCI) for the taxable year.

Section 954(c)(1)(A) defines FPHCI to include the portion of gross income which consists of dividends, interest, royalties, rents and annuities. In addition, section 954(c)(1)(B) defines FPHCI to include, subject to certain exceptions, the excess of gains over losses from the sale or exchange of property (i) which gives rise to income described in subparagraph (A) (i.e., dividends, interest, etc.), (ii) which is an interest in a trust, partnership, or REMIC, or (iii) which does not give rise to any income. Section 1.954-2(e)(3) specifically classifies, subject to certain exceptions which are not relevant with respect to the LRMS Option, rights and interests in property, including options, as property that does not give rise to income for purposes of determining FPHCI. A "sale or exchange" is not defined for purposes of section 954(c)(1)(B).

In the absence of a specific definition, it is appropriate to look to how the sale or exchange of an option is defined generally for purposes of the Code. A review of the provisions of section 1234 and its legislative history reveals an existing Congressional definition of "sale or exchange" with respect to the cash settlement of an option which is equally applicable in the section 954 as well as the section 1234 context.

Section 1234(a) sets forth a general rule for purchasers of put and call options. Specifically, the character of property in the hands of a taxpayer determines the character of gain or loss upon the taxpayer's sale, exchange, or lapse of an option to buy or sell that same property.

As noted in the House Report for the 1954 Code, H. Rep. No. 1337, 83d Cong., 2d Sess. A278 (1954), the rule for lapses of options carried over from section 117(g)(2) of the 1939 Code while the rule for sales or exchanges of options was new. Congress concluded that "an option is no more than a right to buy or sell property and, in determining whether or not a capital transaction is involved, the character of the property to which the option relates should be controlling." Congress wanted consistency not only in the character but also in the holding period. It noted that under present law, holders of options realized short-term losses and grantors short-term gains on lapses, but that holders who were not dealers could realize long-term gains or losses if the option itself was held for the requisite holding period. Consequently, to fully equate the tax treatment of loss on failure to exercise an option to loss on the sale of

such an option, a capital loss realized on a lapse would be treated as long-term loss if the option were held for the required holding period. This rule ensured that it would make no difference whether the holder sold an option at a loss or failed to exercise it. Thus, section 1234(a) was amended to provide "consistent treatment for sales and failures to exercise an option and in the case of the [holder made] the treatment depend on the nature of the underlying asset." H. Rep. No. 1337 at 83. A nearly identical explanation can be found in the Senate Report, S. Rep. No. 1622, 83d Cong., 2d Sess., 113 and 438 (1954).

This theme of consistency was played again by Congress in 1984, when it amended section 1234(c) to address options that settle for cash on exercise. As stated in the House Report, H.R. Rep. No. 482, 98th Cong., 2d Sess. 1263 (1984), for grantors of options it was unclear whether the rule in section 1234(b) addressing lapses and closing transactions applied to options that either settle or could settle in cash. When the Senate considered this new provision, it noted in S. Prt. 169, 98th Cong., 2d Sess. (Vol. 1) 285 (1984), that "[b]ecause the rules of secs. 1234(a) and 1234(b) apply to options in property, it is unclear whether these rules apply to options that settle in (or could be settled in) cash." In H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 904 (1984), the Conference Committee acknowledged the lack of clarity for both grantors and holders.

To address this problem for cash settlement options, Congress enacted section 1234(c)(2). Section 1234(c)(2)(A) provides the general rule that for purposes of both sections 1234(a) and 1234(b), a cash settlement option is treated as an option to buy or sell property. Section 1234(c)(2)(B) sets forth a definition for cash settlement options, specifically that they are options that, on exercise, either settle in or could be settled in cash or property other than the underlying property referenced by the option. Thus, section 1234(c) brings cash settlement options within the operating rules of sections 1234(a) and 1234(b).

You are now facing the argument that section 1234 neither creates nor contemplates a sale or exchange of an option when it is settled in cash. If this were true, then section 1234(c) would not eliminate all the mismatches concerning Congress in 1984. The legislative amendments and the accompanying reports show an intent by Congress to ensure that the treatment of gain or loss from an option be the same, whether the option is sold, exchanged, allowed to lapse, or settled in cash. Specifically, all of these events should be afforded the same character treatment as a purchase of the underlying property upon exercise of the option and an immediate sale of the property by the purchaser. It is important to note that, rather than amending the language of section 1234(a)(1) to apply to "the sale, exchange, or cash settlement" of an option to buy or sell property, Congress instead retained the "sale or exchange" language in section 1234(a)(1) and clarified that an option that settles in cash be treated as an "option to buy or sell property." Congress must have considered the cash settlement of an option to constitute a "sale or exchange" of that option. Otherwise, the addition of section 1234(c)(2)(A) to treat a "cash settlement option" as an "option to buy

or sell property" for purposes of section 1234(a)(1) would not bring the cash settlement of an option within the scope of section 1234(a)(1).

For example, assume a taxpayer holds a cash settlement option whose underlying property is described in section 1231. If the taxpayer receives a payment of cash upon exercise of the option, that payment is a taxable event that closes the option. The payment is not a lapse of the option. If it were also not a sale or exchange of the option, then it would not be subject to the operating rule of section 1234(a)(1), which applies to "gain or loss attributable to the sale or exchange of, or loss attributable to failure to exercise, an option to buy or sell property." Because the payment would not be within the operating rule, it would be ordinary income to the taxpayer. If the taxpayer had sold the option, however, that sale would be subject to the operating rule of section 1234(a), and it could be treated as the sale or exchange of a section 1231 asset. This is the type of mismatch that Congress intended to eliminate when it enacted section 1234(c). Consequently, Congress must have intended that for cash settlement options, the payment of cash at settlement must be a sale or exchange under section 1234(a).

The analysis set forth above is consistent with the Service's analysis of the treatment of the cash settlement of a right that was attached to a share of common stock in Rev. Rul. 88-31, 1988-1 C.B. 302. In that ruling, the Service determined that the right was a cash settlement put option under section 1234(c)(2). Citing the 1984 legislative history, the Service concluded that a cash payment by the issuer to the holder of the right would be treated as an exercise and a sale or exchange of the option.

Because the cash settlement of an option is generally considered by Congress to constitute the sale or exchange of an option, the cash settlement of an option should be treated as a sale or exchange of that option for purposes of section 954 as well.

The next question is whether the "damages" payment by X to the CFC under the LRMS Option would be a payment upon exercise of a cash settlement option. X's characterization of the payment as "damages" is not controlling. Instead, the substance of the payment determines its treatment for tax purposes.

The payment of cash by X to the CFC is contemplated by the LRMS Option arrangement. Under the terms of the arrangement, upon an exercise of the CFC's LRMS Option, X may deliver cash or property to the CFC. A cash payment does not compensate the CFC for any harm or any special use it would have made of the property. Instead, like any payment in settlement of a cash settlement option, it compensates the CFC for a portion of the value of the underlying property. It terminates the CFC's rights and X's obligations, but does so pursuant to the terms of the arrangement. Although the promoter's materials refer to the payment as a termination fee, they also refer to it as a cash payment that settles the LRMS Option. Accordingly, the "damages" payment constitutes a cash payment in settlement of a cash settlement option.

Therefore, if the CFC receives the “damages” payment upon settlement of the LRMS Option, any gain resulting from the receipt of the “damages” payment will constitute gain from the sale or exchange of the LRMS option. Any gain from the payment will thus result in the recognition of subpart F income under section 954(c)(1)(B)(iii) and section 1.954-2(e)(3) as gain from the sale or exchange of property that does not give rise to income.

OTHER CONSIDERATIONS

It is understood that you will be considering challenging the economic substance of the LILO and SILO transactions.

As noted above, this memorandum does not cover all analyses of the LRMS Option. As you develop these cases, you should consider whether other characterizations of the LRMS Option are appropriate and whether the LRMS transaction, or steps thereof, can be ignored or recharacterized based on a lack of economic substance.

Depending on the circumstances, the LRMS Option may be appropriately treated as a loan. That recast may be particularly appropriate if the prospect of nonexercise of the LRMS Option is found to be remote. In this regard, particular attention should be given to whether the value of the property is effectively subject to a floor by virtue of X’s right to require Y to lease the interest at preset rates. You will want to consider this argument in the initial tax year of the LRMS Option if the CFC has current or accumulated earnings and profits because the recast as debt would be a section 956 investment in U.S. property taxable as subpart F income. Except for the section 956 investment, the debt recast and sale or exchange analysis may produce largely the same net tax results.

Additionally, please let us know if taxpayers modify the arrangement to attempt to avoid sale or exchange treatment so that we can advise you accordingly. You should also consider whether the underlying residual interest constitutes property described in section 1231 if it ultimately is held by the CFC.

As always, we stand ready to assist you with the development of these cases.