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## CHAPTER 5

### LIMITS OF TAX-DRIVEN CROSS-BORDER LEASING TRANSACTIONS

#### 5.1. Introduction

Over the past few decades, taxpayers have engaged in tax-driven leasing transactions for maximizing tax advantages. The tax advantages sought to be derived from the leasing transactions could be in the form of enhancement of deductions (for instance, depreciation, interest deduction, etc.) or deferment of taxable leasing income, or a combination of enhancement of deductions as well as deferral of income.

In their pursuit of maximizing tax advantages, particularly with respect to big-ticket assets, taxpayers often prefer aggressive leasing transactions. Analytical review of the various transaction structures suggests the possibility of grouping the tax-driven leasing transaction structures as structures designed to:

- exploit the transaction characterization rules of the national tax laws (e.g. sale-and-leaseback, double-dip transactions, etc.);
- facilitate the deferral of taxation of leasing income (e.g. leases with balloon rental payments);
- circumvent the restrictive or anti-avoidance provisions of a tax law (e.g. chain-lease, replacement lease and lease-in-lease-out transactions);
- facilitate the transfer of tax advantages to equity investors in the lessor entity (e.g. organizing the lessor entity in the form of transparent entities);
- avail of certain beneficial provisions of tax laws or tax treaties (e.g. structures to benefit from the tax sparing credit provisions in tax treaties); and
- enhance tax advantages by increasing a lessor's capacity to lease (e.g. leveraged leases with non-recourse financing, defeasance structures, etc.).

The tax laws of many jurisdictions have specific restrictive or anti-avoidance provisions to impede aggressive leasing transactions. However, due to the dynamic characteristic of the financial services industry, the players in

the leasing arena have been able to innovate the transaction structures beyond the clutches of such restrictive or anti-avoidance provisions, that are inevitably followed by consequential amendments in the national tax laws to plug loopholes. However, the plugging of the said loopholes is often found not pre-emptive enough to check further innovation of the leasing transaction structures. In such cases the only remedy available to the tax authorities is to invoke the general anti-avoidance rules, though they may not always prove effective.

This chapter aims to explore the current limits of the tax-driven leasing transactions by analysing:

- (i) the relevant general anti-avoidance principles in the select jurisdictions;
- (ii) the types of tax-driven leasing transaction structures commonly undertaken by taxpayers; and
- (iii) specific provisions under the national tax laws or court decisions that may have influence on such transaction structures.

### **5.2. Relevant anti-avoidance rules in select jurisdictions: a brief overview**

#### 5.2.1. United States

The IRC does not specifically include a general anti-avoidance rule.<sup>169</sup> However, the United States being a common law jurisdiction, substantial tax jurisprudence on the subject of tax avoidance has developed as a result of court decisions.<sup>170</sup> The general anti-avoidance principles in the United States may be classified into the following doctrines:

- (a) the sham transaction doctrine;
- (b) the step transaction doctrine;
- (c) the business purpose doctrine;
- (d) the substance-over-form doctrine; and
- (e) the economic substance doctrine or the economic sham transaction doctrine.

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169. See Streng, Yoder, “Form and Substance in Tax Law” (Chapter for the United States, paragraph 5.4), *Cahiers de droit fiscal international*, Volume LXXXVIIa, IFA 2002 Congress, Oslo.

170. See Streng, Yoder, “Form and Substance in Tax Law” (Chapter for the United States, paragraph 5.3), *Cahiers de droit fiscal international*, Volume LXXXVIIa, IFA 2002 Congress, Oslo.

It is important to note that these doctrines are not mutually exclusive, and the IRS may seek to neutralize an aggressive transaction by invoking more than one doctrine.

#### 5.2.1.1. The sham transaction doctrine

A sham transaction could be either a “factual sham” transaction or an “economic sham” transaction. A transaction is regarded as factual sham, when the factual events occurring in the course of a transaction are inconsistent with the transaction described by the taxpayer in the relevant documents. In other words, a transaction is regarded as a factual sham if it is found to be “fake”.

This doctrine covers only the factual sham transactions, and the economic sham transactions are covered under the economic substance doctrine.<sup>171</sup> In cases where the sham transaction doctrine applies, the relevant transaction documents are disregarded and the transaction is considered non-existent for tax purposes.<sup>172</sup>

#### 5.2.1.2. The step transaction doctrine

Under the *step transaction doctrine*, separate transactions within a series of transactions are treated as one composite transaction, if such a treatment more accurately reflects the underlying substance of the transactions. In this regard, the US Supreme Court decision in *Minnesota Tea Co. v. Helvering*<sup>173</sup> is considered an authority.

It appears that for ascertaining whether the step transaction doctrine applies to a particular series of transactions, the US courts have applied three main tests, namely:<sup>174</sup>

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171. For that reason, the economic substance doctrine is also referred to as “economic sham transaction doctrine”.

172. For a detailed discussion on this doctrine, see Streng, Yoder, “Form and Substance in Tax Law” (Chapter for the United States, paragraph 5.7.4), *Cahiers de droit fiscal international*, Volume LXXXVIIa, IFA 2002 Congress, Oslo.

173. 302 US 609 (1938). In this decision, the Supreme Court coined the step transaction doctrine by stating that a given result at the end of a straight path does not change by taking a devious path.

174. See Country Report for the United States by William P. Streng and Lowell D. Yoder, “Form and substance in tax law”, *Cahiers* for the 2002 IFA Congress.

- (i) the binding commitment test;
- (ii) the mutual interdependence test; and
- (iii) the end result test.

A series of transactions can be combined as one composite transaction under the *binding commitment test* if, at the time of the first transaction the taxpayer was under a binding obligation to follow the other transactions. Conversely, in absence of such binding obligation on the taxpayer, a series of transactions cannot be combined as one composite transaction unless the other two tests under this doctrine apply.<sup>175</sup>

Under the *mutual interdependence test*, a series of transactions can be clubbed together as one composite transactions if the relationship between the two or more transactions is such that the legal relationship arising from one transaction would have been meaningless without undertaking the other transactions within the series.<sup>176</sup>

Under the *end result test*, a series of transactions can be combined as one transaction if so intended by the parties to the transactions. Apparently, this third test resembles the “substance-over-form doctrine”.<sup>177</sup>

### 5.2.1.3. Business purpose doctrine

Under the business purpose doctrine, a transaction or a series of transactions is disregarded if the transaction lacks a valid business purpose other than avoidance of federal tax. *Gregory v. Helvering*<sup>178</sup> is the leading authority on this doctrine, wherein the US Supreme Court disregarded a corporate

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175. The US Supreme Court decision in *Commissioner v. Gordon* 391 US 83 (1968). In this case, a corporation distributed 57% of the stock of its wholly owned subsidiary to its shareholders and informed the shareholders that it intended to distribute the remaining 43% stock within the next few years. Two years subsequent to the first distribution, when the corporation distributed the remaining 43% stock, the taxpayer claimed that the two distributions should be combined as one transaction so as to treat it as a tax-free reorganization. Rejecting the claim of the taxpayer, the Court held that for a transaction to be characterized as first step in a composite transaction there must exist a binding commitment in respect of the later step.

176. *American Bantam Car Co v. Commissioner* 11 T.C. 397 (1948), aff’d per curium, 177 F.2d 513 (3rd Cir. 1949), cert. denied 339 US 920 (1950).

177. For a discussion on step transaction doctrine, see Streng, Yoder, “Form and Substance in Tax Law (Chapter for the United States, paragraph 5.7.1), *Cahiers de droit fiscal international*, Volume LXXXVIIa, IFA 2002 Congress, Oslo.

178. 293 US 465 (1935).

reorganization for want of an underlying business purpose. The following extract from the decision forms the genesis of the doctrine:

When [the statute] speaks of a transfer of assets by one corporation to another, it means a transfer made “in pursuance of a plan of reorganization” of corporate business; and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either, as plainly is the case here ... [T]he transaction upon its fact lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.<sup>179</sup>

#### 5.2.1.4. The substance-over-form doctrine

Under the substance-over-form doctrine, the tax authorities or a court may recharacterize a transaction in accordance with its economic substance, if the legal form of the transaction does not reflect its true economic substance.<sup>180</sup>

In *Gregory v. Helvering*,<sup>181</sup> the US Supreme Court disregarded the legal form (corporate reorganization) and held that, in substance, the transaction was in respect of dividends of appreciated securities taxable as ordinary income of the taxpayer.<sup>182</sup>

#### 5.2.1.5. The economic substance or the economic sham transaction doctrine

Under this doctrine, a taxpayer is denied a tax advantage if the economic substance of the transaction is insignificant compared to the tax advan-

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179. For a discussion on business purpose doctrine, see Streng, Yoder, “Form and Substance in Tax Law” (Chapter for the United States, paragraph 5.7.2), *Cahiers de droit fiscal international*, Volume LXXXVIIa, IFA 2002 Congress, Oslo.

180. For a discussion on substance over form doctrine, see Streng, Yoder, “Form and Substance in Tax Law” (Chapter for the United States, paragraph 5.7.3), *Cahiers de droit fiscal international*, Volume LXXXVIIa, IFA 2002 Congress, Oslo.

181. 293 US 465 (1935).

182. *ASA Investering Partnership v. Commissioner* (T.C. Memo 1998-305, aff’d. 201 F.3d 505 (2000), cert. denied, 531 US 87) is a recent case where the Court applied the substance-over-form doctrine to recharacterize a transaction.

tage.<sup>183</sup> *Goldstein v. Commissioner*<sup>184</sup> is one of the early cases where a transaction was disregarded due to lack of economic substance.

*ACM Partnership v. Commissioner*<sup>185</sup> is another leading case where a transaction (purchase and sale of a property within a 24-day period) was disregarded for want of economic substance. However, in *United Parcel Service v. Commissioner*<sup>186</sup> the Court of Appeals (11th Circuit) respected a transaction as the taxpayer was able to demonstrate economic substance in the transaction challenged by the IRS.

As various federal courts of appeal in the United States are organized in different circuits, the decisions of one federal court of appeal are not binding on the other federal courts of appeal. Accordingly, it is possible that two federal courts of appeal may reach contrasting conclusions on the same issue. This aspect could be best appreciated by comparing the outcome of comparable dividend-stripping transactions in *Compaq Computer Corp. v. Commissioner*<sup>187</sup> and *IES Industries Inc. v. United States*.<sup>188</sup>

In *Compaq Computer Corp. v. Commissioner*, the taxpayer acquired “cum dividend” certain American Depository Receipts (ADRs) issued by Royal

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183. For a discussion on this doctrine, see Streng, Yoder, “Form and Substance in Tax Law” (Chapter for the United States, paragraph 5.7.4), *Cahiers de droit fiscal international*, Volume LXXXVIIa, IFA 2002 Congress, Oslo.

184. 364 F.2d 734 (2nd Cir. 1966). In this case, the taxpayer sought to derive a tax deferral benefit by taking a loan involving prepaid interest to invest in US Treasury securities that did not involve prepaid interest. As the transaction lacked economic substance and the only underlying purpose was to obtain a significant amount of tax deduction (to set off against sweepstakes winnings by the taxpayer), the Court disregarded the transaction.

185. T.C. Memo 1997-115, aff’d. in part and reversed in part, 157 F.3d 231 (3rd Cir. 1998), Cert. denied 526 US 1017 (1999). In this case, the Court of Appeals remarked about the transaction that “viewed according to their objective economic effect rather than their form, transactions involved only a fleeting and economically inconsequential investment in and offsetting divestment from the [debt instruments] ... The transactions with respect to the [debt instruments] left the [taxpayer] in the same position it had occupied before engaging in the offsetting acquisition and disposition of those notes.”

186. 254 F.3d 1014 (11th Cir. 2001). In this case, the package delivery service company United Parcel Services (UPS) formed a subsidiary in Bermuda which assumed (for compensation) certain UPS risks for lost or damaged parcels. The IRS sought to disregard the transaction between UPS and the Bermuda subsidiary and tax profits of the Bermuda subsidiary as income of UPS. UPS was successful in arguing before the Court of Appeals that its transaction with the Bermuda subsidiary had economic substance and it comprised a genuine exchange of obligations between two real and independent entities. On that ground, the Court of Appeals respected the transaction.

187. 277 F.3d 778 (5th Cir. 2001).

188. 253 F.3d 350 (8th Cir. 2001).

Dutch Petroleum and sold the same “ex dividend” within an hour of the acquisition. Though the transaction could not be expected to yield any economic benefit, the taxpayer sought to acquire foreign tax credits to the extent of USD 3.4 million and set off the capital loss<sup>189</sup> (for tax purposes) produced by the transaction against another taxable capital gain. The Tax Court disregarded the transaction due to lack of economic substance. On further appeal by the taxpayer, the Court of Appeals (5th Circuit) commented that the transaction did not involve a bona fide business purpose and the Court was not persuaded that Congress intended to encourage or permit a transaction that merely manipulated the foreign tax credit system to achieve US tax savings.

*IES Industries Inc. v. United States* involved a similar dividend stripping transaction. However, unlike in *Compaq Case*, the Court of Appeals (8th Circuit) respected the transaction.

#### 5.2.1.6. The US Supreme Court decision in the *Frank Lyon* case

In the context of respectability of the legal form of a lease transaction, the following observations made by the US Supreme Court reflect the relevant principle:<sup>190</sup>

Where 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. Expressed another way, so long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes. What those attributes are in any particular case will necessarily depend upon its facts. It suffices to say that a sale-and-leaseback, in and of itself, does not necessarily operate to deny a taxpayer’s claim for deductions.

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189. As the ADRs were sold “ex dividend”, the taxpayer fetched a lower price as compared to the price it had paid for purchasing the ADRs “cum dividend”. This difference resulted in a capital loss for tax purposes, though, in reality, the taxpayer did not incur any loss as the “capital loss” represented the dividend value in the ADRs which the taxpayer encashed before selling the ADRs.

190. 435 US 561.

5.2.1.7. Application of “two-fold test” by the lower courts in the United States

In recent cases, as discussed hereafter, the lower courts have applied the following two tests to determine whether a transaction should be respected as a lease for federal income tax purposes:

- (i) whether the transaction is not a sham devoid of economic substance (“sham transaction test”); and
- (ii) whether the lessor has acquired and retained the requisite burdens and benefits of ownership of the leased property (“burden and benefits of ownership test”).

Where both the tests show a positive result, generally the courts have respected the transactions as a lease.

(i) *Sham transaction test*

The “sham transaction test” consists of a factual analysis.<sup>191</sup> In recent cases, the courts have focused on the economic substance of the transactions.<sup>192</sup> The economic substance analysis consists of an examination of the objective factors indicating whether the taxpayer had a reasonable opportunity to receive economic profit from the transaction, apart from any tax benefit.

In one case,<sup>193</sup> the Tax Court considered the following factors as significant in analysing whether a transaction has economic substance apart from tax benefits:

- presence (or absence) of arm’s length price negotiations;
- relationship between the sale price and the fair market value;
- financial structure of the transaction;
- degree of adherence to contractual terms; and
- reasonableness of the income and residual value projections.

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191. See *Smoot v. Commissioner*, 61 T.C.M. (CCH) 2897 (1991); *Emershaw v. Commissioner*, 59 T.C.M. (CCH) 621 (1990), aff’d, 917 F.2d 1040 (8th Cir. 1990).

192. See *Shriver v. Commissioner*, 899 F.2d 905 (10th Cir. 1990); *Casebeer v. Commissioner*, 862 F.2d 1486 (11th Cir. 1989); *Rose v. Commissioner*, 868 F.2d 851, 854 (6th Cir. 1989).

193. See *Levy v. Commissioner*, 91 T.C. 838 (1988).



(ii) *Burden and benefits of ownership test*

Generally, for a lease transaction to be respected, the lessor must have the “upside” (profit and appreciation benefits) and “downside” (risk of loss) with respect to the property.<sup>194</sup>

## 5.2.2. United Kingdom

In the United Kingdom, tax consequences are determined by the legal form of a transaction, unless such result would conflict with the general or specific anti-avoidance rules (the general anti-avoidance principles are developed by the judge-made common law).<sup>195</sup> As specific anti-avoidance provisions may not be pre-emptive enough to check the aggressive tax-driven leasing transactions, the general anti-avoidance principles define the boundaries of freedom that a taxpayer may reasonably assume in “designing” the legal form of leasing transactions. The general anti-avoidance principles emerging from various court decisions could be encapsulated as follows:

### 5.2.2.1. The Ramsay principle (*W.T. Ramsay v. IRC*)<sup>196</sup>

In the landmark case of *W. T. Ramsay v. IRC*, the House of Lords established the principle that a court is not compelled to look at a document or a transaction in isolation, divorced from the context to which it properly belongs. If a document or transaction was intended by the parties to it to have a particular effect as part or nexus of a series of transactions, or as an element in a wider transaction intended by the taxpayer to operate as a whole, then the court is not obliged to view the document or the transaction in accordance with the purported legal effect; and the court is free to consider the transaction in accordance with the intended effect. This principle is now commonly referred to as *the Ramsay principle*.

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194. See observations of the Supreme Court in *Frank Lyon Co. v. United States*, 435 U.S. 561; *Sun Oil Co. v. Commissioner*, 562 F.2d 258 (3rd Cir. 1977), cert. Denied, 436 U.S. 944 (1978); *Emershaw v. Commissioner*, 59 T.C.M. (CCH) 621 (1990), aff’d, 917 F.2d 1040 (8th Cir. 1990); *Levy v. Commissioner*, 91 T.C. 838 (1988).

195. See Ballard, Richard, and Davison, Paul, “Form and Substance in Tax Law” (Chapter for the United Kingdom), *Cahiers de droit fiscal international*, Volume LXXXVIIa, IFA 2002 Congress, Oslo.

196. [1982] AC 300 (HL).