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# Taxation of Sale and Leaseback Transactions - A General Review

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# Taxation of Sale and Leaseback Transactions—A General Review

TABLE OF CONTENTS


I. INTRODUCTION ........................................ 945
II. OPERATION OF A SALE AND LEASEBACK TRANSACTION .. 946
A. *Introduction* ........................................ 946
B. *Description of a Sale and Leaseback Transaction* 948
C. *Financial Considerations* ........................ 949
D. *Tax Considerations* ................................ 952
E. *Internal Revenue Service Treatment of Sale and Leaseback Transactions* ........................ 954
III. JUDICIAL TREATMENT OF SALE AND LEASEBACK TRANSACTIONS ........................................ 956
A. *Introduction* ........................................ 956
B. *Section 1031 Like-Kind Exchange* ............ 956
(1) *Century Electric* ................................ 960
(2) *Jordan Marsh* .................................... 965
(3) *Leslie Co.* ........................................ 967
(4) Summary ............................................ 968
C. *Recharacterization of the Sale and Leaseback as a Mortgage Loan* ................................ 968
(1) Traditional Analysis ............................ 968
(2) Recent Cases ...................................... 971
(3) Analysis of *American Realty, Sun Oil,* and *Lyon* ................................................ 977
(4) Proposed Solution ................................ 980
IV. CONCLUSION ........................................ 982


## I. INTRODUCTION

Since the sale and leaseback transaction gained prominence in the 1940's,[1] its financial and tax repercussions have been the subject of much discussion among legal scholars.[2] Many of these scholars

1. Agar, *Sales and Leasebacks,* 18 A.B.A. SECTION TAX. (PT. 2), 61, 63 (1965); Cary, *Corporate Financing Through the Sale and Lease-Back of Property: Business, Tax and Policy Considerations,* 62 HARV. L. REV. 1 (1948).

2. Agar, *supra* note 1; Cary, *supra* note 1; Mandell, *Tax Aspects of Sales and Leasebacks as Practical Devices for Transfer and Operation of Real Property,* 18 N.Y.U. INST. FED. TAX. 17 (H. Sellin ed. 1960); Marcus, *Real Estate Purchase-Leasebacks as Secured Loans,* 2 REAL EST. L.J. 664 (1974); Morris, *Sale-Leaseback Transactions of Real Property—A Proposal,* 30 TAX. LAW. 701 (1977); Wilson, *Sales and Leasebacks,* 16 U.S.C. TAX INST. 149 (J. Ervin ed. 1964).

have analyzed the extensive use of the sale and leaseback as a financing tool for business expansion. Other discussion has focused on the unsettled state of the tax law in this area. Some recent articles have analyzed the particular changes in the law[3] brought about by the recent cases of *Leslie Co. v. Commissioner,*[4] *American Realty Trust v. United States,*[5] *Sun Oil Co. v. Commissioner,*[6] and *Frank Lyon Co. v. United States.*[7] These articles, however, have primarily focused on the narrow issues presented in each case. Thus the area is ripe for a comprehensive analysis of the financial and tax aspects of the sale and leaseback transaction, the development of the tax law concerning this transaction, and the recent cases in the area. After such a comprehensive analysis, this Note will attempt to determine the proper tax treatment of a sale and leaseback transaction.

This Note first discusses in detail the operation of a sale and leaseback transaction and delineates its various uses. The Note next points out the tax and financial advantages and disadvantages of the sale and leaseback, sets forth the possible avenues of attack on the transaction by the Internal Revenue Service (Service), and describes the consequences of a successful attack by the Service. The final section of the Note analyzes the judicial treatment of sale and leaseback transactions for tax purposes, focusing both on the traditional tests used by the courts and on changes in the law brought about by recent United States Circuit and Supreme Court cases.[8] This section also identifies problems arising from application of the traditional tests and highlights the shortcomings of present judicial analysis. The Note concludes by proposing several analytical methods for determining the proper tax treatment of a sale and leaseback and by suggesting solutions to the problems that arise from the present judicial analysis of these transactions.

## II. OPERATION OF A SALE AND LEASEBACK TRANSACTION

### A. Introduction

The phrase "sale and leaseback" is not a precisely defined term

3. Kaster, *Sale-Leaseback: Effect on Net Leases of the* Sun Oil Company *Loan-or-Lease Criteria,* 48 J. TAX. 194 (1978); Zarrow & Gordon, *Supreme Court's Sale-Leaseback Decision in* Lyon *Lists Multiple Criteria,* 49 J. TAX. 42 (1978); Note, *Sale and Leaseback Transactions—Loss on Sale Portion of Sale and Leaseback Transaction Deductible by Seller-Lessee*—Leslie Co. v. Commissioner, 52 N.Y.U. L. REV. 672 (1977).

4. 539 F.2d 943 (3d Cir. 1976).

5. 498 F.2d 1194 (4th Cir. 1974).

6. 562 F.2d 258 (3d Cir. 1977), *cert. denied,* 436 U.S. 944 (1978).

7. 435 U.S. 561 (1978).

8. *See* text accompanying notes 4-7 *supra.*

of art. Instead, it is used to describe a variety of transactions that include the transfer of property and the subsequent leaseback of the same property from the transferee to the original owner. These transactions take a myriad of forms and transfer diverse types of property, such as equipment, improved or unimproved real estate, and intangible property. For various tax and financial reasons,[9] several variations on the "true" sale and leaseback[10] have developed. These include the gift and leaseback,[11] the trust and leaseback,[12] and the bootstrap sale and leaseback.[13] Although each of these variations has characteristics in common with the true sale and leaseback, each possesses special attributes that are beyond the scope of this Note. Rather than detail these variations, this Note focuses on the tax and financial aspects of the true sale and leaseback transaction, with particular emphasis on the real estate sale and leaseback. Nevertheless, this discussion is generally applicable to all sale and leaseback transactions, and specific references will be made to other

9. Transactions such as the gift and leaseback, and the trust and leaseback, are used as income-splitting devices. *See* notes 11-12 *infra.* If successful these transactions can be used to shift income from high-bracket to low-bracket taxpayers (usually within the same family). The bootstrap sale and leaseback often provides 100% financing at relatively low interest rates. *See* note 13 *infra.*

10. The "true" sale and leaseback includes a permanent transfer of property for valuable consideration (as opposed to a gift or contribution to capital) and a simultaneous leaseback for a term of years.

11. The gift and leaseback includes an outright gift of property, usually to a relative or a controlled corporation, and the subsequent leaseback of the property to the original owner. If the original owner is in a higher tax bracket and the donee is in a low tax bracket, this transaction can produce substantial tax savings by shifting income in the form of lease payments to the low-bracket donee-lessor and providing the high-bracket donor-lessee with a deduction for rents.

12. The trust and leaseback is a variation of the gift and leaseback. *See* note 11 *supra.* If the donor does not wish to give the proposed donee full control of the transferred property (or possibly if the proposed donee is a minor), the donor may transfer the property in trust for the benefit of the proposed donee and then lease the property back from the trust. This transaction has the same results as a gift and leaseback, but does not have the attendant risk that the donee may dispose of or squander the property or the related income. Tax consequences in the trust and leaseback situation are less certain, however, especially if the trustee is related to the donor of the property.

13. The bootstrap sale and leaseback includes the sale of property to a tax-exempt organization, with the purchase price usually being represented by a note to the seller, and the subsequent leaseback of the property to the original owner, or to a corporation controlled by the original owner. The lease payments are set at a percentage of net income. The note is nonrecourse and note payments are set at a percentage of the lease payments. This transaction has the effect of "bailing out" ordinary income from the property at capital gains rates. Further, if the tax-exempt purchaser is not required to pay tax on the income from the lease, it will normally accept a lower rate of return on its investment (if any) than would be required under a conventional financing technique. The use of the bootstrap sale and leaseback was severely limited by the enactment of I.R.C. § 512, which taxes tax-exempt organizations on unrelated business income. For a more detailed discussion of bootstrap sale and leaseback transactions, see 11 VILL. L. REV. 563 (1966).

types of sale and leaseback transactions, including the variations mentioned above.

### *B. Description of a Sale and Leaseback Transaction*

The typical real estate sale and leaseback transaction includes the sale of land or land and buildings to an investor and the simultaneous leaseback of the property to the original owner. The investor pays the seller either in cash or with a note and takes legal title to the property. The seller-lessee then obligates itself to lease the property for an extended term that may be less than, equal to, or greater than the estimated useful life of any depreciable assets included in the lease. The lease may also contain options to renew or options for the seller-lessee to repurchase the property at a future date for a stated price or for a price to be determined by a future appraisal. If the transaction is upheld for tax purposes as a valid sale and leaseback,[14] the purchaser-lessor will have title to the property, will receive ordinary income in the form of rental payments,[15] and will be allowed a tax deduction for depreciation[16] and for any interest paid[17] on indebtedness related to the property. The seller-lessee will have both the asset and any related liabilities removed from his books,[18] will have in place of the land or building a current asset in the form of cash or a note that may be factored, and will be allowed a rental deduction for the lease payments.[19]

The basic sale and leaseback transaction described above is composed of several simple components—a sale for valuable consideration, a lease for a term of years, and various options to renew or repurchase. The possible combinations of these components, however, provide a flexible yet complex tool for financing or business expansion. The consideration paid by the purchaser is generally the fair market value of the property, but may be a lesser amount when other aspects of the sale or the leaseback favor the seller. Rental payments may be set at the fair rental value of the property, but

14. Sale and leaseback transactions may be held invalid for tax purposes for various reasons. For example, the transaction may be classified as a tax-free § 1031 like-kind exchange or may be recharacterized as a mortgage loan. *See* text accompanying notes 48-54 *infra*.

15. I.R.C. § 61(a)(5).

16. I.R.C. § 167.

17. I.R.C. § 163.

18. Under certain circumstances, however, generally accepted accounting principles require that the leasehold be capitalized and that the obligation to make future lease payments be shown on the books of account as a liability. FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 13, (Nov. 1976), *reprinted in* [1979] 3 AICPA PROF. STAND. (CCH) § 4053.

19. I.R.C. § 162(a)(3).

are often set at a rate that will amortize the purchaser's investment over the lease's primary term at a specified rate of return.[20] This procedure provides the purchaser with a safe, guaranteed return on his investment. Repurchase and renewal options can also add flexibility to a sale and leaseback transaction. The renewal option assures the seller of continued use of property needed in his trade or business even though he has relinquished title. In addition, the original lease may state rentals for the renewal periods, enabling the seller-lessee to ascertain its maximum future costs of land and buildings. If the rental payments during the primary term of the lease fully amortize the purchaser's investment, many purchaser-lessors will accept reduced rent for the renewal periods. The repurchase option provides the seller with a means of reacquiring the property if necessary due to future business developments. The option may allow repurchase at any time during the lease, only at specified times, or only at the expiration of the lease. The option price may be stated, determined by appraisal, or tied to the remaining lease payments required to amortize the purchaser's investment.

In addition to the variations mentioned above, a sale and leaseback may be structured as a multiple party transaction to provide additional flexibility. For example, the seller or purchaser may be a syndicate, joint venture, or group of individuals or corporations. The purchaser may also arrange for one or more third party lending institutions to finance the purchase, using the acquired property and the lease as collateral and repaying the loan from the lease payments. These additional possibilities make the real estate sale and leaseback an extremely flexible and useful business tool.

### C. *Financial Considerations*

Sale and leaseback transactions may be utilized for a variety of business and financial purposes.[21] A principal use is to provide the seller-lessee with immediate cash to meet increased working capital needs.[22] The sale and leaseback generally provides cash equal to 100 percent of the fair market value of the property sold, while conventional financing techniques normally yield only 75-80 percent of the fair market value of the property securing the loan. In essence, the seller-lessee uses the sale and leaseback transaction to transform

20. This type of rental payment schedule closely resembles a mortgage payment schedule that provides for repayment of principal and interest in installments at a specified interest rate.

21. *See* Cary, *supra* note 1; Morris, *supra* note 2.

22. *See, e.g.*, Sun Oil Co. v. Commissioner, 562 F.2d 258 (3d Cir. 1977), *cert. denied*, 436 U.S. 944 (1978); Agar, *supra* note 1, at 62.

fixed assets into working capital while retaining possession and use of the property. As a side effect, this technique can provide a better balance sheet position for the seller-lessee, which enables it to obtain a greater amount of conventional financing in the future. The seller-lessee obtains this better balance sheet position by increasing current assets with the proceeds of the sale and thereby increasing its current ratio, an important determinant of credit standing.[23]

Many companies have found the sale and leaseback transaction a useful means for financing expansion of facilities or obtaining funds for construction. This technique has been especially prevalent in the retail sales industry. Many businesses in this industry must make a significant investment in their physical plant, and simultaneously require large amounts of working capital for inventory and operating expenses. If the business is growing rapidly, the working capital requirements often become so great that the business finds needed expansion of its physical plant impossible to finance. These businesses often expand or build new stores and then enter into sale and leaseback transactions[24] to convert fixed assets into working capital.[25]

Another use of the sale and leaseback transaction is to obtain financing in a tight money market.[26] When credit is tight and conventional financing is difficult to obtain, investors may be willing to enter into a sale and leaseback transaction as a substitute for a loan because ownership of property provides a hedge against inflation for the investor and also eliminates legal problems connected with foreclosure and collection of debt if the seller is unable to meet his obligations.[27]

In addition to the advantages listed above, a seller-lessee may be able to use a sale and leaseback transaction to circumvent loan restrictions or state and federal regulations. Although loan agree-

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23. The current ratio is the ratio of current assets to current liabilities. Lending institutions view this ratio as an indicator of a debtor's ability to service immediate obligations under short-term loans. When fixed assets are sold the cash received increases current assets without a corresponding increase in current liabilities, thus increasing the current ratio and providing the debtor with a better credit standing for short-term borrowing.

24. Some of the major retail sales concerns that have taken advantage of this technique include Allied Stores Corp., Federated Department Stores, Inc., Gimbel's, Sears Roebuck and Co., and Montgomery Ward & Company. Cary, *supra* note 1, at 2 n.4.

25. This technique is also used by contractors to acquire funds for independent construction. The contractor first purchases a construction site with his own funds and then enters into a sale and leaseback transaction to obtain financing necessary to construct a building on the site.

26. Mandell, *supra* note 2, at 18.

27. Since the lessor owns legal title to the property, he need not go through foreclosure proceedings to take possession of the property. Further, the property will not be tied up in any bankruptcy proceedings that may ensue if the lessee becomes insolvent.

ments often contain provisions limiting additional borrowing and requiring the debtor to meet certain ratio tests,[28] leaseback agreements seldom have similar provisions.[29] Moreover, the parties often can structure the sale and leaseback transaction so that it does not breach provisions of prior loan agreements that conventional financing techniques would violate. Also, several state and federal regulations relating to the ownership of property by certain organizations do not apply to leaseholds under a sale and leaseback transaction.[30]

The purchaser-lessor in a sale and leaseback may also obtain certain financial advantages from the transaction. The rate of return is generally higher on a sale and leaseback than on a loan secured by the same property.[31] The investor in a sale and leaseback procures this higher return because he takes additional risks by investing 100 percent of the fair market value of the property, rather than the lower percentage generally securing a loan. In addition, by entering a sale and leaseback transaction rather than a conventional loan, he foregoes any rights he would have as a creditor under a mortgage loan.[32] Moreover, the purchaser-lessor can often circumvent state usury laws by utilizing a sale and leaseback and thereby obtain a greater yield than would be available under a mortgage loan. Another significant advantage to the purchaser-lessor is that the ownership of property provides a hedge against inflation since any appreciation in value will accrue to the owner.[33] Finally, since most leasebacks are "net leases,"[34] the purchaser has a relatively management-free investment with a built-in tenant and a guaranteed return.

28. These ratio tests include the current ratio, debt-equity ratio, and quick asset ratio. These ratios are indicators of the debtor's continued ability to service its debt.

29. Agar, *supra* note 1, at 63.

30. For example, the Federal Reserve System places limits on the amount a banking institution can invest in its banking premises. Banks can circumvent these limits by a sale and leaseback transaction. *See* Frank Lyon Co. v. United States, 435 U.S. 561 (1978).

31. Agar, *supra* note 1, at 74; Marcus, *supra* note 2, at 668 n.8.

32. These rights include the ability to force a debtor into bankruptcy, to obtain preferred status in bankruptcy, to sue upon the debt for execution or garnishment, and to participate in a bankruptcy distribution to the full extent of the creditor's investment.

33. This hedge against inflation may be limited or eliminated if the lease contains a repurchase option that sets the option price at anything other than the fair market value of the property at the time the option is exercised. Any other type of repurchase option is likely to allow the lessee to enjoy partially or fully the benefits of any appreciation. *See* Agar, *supra* note 1, at 73-74.

34. A net lease is an arrangement under which the lessee pays all taxes, assessments, maintenance, and other expenses related to the property. The lessor thus receives his rent payments free of any expenses related to the property.

### D. *Tax Considerations*

In addition to numerous business and financial reasons, the attendant tax considerations are often a principal factor in the decision to utilize a sale and leaseback.[35] From the viewpoint of the seller-lessee, one of the principal tax advantages of a valid sale and leaseback is that the rental payments under the lease are fully deductible.[36] This provides a significantly greater deduction than would be available under conventional financing techniques in which only the interest payments are deductible. In addition, if the property consists primarily of a nondepreciable asset, such as land, the full rental deduction has the effect of allowing a depreciation deduction for the nondepreciable portion of the property.[37] The full rental deduction is, however, only part of the tax picture. To determine the net tax advantage or disadvantage of a sale and leaseback, the seller must take into consideration the loss of a depreciation deduction upon the sale of the property. In many situations this loss of depreciation more than offsets the advantage gained from the full rental deduction, particularly if the property consists principally of improvements that may be depreciated at accelerated rates.

A second advantage to the seller in a sale and leaseback is its usefulness in timing the realization of gains or losses. If a business has assets with a fair market value below their adjusted basis, it may be advantageous from a tax standpoint for the business to dispose of the assets and use the loss to offset other income. If, however, the assets are necessary for the operation of the business, an outright sale is impossible. Under these circumstances the business can utilize a sale and leaseback transaction to realize the loss for tax purposes and still retain possession and use of the property.[38] On the other hand, if a business owns assets that have appreciated to a value above their adjusted basis, the business may want to realize the gain in order to take advantage of investment credit or net-operating-loss carryovers that are about to expire.[39] A sale of the

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35. Agar, *supra* note 1, at 62.

36. I.R.C. § 162(a)(3).

37. Although land cannot be depreciated, rental payments for the use of land are a fully deductible expense. Since rental payments under leaseback arrangements include a payment for the use of any land transferred, the lessee is allowed a deduction (analogous to depreciation) for the use of the land.

38. The Service, however, may attempt to deny any loss on such transaction by claiming that the transaction is a tax-free § 1031 like-kind exchange. *See* text accompanying notes 48-53 *infra*.

39. Investment credit and net-operating-loss carryovers that are not fully utilized in the year in which they occur or in carryback years may be carried forward for seven taxable years. These carryovers are lost if not utilized during this seven year period. I.R.C. §§ 46(b), 172(b).

assets would result in realization of gain that could be offset by the credits or losses. If the assets were being used in a trade or business, any excess gain would be taxed at the reduced capital gains rates.[40] Once again, however, if the assets are necessary for the operation of the business, an outright sale is impossible and the business must resort to a sale and leaseback transaction. This technique is not without hazards. First, any gain on the sale of appreciated assets may be subject to investment credit or depreciation recapture[41] and therefore taxed at ordinary income rates. This taxation may offset any advantage of the sale and leaseback. Second, the sale and leaseback may be characterized as a tax-free section 1031 like-kind exchange (an exchange of the property for the resulting leasehold).[42] If this is the case, no gain or loss will be recognized on the transaction and the utility of this sale and leaseback technique will be destroyed.

From the viewpoint of the purchaser-lessor, a sale and leaseback transaction has certain limited tax advantages. The purchaser owns the property and can claim a depreciation deduction that can be used to offset part of the income from the property.[43] If accelerated depreciation methods are available, the depreciation deduction may fully offset income during the early years of the lease and also provide a tax shelter for other income.[44] If the purchaser financed the acquisition of the property, he will be allowed an interest deduction that will further offset ordinary income. Perhaps the greatest tax advantage of a sale and leaseback transaction arises when the purchaser is a tax-exempt organization, such as a charitable organization or a pension fund. In this case, if the purchase is for cash, all income from the lease is exempt from taxation. If the leaseback utilizes a net lease provision,[45] the sale and leaseback provides the organization with a management-free, tax-free, high-yield investment. This technique loses some of its utility, however, if the purchase of the property is financed and therefore subject to the "unrelated business income" rules of section 511.[46] This section includes in the taxable income of tax-exempt organizations a percen-

40. I.R.C. § 1231.

41. I.R.C. §§ 47 (investment credit recapture), 1245, 1250 (depreciation recapture).

42. *See* text accompanying notes 48-53 *infra*.

43. I.R.C. § 167.

44. Even though the use of accelerated depreciation methods will reduce depreciation deductions available during the later years of the lease, the time value of money makes it advantageous for the lessor to take the greater deduction in the earlier years if possible.

45. For a description of a net lease, see note 34 *supra*.

46. I.R.C. §§ 511-514. Most bootstrap sale and leaseback transactions are financed and thus have limited utility.

tage of the total rents received from "business leases" that is equal to the ratio of business lease indebtedness to the adjusted basis of the property.[47] As a result, the organization is taxed on part or all of the income from the lease, which destroys the advantage of the sale and leaseback.

### *E. Internal Revenue Service Treatment of Sale and Leaseback Transactions*

Despite the potential tax and financial advantages of the sale and leaseback transaction, significant hazards accompany use of this technique. The Service has repeatedly challenged the validity of sale and leaseback transactions, employing three principal methods of attack. The first arises under section 1031 of the Code, which provides that no gain or loss shall be recognized when property held for productive use in a trade or business is exchanged for property of a like kind.[48] The section further states that if the exchange is for like-kind property plus other property or money, no loss will be recognized, and the gain will be recognized only to the extent of the value of the other property or money received.[49] Treasury regulations promulgated under this section indicate that real estate and a real property leasehold of thirty or more years are like-kind property.[50] Based on this section and regulation, the Service often argues that a sale coupled with a leaseback for more than thirty years constitutes a like-kind exchange upon which no gain or loss will be recognized.[51] If the Service successfully presses this argument, drastic tax consequences for the seller may result. If the seller entered into the sale and leaseback in order to produce a loss to offset ordinary income,[52] it may be subject to a significant deficiency assessment when the loss is denied.[53] If the purpose of entering into the

47. Treasury Regulation § 1.514(a)-1(a)(1)(iv) (1972) gives the following example of the operation of this rule:

(iv) *Example.* Subdivisions (i), (ii), and (iii) of this subparagraph are illustrated by the following example. For purposes of this example it is assumed that the property is debt-financed property.

*Example.* X, an exempt trade association, owns an office building which in 1971 produces $10,000 of gross rental income. The average adjusted basis of the building for 1971 is $100,000, and the average acquisition indebtedness with respect to the building for 1971 is $50,000. Accordingly, the debt/basis percentage for 1971 is 50 percent (the ratio of $50,000 to $100,000). Therefore, the unrelated debt-financed income with respect to the building for 1971 is $5,000 (50% of $10,000).

48. I.R.C. § 1031(a).

49. I.R.C. § 1031(b)-(c).

50. Treas. Reg. § 1.1031(a)-1(c) (1967).

51. *See* text accompanying notes 56-57 *infra.*

52. *See* text accompanying note 38 *supra.*

53. *See* Century Elec. Co. v. Commissioner, 192 F.2d 155 (8th Cir. 1951), *cert. denied,*

transaction was to produce gain in order to take advantage of expiring investment credit or net-operating-loss carryovers, these carryovers may be lost if the gain is not recognized under section 1031.

A second way in which the Service can attack a sale and leaseback is to recharacterize the transaction as a mortgage loan with the property pledged as security.[54] The Service utilizes this procedure when the sale and leaseback appears to be a substitute for conventional financing and the seller retains substantial control. If the Service succeeds in recharacterizing the sale and leaseback as a mortgage loan, several tax consequences ensue. The seller-lessee is not allowed a rental deduction for the full amount of the lease payments, but instead is allowed to deduct only a portion of the payments as interest. In addition, because the purchaser will not be considered the owner of the property, it will not be allowed any deduction for depreciation. Mitigating factors exist, however, in that the seller is allowed a depreciation deduction, and the purchaser need only include in income the portion of the lease payment that constitutes interest. Nevertheless, in many situations (especially if the purchaser is a tax-exempt organization) the tax consequences of a recharacterization of a sale and leaseback are disastrous.

The last method used by the Service to attack a sale and leaseback does not focus on the validity of the transaction, but rather concentrates on the fairness of the rental payments under the lease. This method is used principally when the rent charged during the later years of the lease or during renewal periods is disproportionately low in relation to that charged during the early years. Under these circumstances, the Service characterizes part of the payments during the primary term as prepaid rent and requires that they be capitalized and amortized over the full term of the lease.[55] This treatment in essence amounts to the deferral of a deduction. Because this method does not strike at the validity of the entire transaction, it does not have the harsh effect on the parties that the Service's successful use of the section 1031 attack or mortgage-loan recharacterization has.

342 U.S. 954 (1952) (denying the loss deduction, but allowing the loss to be amortized over the life of the lease as a capitalized expense related to acquiring the lease).

54. For a further discussion of this method of attack, see Part III(C) *infra*.

55. *See* Agar, *supra* note 1, at 65; Mandell, *supra* note 2, at 24.

## III. Judicial Treatment of Sale and Leaseback Transactions

### A. Introduction

For over thirty-five years courts have grappled with the question of the proper tax treatment of a sale and leaseback, and have yet to find a satisfactory solution. An analysis of sale and leaseback cases shows that courts have taken various approaches in dealing with the Service's attacks on sale and leaseback transactions. The following sections describe and analyze the tests used by the courts to determine the proper tax treatment of sale and leaseback transactions in light of the Service's two most prevalent attacks—the section 1031 like-kind exchange approach and recharacterization as a mortgage loan.

### B. Section 1031 Like-Kind Exchange

Courts have divided on the issue whether a sale and leaseback for a term of thirty or more years is a section 1031 like-kind exchange. An examination of two United States courts of appeals cases, *Century Electric Co. v. Commissioner*[56] and *Jordan Marsh Co. v. Commissioner,*[57] best explains this division of opinion. In *Century Electric* the taxpayer sold a foundry used in its business for $150,000 when its adjusted basis was over $531,000. Simultaneously, the property was leased back to the taxpayer for ninety-five years, subject to the right of the seller-lessee to terminate the lease after twenty-five years. Evidence indicated that the fair market value of the property at the time of the sale and leaseback was between $200,000 and $250,000. When the taxpayer deducted a loss on the sale of over $381,000 (the difference between the sales price and the adjusted basis), the Service denied the deduction. The Eighth Circuit upheld the Service's denial of the deduction on the ground that the sale and leaseback were part of an integrated transaction that constituted a like-kind exchange[58] of the property for $150,000 in cash plus a ninety-five year lease on the same property.

In *Jordan Marsh,* a case with quite similar facts, the Second Circuit reached the opposite result. The taxpayer in *Jordan Marsh* sold a store used in its business at a substantial loss. At the same time, the taxpayer leased back the store for a period of thirty years and three days with an option to renew for an additional thirty years. The stipulated facts of the case indicated that the sales price

56. 192 F.2d 155 (8th Cir. 1951), *cert. denied,* 342 U.S. 954 (1952).

57. 269 F.2d 453 (2d Cir. 1959).

58. This case was decided pursuant to § 112 of the Internal Revenue Code of 1939, the predecessor of the present § 1031.

of the property was its fair market value and that the rental payments equaled the property's fair rental value. The taxpayer took a tax deduction for the loss on the sale. Characterizing the transaction as a like-kind exchange,[59] the Service denied the deduction. The court rejected the Service's argument and allowed the claimed loss deduction. Indicating that, in its view, there had been no *exchange* of property for a long-term lease, the court concluded that the transaction was a valid *sale* with a resulting deductible loss.[60]

Although the two cases are arguably distinguishable on their facts because the evidence in *Century Electric* indicated that the sale of the property was for less than its fair market value, most courts and commentators view the cases as inherently in conflict.[61] This perceived conflict has caused significant confusion. Thus the Service's section 1031 attack on sale and leaseback transactions has met with varying degrees of success in the lower courts, depending on whether the particular court accepted the rationale of *Century Electric* or *Jordan Marsh.*

The most recent court of appeals case to address the split between *Century Electric* and *Jordan Marsh* was *Leslie Co. v. Commissioner,*[62] in which the Third Circuit confronted the issue of how to treat a loss to the seller-lessee on the sale component of a sale and leaseback transaction. Although the facts in *Leslie* differ from those in both *Century Electric* and *Jordan Marsh,* the *Leslie* court considered the issue to be the same and held that *Jordan Marsh* was controlling. In *Leslie* taxpayer entered into an agreement with Prudential Life Insurance Company under which Prudential was to purchase a plant newly constructed by taxpayer and simultaneously lease it back to taxpayer for thirty years plus renewal periods. The purchase price to Prudential was to be the lesser of $2,400,000 or the actual cost to taxpayer. Because the completed structure cost over $3,100,000 taxpayer took a deduction for its loss on the sale of over $700,000. Contending that the transaction was a section 1031 like-kind exchange of property, the Service denied the loss deduction.

When taxpayer appealed the Service's denial of the deduction, the Tax Court rejected the Service's section 1031 argument, holding

59. This case was decided pursuant to § 112 of the Internal Revenue Code of 1939, the predecessor of the present § 1031.

60. The Service has announced that it will not follow the *Jordan Marsh* decision. Rev. Rul. 60-43, 1960-1 C.B. 687.

61. *E.g.,* Leslie Co. v. Commissioner, 539 F.2d 943 (3d Cir. 1976); Mandell, *supra* note 2, at 29; Wilson, *supra* note 2, at 157.

62. 539 F.2d 943 (3d Cir. 1976).

that the transaction was not a like-kind exchange.[63] The Tax Court based its decision on findings of fact that the $2,400,000 purchase price paid by Prudential was approximately the fair market value of the property and that the lease payments by taxpayer equaled the property's fair rental value. These findings indicated that there had been a *sale* for full consideration rather than an *exchange*. In affirming the Tax Court, the Third Circuit considered the rationales of both *Century Electric* and *Jordan Marsh*. Indicating that it considered the cases to be in conflict, the court elected to follow the approach of the Second Circuit in *Jordan Marsh*.[64] Accordingly, the court held that when a taxpayer sells its property unconditionally for cash equal to its fair market value and pays fair rental value for any leasehold it acquires, no property other than cash is received on the sale and there is no exchange for purposes of section 1031. The court concluded that since section 1031 did not apply, the loss deduction should be allowed.

*Leslie* underscores the importance of structuring sale and leaseback transactions so that the purchase price approximates the fair market value of the property. Under the *Leslie* rationale, the purchase price appears to be the crucial factor if the taxpayer desires to deduct a loss on the sale. If the transaction meets both the fair market value and the fair rental value tests, *Leslie*'s interpretation of *Jordan Marsh* would allow a loss deduction. *Leslie* does not, however, resolve the conflict between *Century Electric* and *Jordan Marsh*. The Third Circuit simply aligns itself with the *Jordan Marsh* court without applying any original analysis, and therefore leaves unchanged the underlying conflict between the cases.

*Century Electric, Jordan Marsh,* and *Leslie* typify situations in which the Service will characterize a sale and leaseback as a section 1031 like-kind exchange. The conflict between *Century Electric* on the one hand and *Jordan Marsh* and *Leslie* on the other highlights the difficulty courts have had in determining the proper application of section 1031 to this type of sale and leaseback transaction. This

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63. 64 T.C. 247 (1975).

64. The court stated:

> Thus we may interpret the essential difference between *Jordan Marsh* and *Century Electric* as centering on their respective views of the need to value property involved in a sale and leaseback. . . .
>
> We are persuaded that the *Jordan Marsh* approach is a more satisfactory one. First, it is supported by the Commissioner's own definition of "exchange" which distinguishes an exchange from a transfer of property *solely* for a money consideration. . . . Second, if resort is to be had to legislative history, it appears to us that the view of Congressional purpose taken by the *Jordan Marsh* court is sounder than that of the Eighth Circuit in *Century*.

539 F.2d at 948-49 (footnotes omitted) (emphasis in original).

Note suggests, however, that whatever conflict appears to exist arises not from a disagreement as to the proper application of section 1031, but rather because in two of the three cases section 1031 analysis should not have been applied at all. Although the Service and the courts viewed each of these cases as containing a similar factual situation that had to be decided under section 1031, when viewed in terms of economic substance, they represent three distinct situations. Section 1031 should be applied to only one of the three cases.

Of the three cases, *Century Electric* is the only one that included any exchange of properties. In both *Jordan Marsh* and *Leslie* the taxpayer received in cash the fair market value of the property sold; the resulting leasehold had no independent value and was not given in "exchange" for the property. In *Century Electric*, however, the taxpayer received less than the fair market value of the property in cash and also received a valuable leasehold on the property. The lease in *Century Electric* apparently[65] required a rental payment that was less than the fair rental value of the property. This reduced rental gave the leasehold independent value. It is clear, therefore, that the leasehold constituted additional consideration received by taxpayer on the sale. Only in this type of sale and leaseback situation, when the leasehold has independent value, should it be considered part of the consideration for the property. Only under these circumstances, therefore, can section 1031 possibly have any application to a sale and leaseback because only under these circumstances is there an exchange of property to which section 1031 can apply. In the *Jordan Marsh* and *Leslie* situations section 1031 was irrelevant and should not have been applied.

Since *Century Electric* is the only case to which section 1031 was technically applicable, analysis of each case in terms of section 1031 has caused an apparent conflict in tax treatment that should not exist. If each case is properly analyzed in terms of its economic substance, the appropriate tax treatment is more easily discernible. In terms of economic substance the three fact situations presented by these cases can be summarized, though somewhat simplistically, as follows. In *Century Electric* the taxpayer exchanged his property for cash plus a valuable leasehold, the value of which is measured by the difference between the value of the cash or other property received and the fair market value of the property transferred. In *Jordan Marsh* the taxpayer closed out a losing venture by selling property for cash equal to its fair market value and simultaneously

65. The Court did not expressly state that the lease included reduced rentals. The record, however, contained evidence indicating that the rentals were below the fair rental value of the property.

acquired a lease of no independent value under which it paid a fair rental. In *Leslie* the taypayer constructed specific property as one step in a series of transactions designed to culminate in a sale and leaseback. The remainder of this section will present an analysis of these three fact situations and will suggest that courts can determine proper tax treatment for each without conflict.

(1) *Century Electric*

Because *Century Electric* considered an exchange of the fee ownership of property in part for a valuable leasehold, it presented a situation in which section 1031 analysis could technically be applied. Section 1031, however, constitutes only one of three possible tax treatments of this type of transaction and is the least desirable of the three. First, one negative effect of applying section 1031 to a *Century Electric* situation is that it creates a disparity of tax treatment between sale and leaseback transactions including leases that run for less than thirty years and those including leases that run for more than thirty years.[66] This disparity is not based on any economic difference between the transactions, but instead results from an arbitrary distinction drawn by the Service in an attempt to prevent perceived tax abuses by expanding section 1031 to cover certain sale and leaseback transactions. Second, and more important, the application of section 1031 to a *Century Electric* situation does not effectuate the policy underlying section 1031. Although courts have disagreed on the primary policy underlying this section[67] and although the legislative history of the section leaves room for speculation,[68] the Second Circuit seems to have reached the best conclusion in *Jordan Marsh*—the primary purpose of the nonrecognition provision in section 1031 is to avoid the inequity of forcing a taxpayer to recognize a paper gain or loss that is tied up in a continuing investment of the same sort.[69] In view of this policy, section 1031 should

66. This disparity arises from the Service's implied statement in Treasury Regulation § 1.1031(a)-1(c) that a real estate lease for a term of 30 or more years is the equivalent of the ownership of a fee for purposes of § 1031. *See* note 50 *supra* and accompanying text.

67. The *Century Electric* court concluded that the purpose of the section was to avoid valuation problems. 192 F.2d at 159. The *Jordan Marsh* court concluded that the purpose of the section was to avoid the inequity of forcing a taxpayer to recognize a paper gain or loss that was tied up in a continuing investment of the same sort. 269 F.2d at 456.

68. *See, e.g.*, H.R. REP. No. 179, 68th Cong., 1st Sess. (1924), *reprinted in* 1939-1 C.B. (pt. 2) 250-52; H.R. REP. No. 350, 67th Cong., 1st Sess. 10 (1921), *reprinted in* 1939-1 C.B. (pt. 2) 175.

69. 269 F.2d at 456. In reaching this conclusion, the court relied on the following statements from the legislative history of § 1031.

> The provision is so indefinite that it cannot be applied with accuracy or with consistency. It appears best to provide generally that gain or loss is recognized from all ex-

not be applied to a *Century Electric* situation. Although under certain circumstances a leasehold may be very similar to the fee ownership of property,[70] the normal lease situation presents significant differences that make section 1031 inapplicable. The lessor has the reversionary interest in the property and has the power over its ultimate control and disposition. In addition, the lessor generally carries all of the risks of depreciation and receives the benefits of appreciation in the value of the property. A seller-lessee in a sale and leaseback therefore makes a significant change in the economic substance of his investment as well as in its form. Thus the characterization of a sale and leaseback as a section 1031 exchange does not effectuate section 1031's policy of deferring recognition of gain or loss on transactions that do not result in a change in the type of investment owned.[71] The only situation in which the policy underlying section 1031 might be effectuated by characterizing a sale and leaseback as a like-kind exchange is when the property consists primarily of an asset that has a limited useful life equal to or shorter than the term of the lease. Arguably, ownership of a leasehold covering the property's entire useful life is essentially equivalent to ownership of a fee, and therefore the sale and leaseback is a like-kind exchange. Even this situation, however, should not be treated as a section 1031 exchange. In terms of economic substance, the situation is equivalent to the sale of a fee interest for cash and the reacquisition of essentially the same interest for a price equal to the payments required under the lease. This type of transaction

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changes, and then except specifically and in definite terms those cases of exchanges in which it is not desired to tax the gain or allow the loss. This results in definiteness and accuracy and enables a taxpayer to determine prior to the consummation of a given transaction the tax liability that will result.

H.R. REP. No. 179, 68th Cong., 1st Sess. (1924), *reprinted in*, 1939-1 C.B. (pt. 2) 250.

> The law has provided for 12 years that gain or loss is recognized on exchanges of property having a fair market value, such as stocks, bonds, and negotiable instruments; on exchanges of property held primarily for sale; or on exchanges of one kind of property for another kind of property; but not on other exchanges of property solely for property of like kind. In other words, profit or loss is recognized in the case of exchanges of notes or securities, which are essentially like money; or in the case of stock in trade; or in case the taxpayer exchanges the property comprising his original investment for a different kind of property; but *if the taxpayer's money is still tied up in the same kind of property* as that in which it was originally invested, he is not allowed to compute and deduct his theoretical loss on the exchange, nor is he charged with a tax upon his theoretical profit. The calculation of the profit or loss is deferred until it is realized in cash, marketable securities, or other property not of the same kind having a fair market value.

House Ways and Means Committee Report, *reprinted in*, 1939-1 C.B. (pt. 2) 564 (emphasis in original).

70. *See* text accompanying note 71 *infra*.

71. This Note argues that a real estate leasehold, even if long term, and a fee interest in real estate are not like-kind property.

properly should be characterized as a sale and immediate repurchase of the property having no tax effects for the seller-lessee,[72] and section 1031 should not be applied.[73]

Instead of applying section 1031 to a *Century Electric* sale and leaseback, one of two alternative tax treatments should be applied to yield a result more fully in accord with the economic realities of the situation. The first alternative is to characterize the transaction as a sale of property for a package of consideration consisting of the cash[74] received plus a leasehold that includes a rental less than the fair rental value of the property.[75] This lease with reduced rent is an economic benefit to the seller-lessee, the value of which can be measured by the difference between the cash received and the fair market value of the property. The transaction would then be treated as any other sale; the value of the consideration received (cash or

72. *See* text accompanying note 77 *infra*. After the transaction is consumated the seller-lessee owns essentially the same interest as he owned before the sale and leaseback. In essence the sale transaction is one of form and not substance. Under these circumstances the seller-lessee should not be allowed to recognize a loss.

Another way of reaching this result would be to treat the sale and leaseback as a sham transaction. Since the sale portion of the sale and leaseback has no economic substance, it appears that its only purpose is to effect a recognition of a paper loss for tax purposes. Permitting this type of loss would allow form to rule over substance, and thus the loss should not be allowed. Although this sham transaction treatment reaches the result of denying the loss, the sale and repurchase treatment described above is a more proper analytical approach.

73. From the standpoint of the purchaser-lessor this transaction is equivalent to a loan in which the lender has taken title to the property as security for repayment. Payment received by the purchaser-lessor under this type of lease should therefore be treated for tax purposes partially as repayment of principal and partially as payment of interest.

74. As used here, the term "cash" includes all forms of consideration that might be included in the transaction except for the leasehold (e.g., other property, securities, debt instruments).

75. In any arms length sale transaction, it can be assumed that a reasonable seller will not dispose of his property at a price less than its fair market value. If the cash received in an arms length sale is less than the fair market value of the property then it can also be assumed that the seller has received some additional compensation or benefit. In the situation when the lease rentals are less than the fair rental value of the property there is an obvious economic benefit to the seller that should be characterized as part of the consideration for the property. In this situation the seller has actually received an economic benefit equal to the fair market value of the property. It is possible, however, that a seller may benefit from the sale and leaseback in ways that are more difficult to state in economic terms. This situation could arise if the property is unique to the seller's business, to him, or if the sale and leaseback transaction itself has a value to the seller because of his unique business or financial situation. *See* Frank Lyon Co. v. United States, 435 U.S. 561 (1978). Under these circumstances the seller may also be willing to accept an amount of cash less than the fair market value of the property in order to obtain this additional benefit. Although this type of benefit is difficult to value, if the sale and leaseback is an arms length transaction it appears that the value of the benefit to the seller is the difference between the cash received and the fair market value of the property. Even if this type of benefit can be valued, however, there is a significant question whether this benefit is one that should be characterized as consideration for tax purposes. This question is beyond the scope of this Note.

other property plus the value of the leasehold) would be deducted from the taxpayer's basis in the property and the difference would be a deductible loss. In addition, the value of the leasehold would be amortized over the life of the lease. This treatment fully accords with the economic substance of a *Century Electric* transaction. The original owner of the property has changed his interest from fee ownership to a leasehold, and thus has substantially altered his investment in the property.[76] As a result, he does not have a continuing investment of the same sort as before the transaction. In fact, he has closed out a losing venture, the fee ownership of the property, in return for valuable consideration, the cash and the leasehold, and now has a new type of investment, the use and ownership of a leasehold. In this situation the taxpayer has suffered an actual economic loss equal to the difference between his basis in the property and the combined value of the leasehold and the cash received. Under the tax principles embodied in section 165 of the Internal Revenue Code,[77] this loss should be allowed as a deduction. Allowing this loss deduction does not reinstate the tax abuse that the Service perceived in the *Century Electric* case. In that case taxpayer attempted to deduct a loss greater than the actual economic loss suffered. This situation arose because taxpayer attempted to deduct the difference between his basis in the property sold and the cash he received, without taking into consideration the value of the leasehold acquired in the transaction. Under the proposed analysis, however, in an arms length sale the consideration received (the cash plus the leasehold) will always equal the fair market value of the property. Thus any loss determined under this approach will be an actual economic loss and should be allowed as a deduction under section 165.

The principal argument against this tax treatment of a *Century Electric* sale and leaseback is that it would violate the policy underpinning section 1031 by allowing a taxpayer to recognize a loss even though he retains an interest in the property sold. The fallacy of this argument is apparent, however, if it is recognized that the policy of section 1031 is not to prevent recognition of gain or loss when the taxpayer retains an *interest* in the property, but rather is to apply nonrecognition treatment only when the taxpayer retains a *like-kind investment* in the same sort of property. In the normal sale and leaseback situation the taxpayer substantially changes his interest in the property and does not retain a *like-kind* investment. Even

76. *See* text accompanying note 70 *supra*.

77. Section 165 provides general rules for the deductibility of losses.

though he retains an interest in the property, the deduction of his loss does not violate the policy underlying section 1031. Only in the limited situation in which the leasehold is actually equivalent to fee ownership—when the lease covers the full useful life of the property and when the lessee has the rights of ownership (such as the benefits and risks from appreciation or depreciation)—does the possibility of violating the policy underpinning section 1031 exist. Even in this situation, however, the Service and the courts should not attempt to prevent the possible violation through an application of section 1031 principles. Again, this Note proposes that the lease be viewed in terms of its economic substance. From this perspective, a lease that is equivalent to fee ownership should be characterized as a purchase contract rather than a lease. Under this approach, a sale and leaseback transaction could be deemed a sale of the property coupled with an immediate repurchase. This characterization fully accords with the economic realities of the situation. The transaction could then be treated as a wash sale having no tax consequences, leaving the taxpayer in the same position as before the sale and leaseback.[78] This treatment of sale and leaseback transactions would both prevent the abuses that the Service is attempting to avoid by utilizing section 1031, and provide equitable tax treatment for the taxpayer who has in fact closed out a losing venture and acquired another type of investment.

The second alternative tax treatment of a *Century Electric* situation is to treat the taxpayer as having transferred title to the property in return for valuable consideration while retaining a leasehold interest in the property.[79] This situation is analogous to the transfer of a fee subject to a retained interest for a term of years. For tax purposes, the cost basis in the property would be apportioned between the fee interest sold and the leasehold retained on the basis of the fair market value of each.[80] Any gain or loss on the transaction would be calculated by comparing the amount received on the sale with the basis allocated to the fee interest. The basis remaining in the leasehold would then be amortized over the term of the lease. Once again, this treatment accords more closely with the economic realities of the transaction than does section 1031 treatment. Furthermore, it operates to prevent the abuses that the

78. *See* text accompanying note 72 *supra*.

79. This approach has been previously suggested by at least one commentator. *See* Morris, *supra* note 2.

80. The fair market value of the fee interest would be the amount a willing buyer would pay for the property in an arms length transaction. The fair market value of the leasehold would be the difference between the fair market value of the property and the cash or other consideration received by the seller.

Service attempts to eliminate through its section 1031 attack. After a consummated sale and leaseback, the seller-lessee, who once held all of the ownership interests in the property, holds only a portion of those interests. The terms of the lease determine the limits and therefore the value of this portion of the interests. As these interests approach the equivalent of a fee interest, the leasehold will have a higher fair market value and the fee interest a lower fair market value. When the lessee's interest approximates a fee interest, the latter will be allocated only a small portion of the property's cost basis, which reduces or eliminates any possible loss on the sale. This approach effectively prevents a taxpayer from recognizing a paper loss while still retaining an investment in the property that is essentially equivalent to his prior fee ownership. If, on the other hand, the interests retained by the seller-lessee do not approximate a fee interest, the leasehold's fair market value will decrease. As a result, its allocable portion of the basis of the property will diminish. This treatment will increase the fee interest's allocable portion of the basis which will in turn increase the likelihood of a loss on the sale of the fee. Moreover, this approach does not violate the policy underlying section 1031 because the taxpayer has substantially changed his investment in the property and thus should be allowed to deduct any loss incurred in closing out his fee ownership.

Admittedly, both proposed alternatives to section 1031 analysis of a *Century Electric* sale and leaseback will produce some difficulty in application. Both alternatives pose problems of valuation, and the first alternative requires a determination whether the leasehold is essentially equivalent to fee ownership. Similar problems exist, however, in the present tax treatment of sale and leaseback transactions. Although these problems can be quite complex in certain situations, courts are equipped to resolve them. The existence of these problems should not detract from the fact that both proposed alternatives provide tax treatment more consistent with the economic substance of the transaction than that resulting under a section 1031 analysis.

(2) *Jordan Marsh*

Both *Jordan Marsh* and *Leslie* presented fact situations to which section 1031 should not have applied. In each case the seller-lessee sold property for its fair market value, and simultaneously acquired a leasehold that did not constitute a part of the consideration received in the transaction. Thus, there was no exchange of properties to which section 1031 could apply. Although each court correctly recognized that section 1031 did not apply, this finding

improperly terminated the analysis in each case. Each court apparently determined that the cases should be analyzed only under section 1031, concluding that, since this section did not require nonrecognition, the loss deduction should be allowed. This conclusion, however, should have been only the starting point of a proper analysis. By proceeding to examine the economic substance of the transactions in question, the courts could have determined the proper tax treatment of these cases without creating the apparent conflict with *Century Electric.*

When analyzed in terms of economic substance, *Jordan Marsh* is the only case of the three that reached the correct result. This result was reached, however, with improper, or at best inadequate, reasoning. After properly determining that section 1031 did not apply, the court simply held that because this section did not require nonrecognition treatment under the circumstances, the loss deduction would be allowed. Although properly determining that the loss deduction should be allowed, the court was incorrect in basing this determination solely on the inapplicability of section 1031. The court should have undertaken an analysis of the economic substance of the loss to determine whether it was the type of loss that is deductible under section 165. This analysis would have revealed that because the leasehold had no independent value and was not transferred as part of the consideration for the property sold, the taxpayer suffered an actual economic loss equal to the difference between the consideration received and the basis of the property. Under section 165, this actual economic loss should be allowed as a deduction. Although the conclusion is the same as that reached by the *Jordan Marsh* court under its section 1031 analysis, the extended analysis indicates that *Century Electric* and *Jordan Marsh* address two economically different fact situations and therefore do not conflict on the section 1031 issue.

Once it is recognized that the *Jordan Marsh* court should have focused on the economic substance of the loss instead of on whether section 1031 required nonrecognition of the loss, a single method of analysis can be formulated to determine the tax treatment of the type of sale and leaseback transactions present in both *Century Electric* and *Jordan Marsh.* Instead of applying section 1031 analysis, courts should apply the first alternative tax treatment suggested above for *Century Electric.* Each transaction should be viewed as a sale of the property for a package of consideration consisting of cash plus a leasehold. If the leasehold has a value of zero, as in *Jordan Marsh,* the loss equals the difference between the value of the cash or other property received and the basis of the property sold. Under

these circumstances, the leasehold has no value to be amortized over the life of the lease. On the other hand, if the leasehold has an actual value above zero, as in *Century Electric,* the loss amounts to the difference between the basis of the property sold and the value of the cash or other property received *plus* the value of the leasehold. The value of the leasehold should then be amortized over the life of the lease. In either case application of this analysis provides a result consistent with the economic substance of the transaction and also provides a single method for determining the tax treatment of the types of transactions present in *Jordan Marsh* and *Century Electric.*[81]

(3) *Leslie Co.*

As indicated above, *Leslie,* like *Jordan Marsh,* presented a situation in which no section 1031 exchange of properties occurred. The *Leslie* court also correctly recognized that section 1031 did not apply, but failed to analyze the economic nature of the loss to determine whether it was deductible under section 165. Unlike *Jordan Marsh,* however, this defect in the analysis in *Leslie* caused the court to reach a result not in harmony with the economic realities of the transaction.

Although the transactions in *Leslie* and *Jordan Marsh* appear to be similar—the sale of property for fair market value, at a loss, and the leaseback of the same property—close analysis reveals that the two transactions have differing economic substance. The *Jordan Marsh* transaction constituted a closing out of a losing venture and a shifting of investment purpose. In *Leslie,* however, the sale was not the closing out of a losing venture, but was instead a step in a series of transactions designed from the beginning to provide the taxpayer with an investment in a leasehold. The taxpayer specifically constructed the property with the intention of eventually using and holding the property in the form of a leasehold. The loss suffered on the sale of the property was actually a built-in cost of

81. Application of the second alternative method of analysis proposed for *Century Electric* would also produce the same result in *Jordan Marsh* that was reached by the Second Circuit and would provide a single analytical framework for both *Century Electric* and *Jordan Marsh* transactions. Under this analysis the leasehold in *Jordan Marsh* would have a zero fair market value and therefore would not be allocated any of the cost basis of the property. The loss would be the difference between the value of the cash or other property received and the basis of the property sold. In addition, there would be no basis in the leasehold to amortize over the life of the lease. Although this approach provides a single method of analysis for these cases, the first alternative method of analysis proposed for *Century Electric* provides a more appropriate tax treatment in light of the economic substance of *Century Electric* and *Jordan Marsh* type transactions.

acquiring the leasehold, closely analogous to a premium payment made to acquire a leasehold in a standard lease transaction. When viewed in this manner, the loss on the sale of property in a *Leslie* situation is not the type of loss that should be deductible under section 165. Instead, the loss is in the nature of a capital expenditure or lease acquisition cost that should be amortized over the life of the lease.[82] It is therefore suggested that in a transaction in which the taxpayer constructs or acquires property with a view toward entering a sale or leaseback transaction, the proper tax treatment is to amortize any resulting loss over the life of the lease as a cost of acquiring the leasehold.[83]

(4) Summary

The analyses of *Century Electric, Jordan Marsh,* and *Leslie* detailed above indicate that section 1031 analysis is not the proper method for determining the tax treatment of a sale and leaseback transaction in which the taxpayer suffers a loss on the sale. The discussion above analyzes the cases in terms of their economic substance in order to determine the proper tax treatment. The application of this approach reaches a result in harmony with the economic substance of the transactions without causing the type of conflict now existing between the holding in *Century Electric* and those in *Jordan Marsh* and *Leslie.* This Note advances the approach described in the preceding sections as the proper analysis for determining the tax treatment of a sale and leaseback transaction producing a loss on the sale.

### C. *Recharacterization of the Sale and Leaseback as a Mortgage Loan*

(1) Traditional Analysis

The Service employs the recharacterization theory to attack depreciation and rental deductions by the lessor and lessee under a

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82. In the Tax Court consideration of *Leslie,* Judge Tannenwald registered a dissent advocating this tax treatment of the loss suffered on the sale. The Third Circuit, however, did not address the merits of his analysis. For a discussion of Judge Tannenwald's analysis, see 52 N.Y.U. L. REV. 672 (1977).

83. Although the proper tax treatment in these situations should depend on the actual intent of the taxpayer, the administrative and evidentiary difficulties presented in attempting to prove intent would be overwhelming. Therefore a statute should be adopted prescribing a minimum holding period after which the taxpayer will not be considered to have acquired the property with a view toward entering into a sale and leaseback. If, on the other hand, the taxpayer enters the sale and leaseback during the holding period, he should be held to have acquired the property with a view toward entering into a sale and leaseback. This treatment would eliminate administrative difficulties and would provide certainty for tax planning.

sale and leaseback. Because the courts have experienced difficulty in formulating standards for determining the proper characterization of a sale and leaseback transaction, they have followed several different approaches. Historically, courts allocated depreciation deductions on the basis of legal title to the property and allowed a rental deduction for payments for the use of property in which the taxpayer had no equity.[84] This approach, however, often elevated form over substance. As a result, several major caveats developed. In *Helvering v. Lazarus & Co.*[85] the Supreme Court held that the general "form over substance" doctrine permitted the judiciary to reallocate ownership despite the presence or absence of legal title. Citing the intentions of the parties as an important factor in determining ownership,[86] the Court held that although the transaction was structured as a transfer and leaseback, the Service should honor the parties' intentions that the transaction be treated as a mortgage loan. Since *Lazarus,* many lower courts have applied an intention-of-the-parties test to determine the proper tax characterization of a sale and leaseback transaction.[87]

A second major caveat to the title test developed when related parties had entered into a sale and leaseback. Courts closely scrutinize these transactions, requiring that they exhibit a business purpose other than tax avoidance.[88] Even if the sale and leaseback is otherwise valid, when the parties fail to show a purpose other than tax avoidance, courts generally hold that the original seller-lessee is the owner of the property[89] and recharacterize the rental payments as loan repayments.[90]

Several courts have completely abrogated the title test and have developed an approach that relates the standards for characterizing a sale and leaseback to the type of deduction claimed—either depreciation by the purchaser-lessor or rental pay-

84. *See* Alaska Realty Co. v. Commissioner, 141 F.2d 675 (6th Cir. 1944); St. Paul Union Depot. Co. v. Commissioner, 123 F.2d 235 (8th Cir. 1941); Helvering v. Terminal R.R. Ass'n, 89 F.2d 739 (8th Cir. 1937).

85. 308 U.S. 252 (1939).

86. *Id.* at 254.

87. *See, e.g.,* Benton v. Commissioner, 197 F.2d 745 (5th Cir. 1952); Frito-Lay, Inc. v. United States, 209 F. Supp. 886 (N.D. Ga. 1962); Kinzler v. Commissioner, 21 T.C.M. (CCH) 341 (1962). *See also In re* San Francisco Indus. Park, 307 F. Supp. 271 (N.D. Cal. 1969) (bankruptcy case).

88. Southeastern Canteen Co. v. Commissioner, 410 F.2d 615 (6th Cir. 1969); W.H. Armston Co. v. Commissioner, 188 F.2d 531 (5th Cir. 1951). *See also* Standard Envelope Mfg. Co. v. Commissioner, 15 T.C. 41 (1950) (holding transaction to be a valid sale and leaseback when a business purpose other than tax avoidance was shown).

89. *See, e.g.,* W.H. Armston Co. v. Commissioner, 188 F.2d 531 (5th Cir. 1951).

90. *Id.* If the seller-lessee is a corporation and the purchaser-lessor is a shareholder, the rental payments might instead be recharacterized as a distribution of capital.

ments by the seller-lessee. If the seller-lessee attempts to deduct rental payments, the issue under this approach is whether the seller-lessee has or is acquiring an equity interest[91] in the property. If the deduction is for depreciation, the issue becomes whether the purchaser-lessor might suffer economic gain or loss from any appreciation or depreciation in the value of the property.

One of the principal factors upon which courts have focused in determining these issues is the existence of a repurchase option and the terms included therein.[92] A repurchase option allows the seller to reacquire the property, and puts him in a position similar to that of a mortgagor under a loan agreement. If the repurchase price is nominal in relation to the value of the property at the time the seller must exercise the option, or is relatively small in amount when compared with the total payments under the lease, most courts hold that the seller-lessee either has not parted with ownership of the property or is reacquiring an equity interest.[93] If the seller either must exercise the option or is under economic compulsion to do so, courts almost uniformly recharacterize the transaction as a mortgage loan.[94] The existence of a repurchase option, however, will not always result in the determination that a sale and leaseback is a mortgage loan. If the repurchase price approximates the current estimated value of the property at the time the option must be exercised or is tied to a future appraisal of the property's fair market value, the court might recognize the legitimacy of the sale and leaseback.[95] These circumstances support the argument that the purchaser-lessor is the true owner because he receives the benefit of any appreciation in the value of the property.

A second factor that courts consider important is a disparity between the fair market value of the property and the purchase price under the sale and leaseback. A purchase price significantly lower than the value of the property indicates that the transaction is a mortgage loan, especially if the lease contains a repurchase option. Two additional factors that influence many courts are which party bears the risk of loss and whether the lease rental payments are disproportionate in relation to the fair rental value of the property. Courts often allocate depreciation deductions to the party that

91. *See* I.R.C. § 162(a)(3).

92. *See, e.g.,* Commissioner v. H.F. Neighbors Realty Co., 81 F.2d 173 (6th Cir. 1936); Shaffer Terminals, Inc. v. Commissioner, 16 T.C. 356 (1951).

93. *See* Marcus, *supra* note 2, at 672-73.

94. Whether economic compulsion exists depends in part on the relationship between the anticipated value of the property at the end of the lease term and the option price. *Id.* at 673.

95. *See id.* at 674.

has the "at risk" investment. In addition, if rental payments are disproportionately high in relation to the rental value of the property, courts often wholly or partially deny a rental deduction on the ground that the seller-lessee is acquiring an equity interest in the property. These factors alone are not conclusive, but gain importance when combined with other factors such as a repurchase option.

The variety of judicial tests in sale and leaseback cases indicates the difficulty courts have had in devising standards to determine the tax consequences of these transactions. Although the factors identified above are not an exhaustive list of all the factors that a court might consider relevant, it does include those that are most important. Because the resolution of many sale and leaseback issues depends on the facts of each case, more definite guides to the judicial treatment of sale and leaseback transactions are difficult if not impossible to formulate.

(2) Recent Cases

The traditional analysis described above provides the background for the decisions reached in several recent sale and leaseback cases. Since 1974 there have been three significant cases in the area, two at the court of appeals level and one in the Supreme Court.[96] This section will briefly discuss each of these cases and consider its effect on the tax law relating to sale and leaseback transactions.

*American Realty Trust v. United States*[97] presented the issue whether, after a sale and leaseback of a tract of commercial real estate, the seller-lessee or the purchaser-lessor was entitled to claim the tax deductions for depreciation. American, a real estate investment trust, purchased a tract of resort property from Helmsley, an individual entrepreneur, for $7,000,000. The purchase price was composed of $2,500,000 in cash and the assumption of a $4,500,000 mortgage. American then leased the property to Palm Beach Towers, Inc. (Towers), Helmsley's wholly owned corporation, under a net lease arrangement for a period of twenty-one years plus renewal options totaling fifty years. The lease also contained certain rental reduction clauses and provided that Towers was to share in the proceeds of any condemnation award. Helmsley and American also executed an option agreement that allowed Helmsley to repurchase the property at certain stated prices. Helmsley exercised this option during the sixth year of the lease term.

96. Frank Lyon Co. v. United States, 435 U.S. 561 (1978); Sun Oil Co. v. Commissioner, 562 F.2d 258 (3d Cir. 1977), *cert. denied*, 436 U.S. 944 (1978); American Realty Trust v. United States, 498 F.2d 1194 (4th Cir. 1974).

97. 498 F.2d 1194 (4th Cir. 1974).

During the period the lease was in force, American took substantial depreciation deductions for the property. The Service audited American and denied the deduction, determining that the sale and leaseback arrangement was actually a mortgage loan agreement and that American was not the owner of the property for depreciation purposes. American paid the resulting deficiency and filed for a refund in federal district court. The jury found that the transaction was a good faith sale and leaseback and allowed the deduction.[98]

The United States Court of Appeals for the Fourth Circuit accepted the jury's factual findings, but considered the issue as a question of law. The Service argued that the transaction should be recharacterized as a loan, noting that Helmsley retained all the significant benefits of ownership, that he was economically compelled to exercise his repurchase option, and that the rental payments constituted interest payments at a rate of 10½ percent.[99] In affirming the lower court decision, the Fourth Circuit panel rejected these arguments and focused in part on the intent of the parties. The court indicated that the parties had intended in good faith to undertake a sale and leaseback. In addition, however, the court emphasized that Helmsley was not under economic compulsion to repurchase the property and that the original sales price of $7,000,000 was the fair market value of the property. These factors, coupled with the intent of the parties, induced the court to hold that the transaction was a valid sale and leaseback and to allow American a deduction for depreciation.

In *American Realty* the Fourth Circuit adapted the traditional intent test to a multiple factor analysis. Rather than consider the intent of the parties as controlling, the court analyzed additional factors—the repurchase option and the fairness of the purchase price. The court failed, however, to indicate how much weight it placed on each factor, or whether these were the only relevant factors. Thus, *American Realty* arguably stands for the proposition that even if the parties clearly intend a sale and leaseback transaction, a court will require a showing of other factors indicating that the transaction is not a mortgage loan. If this interpretation is correct, it does little to alleviate the confusion surrounding judicial interpretation of the sale and leaseback because it gives no clear indication of the factors that must be shown or the weight they will be given.

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98. *Id.* at 1199.
99. *Id.*

In *Sun Oil Co. v. Commissioner*[100] the Third Circuit considered a denial by the Service of a rental deduction claimed under a sale and leaseback transaction. The court stated that the sole question was whether the transaction was a financing arrangement between the parties or a valid sale. The case concerned two separate transactions in which Sun Oil sold a total of 320 unimproved service station sites to the tax-exempt General Electric Pension Trust (Trust) and simultaneously leased them back for a period of twenty-five years. The lease contained options to renew for a total of sixty-five years at significantly reduced rentals. The rentals were set at a rate that would amortize Trust's investment over the primary term of the lease at an interest rate of 4⅝ percent for the first transaction (120 sites) and 5⅜ percent for the second transaction (200 sites). The lease provided for a "net lease" arrangement and also gave Sun Oil sole right to negotiate any condemnation awards. The lease further provided that Sun Oil had the right to determine whether to retain any condemnation award and continue to pay rent, or to transfer the award to Trust and cancel the lease. In addition, the lease contained several repurchase options under which Sun Oil could reacquire the property. Sun Oil could exercise these repurchase options for prices that under certain circumstances would be equal to the appraised value of the property, but under others would be based on the present value of the remaining lease payments plus a set premium that insured Trust a five percent return. The lease provided, with certain limited exceptions, that Trust could reject any repurchase offer, but also stated that such a rejection would terminate the lease. If Trust rejected any repurchase offer, the lease gave Sun Oil the right to tender substitute property of equal value (to be determined by Sun Oil's cost basis) and required Trust to accept this property in exchange for the property under lease.[101]

The Service disallowed Sun Oil's tax deduction for the rental payments under the lease on the grounds that the transaction did not constitute a true sale and that the rental payments were not a valid business expense. Rejecting the Service's argument, the Tax Court held the rental payments deductible. The Third Circuit reversed and upheld the Service's denial of the deduction. The Third Circuit panel viewed the prime issue as whether the ownership interests of the lessor and lessee as characterized by the parties were consistent with traditional substantive business bargains between

100. 562 F.2d 258 (3d Cir. 1977), *cert. denied*, 436 U.S. 944 (1978).

101. This provision of the lease in essence allowed Sun Oil to reap the benefit of any appreciation in value of the property.

lessors and lessees. In holding that Sun Oil's sale and leaseback transaction in actuality constituted a financing arrangement, the court focused on a multitude of factors. The numerous risks, burdens, and benefits borne and controlled by Sun Oil as lessee were, according to the court, strong indicia of ownership.[102] The court also found the particular structure of lease payments, including the presence of a guaranteed rate of return for the lessor and prepayment penalties, markedly similar to debt financing.[103] In addition, the court found the inclusion of an option for the lessee to acquire the property at the end of the primary term at the value to the lessor to be a form of equity.[104]

In reaching its decision, the Third Circuit gave no indication of how much weight it gave any particular factor. The court admitted that the lease contained provisions that indicated a valid sale and leaseback,[105] but did not identify which or how many countervailing factors were necessary to overturn the parties' characterization of the transaction. In its six page analysis of these countervailing factors, the court did little more than list them in detail and describe their operation under the particular facts of this case. In the final analysis, *Sun Oil* gives little guidance to practitioners attempting

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102. In summarizing the facts upon which it based its holding the court stated:

> As the lessee, [Sun Oil] bore the burdens, risks, and responsibilities for the properties, including the obligation to provide the Trust with a fixed guaranteed return under all circumstances and conditions. The lessee also controlled important benefits traditionally reserved to the owner of property: the lessee had the right to negotiate the settlement or accept the condemnation award and receive the payment; in the event of total or partial condemnation the lessee retained the right to terminate the lease . . . and to make a "rejectable offer" which for all practical purposes was unrejectable; the lessee, in any event, enjoyed the right to substitute other land if perchance an offer was rejected or in substitution of a rejectable offer. These risks, burdens, and benefits are strong attributes of ownership, not of a leasehold interest.

562 F.2d at 269.

103. The court stated:

> The leases also bear marked similarities to debt financing . . . including the structural and guaranteed interest rate . . . the prepayment penalties, the schedule of payments, and the rejectable offer procedures. The rents have no visible connection with the economic value of the property but are evidently related to a fixed interest return on the advances. Finally, the options to acquire the property at the end of the primary term at the value to the lessor is a form of "equity" because the value to lessor is really the present value of future payments for sixty-five years at a specified rate.

*Id.*

104. *Id.*

105. *Id.* The court stated:

> We also note that some of the provisions of the leases in the instant case when viewed independently do not brand the transaction as a financing arrangement. A number of other important features, however, "have been employed in the same transaction with the cumulative effect of depriving [the lessor] of any significant ownership interest."

*Id.* (citing Frank Lyon Co. v. United States, 536 F.2d 746, 754 (8th Cir. 1976)).

to ascertain the tax consequences of a sale and leaseback transaction. Instead, the case only adds to the confused state of the law.

*Frank Lyon Co. v. United States*[106] is the most recent Supreme Court statement on the proper characterization of sale and leaseback transactions for tax purposes. The Court's opinion, however, does little to clarify the law in this area. Stated narrowly, the Court confronted the issue whether the purchaser-lessor was entitled to a deduction for depreciation and for interest on a mortgage on the property. The more important issue, however, concerned the proper allocation of ownership for tax purposes under a sale and leaseback transaction.

The facts of the case are extremely complex. The lessee, Worthen Bank and Trust Company (Worthen), leased a tract of land to Frank Lyon Company (Lyon) for twenty-five years with options to renew for an additional fifty years. Worthen constructed an office building on the leasehold and sold it to Lyon for the cost of construction. Worthen then leased back the building and subleased the land for twenty-five years with options to renew for an additional forty years, leaving a ten-year period during which the improvements were not subject to Worthen's leaseback. At the end of this ten-year period, the land and all improvements were to revert to Worthen in fee.

Lyon paid $500,000 toward the almost $8,000,000 purchase price from its own funds. The remainder of the purchase price was obtained through financing previously arranged by Worthen with New York Life Insurance Company. The leaseback was a net lease arrangement, and the lease rental payments during the twenty-five year primary term of the lease were exactly the amount necessary to amortize fully Lyon's long-term note with New York Life. The lease also contained options allowing Worthen to repurchase the property at the end of the eleventh, fifteenth, twentieth and twenty-fifth years of the lease. The purchase price under each option equaled the unamortized balance of Lyon's note to New York Life plus an amount equal to Lyon's initial investment compounded at a six percent annual rate. Worthen retained the rights to investment tax credits and to sales tax incurred during construction. The parties agreed to apply any condemnation awards or insurance proceeds resulting in a termination of the building lease first to repay the mortgage and then to Lyon up to the amount necessary to return its original investment plus a return of six percent compounded annually, with any balance accruing to Worthen.

106. 435 U.S. 561 (1978).

Lyon, as purchaser-lessor, took a tax deduction for depreciation and for the interest paid on the New York Life mortgage. The Service disallowed these deductions, claiming that the transaction was in reality a financing arrangement. The district court rejected the Service's argument and allowed the deduction. The United States Court of Appeals for the Eighth Circuit agreed with the Service's contentions and reversed. The Supreme Court granted certiorari because of an apparent conflict with *American Realty Trust*. The Court apparently agreed with the Eighth Circuit's holding that the important issue in analyzing the sale and leaseback was whether Lyon had retained enough "significant and genuine attributes of the traditional lessor status"[107] to be entitled to the deductions claimed. In making this determination, however, the Court disagreed with the lower court's analysis of the facts and reversed, thus allowing Lyon to take the claimed deductions.

Although this result is probably correct in light of the facts of the case, the Court's opinion gives no indication of the general standards used in reaching its determination. The Court did not apply traditional lines of sale and leaseback analysis, but instead used a multiple factor approach. The Court cited over twenty-five factors it considered relevant to its decision,[108] but did not indicate the relative significance of particular factors. Only in its holding sentence did the Court place particular emphasis on any factors:

> where, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realties, 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.[109]

The five factors set forth in this holding appear only to be a listing of the categories into which the Court's twenty-five plus factors fell,[110] and provide no standards by which to judge future sale and leaseback transactions. The Court simply took an overall view of the transaction and decided that the deductions should be allowed. In essence, the decision can be viewed as an instinctive judgment by the Court that, under the given facts, the transaction was a valid sale and leaseback. This analysis may be satisfactory for application on a case-by-case basis, but as a practical matter it totally undermines the possibility of adequate tax planning, since few if any

107. *Id.* at 584.
108. For a listing of these factors, see Zarrow & Gordon, *supra* note 3, at 43.
109. 435 U.S. at 583-84.
110. Zarrow & Gordon, *supra* note 3, at 46.

future transactions will be on all fours with *Lyon* and it is impossible to determine which of the factors listed by the Court will control.

(3) Analysis of *American Realty, Sun Oil,* and *Lyon*

In determining whether a particular sale and leaseback should be recharacterized as a mortgage loan, the courts in *American Realty, Sun Oil,* and *Lyon* faced the basic problems that have made it difficult for the judiciary to formulate adequate standards for resolving the recharacterization issue. The basic question is determining the owner of the property for tax purposes. The basic problem is that no single "owner" possessing all the attributes of ownership can be identified and the court therefore must choose between two possible owners, each possessing some but not all of the attributes of ownership. The problem was perhaps best characterized by the Fourth Circuit in *Sun Oil* when it stated that the relevant question is whether the ownership interests of the lessor and lessee as characterized by the parties are consistent with traditional substantive business bargains between lessors and lessees.[111] In recent cases that have addressed this question, however, the issue has been complicated by the uniqueness and complexity of the transactions. The courts have not only faced the problem of having to make this determination without adequate standards to guide them, but have also faced the difficulty of applying these inadequate standards to increasingly complex fact situations.

The courts in *American Realty, Sun Oil,* and *Lyon* characterized the determination of the true owner of the transferred property as a question of law. In making this determination, however, each court marshaled and weighed the available evidence much as it would have in deciding a question of fact. Several commentators have analyzed this approach in detail, focusing on each court's treatment of the issue and the factors that were relevant to its decision.[112] This analysis reveals that the cases do not develop a general rule for determining who is the true owner of the property in the transaction. Instead, each court focused solely upon the unique fact situation before it without attempting to build upon prior precedent to formulate a coherent standard. Therefore, further examination of these cases will not reveal a decisional rule.

Because these cases do not establish a new decisional rule, the important aspect of the cases is the courts' approach in analyzing

111. 562 F.2d at 262 (quoting Rosenberg & Weinstein, *Sale-Leasebacks: An Analysis of These Transactions After the* Lyon *Decision*, 45 J. TAX. 146, 148 (1976)).

112. Kaster, *supra* note 3; Rosenberg & Weinstein, *supra* note 111; Zarrow & Gordon, *supra* note 3.

the ownership issue. Each court implicitly rejected a strict application of any existing test to determine ownership of property transferred in a sale and leaseback. In *American Realty* the court, although focusing upon intent of the parties as one factor, actually based its decision upon a synthesis of several factors. The courts in *Sun Oil* and *Lyon* simply identified a laundry list of relevant facts, determined the impact of the combination of those facts, and decided that the combination indicated that a particular party owned the property. In essence, all three courts, faced with the task of determining which of two possible owners of property would be considered the owner for tax purposes, rejected any analysis that focused on a limited number of factors and took an overall view that incorporated all operative factors, without any explicit determination of their relative importance. This "totality of the transaction" analysis of sale and leaseback transactions is the important development in these cases.

Adoption of this totality of the transaction approach to sale and leaseback cases by two circuit courts of appeals and the Supreme Court indicates a substantial judicial shift in sale and leaseback analysis. The courts, however, were more than justified in rejecting existing tests. The legal title and intention-of-the-parties tests elevate form over substance and often have little relation to the economic realities of a sale and leaseback transaction. Further, they are so inflexible in their application that they do not allow a court to take into consideration the policies underlying deductions such as rental payments, depreciation, and interest payments. Other existing tests that relate the determination of ownership to the type of deduction claimed and the policies underlying that deduction[113] focus only on a limited number of factors. This limited focus often produces a result at odds with the economic substance of the sale and leaseback because the transaction may include many relevant factors that are not taken into consideration. The increasing complexity of sale and leaseback transactions and the variety of clauses and options that parties may include in a lease make it almost impossible for a court to prevent abuses of the tax law by applying a test that considers only a limited number of factors. Thus an analysis that considers all the circumstances surrounding a sale and leaseback is a vast improvement over any test that focuses only on a limited number of factors that may or may not be crucial in any given situation.

The totality of the transaction approach offers the best method

113. *See* text accompanying note 91 *supra*.

of analysis for judicial application. Only an analysis that takes into consideration all factors in a complex sale and leaseback case can yield a result in harmony with the economic realities of the transaction. The totality of the transaction approach is sufficiently flexible to be applicable to all sale and leaseback transactions and also allows a court significant freedom to prevent abuse of the tax laws. Since a court is not equipped to impose substantive changes in the tax laws that might reduce the complexity of the issue, an analysis that takes a comprehensive view of all relevant factors is the best approach available.

Although the totality of the transaction approach is the best analysis available to a court, it is not a wholly satisfactory solution to the problems that arise in determining the owner of sale and leaseback property for tax purposes. At least two significant problems arise in the application of this approach. First, since the approach focuses on a multitude of factors, many of which are unique to each transaction, cases decided under this approach have little precedential value. Only if a previously decided case is on all fours with a case in litigation will the prior case control. Because of the unique character of each sale and leaseback transaction, this identity of facts is unlikely to occur. This fact may work to the Service's advantage in attacking the validity of sale and leaseback transactions. Because it will be able to distinguish virtually any previous decision upholding a sale and leaseback, the Service will be able to attack any transaction it considers abusive of the tax laws. Similarly, taxpayers whose transactions are challenged will be unable to rely on precedent and will be forced to defend the transaction on its individual merits.

A second and more important problem with the totality of the transaction approach is that it does not provide any certainty of tax consequences for tax planners and therefore damages the utility of the sale and leaseback transactions as a business planning tool. Because the approach emphasizes factual analysis, it causes confusion about the probable tax characterization of any particular sale and leaseback. This confusion detracts from the desirability of a sale and leaseback as a business planning tool since the tax consequences of this type of transaction often play an important if not crucial role in determining whether the parties should utilize a sale and leaseback and how the transaction should be structured. Thus certainty, or at least a predictable probability, of tax consequences is necessary if the sale and leaseback is to survive as a useful business planning tool. The totality of the transaction approach does not provide this needed certainty.

(4) Proposed Solution

Any solution to the problem of determining the proper tax characterization of a sale and leaseback must adequately accommodate two competing policy considerations. On the one hand, the Service has an interest in preventing tax abuses that arise from sale and leaseback transactions; on the other hand, business planners need a certainty of tax consequences that will allow them to utilize adequately this useful business tool. Although the interests of preventing tax abuse and providing tax certainty do not inherently conflict, they do conflict in the sale and leaseback situation. The complex division of the attributes of ownership in a sale and leaseback transaction makes it especially difficult to police tax abuse. Thus courts must take a flexible case-by-case approach to the issues presented. Because courts must scrutinize the particular facts of each transaction to determine the proper tax treatment, they are unable to provide certainty as to tax consequences in future cases. This Note argues, therefore, that the judiciary cannot provide a solution to the problems that arise in characterizing sale and leaseback transactions for tax purposes. These problems are best suited to resolution through the administrative rulemaking processes of the Service.

This Note proposes that the Service review its position concerning sale and leaseback transactions, determine the abuses that must be prohibited, and promulgate regulations aimed at preventing these abuses while providing certainty of tax consequences for valid sale and leaseback transactions. As a format for these regulations, this Note suggests that the Service promulgate a series of objective tests that, when met, will provide a "safe harbor" for a sale and leaseback transaction. These tests should focus on the principal attributes of property ownership and the policies underpinning the tax deductions available in a sale and leaseback. Although the tests should minimize the possibility of tax abuse, the regulations must not be drawn too restrictively. In order to serve the dual functions of providing certainty of tax consequences and reducing confrontation, and thus the amount of litigation between the taxpayer and the Service, the regulations must allow enough flexibility of business planning within the safe harbor so that a businessman wishing to use a sale and leaseback would prefer to structure his transaction within the safe harbor and obtain predictable tax consequences rather than risk litigation concerning the proper tax characterization of the transaction. In addition, if the regulation is not overly restrictive, the Service should be able to convince the courts to scrutinize closely the potential for abuse in any transaction that oversteps the bounds of the safe harbor. The flexibility required to

make this regulation practicable will require a trade-off between potential for tax abuse and flexibility for business planners. A properly drawn regulation,[114] however, could go far in eliminating the

114. This Note does not purport to propose a new regulation in detail. The general framework suggested below, however, is offered as a basis for such a regulation.

Framework for Regulation

The proposed regulation should first require that the lease portion of the sale and leaseback transaction be a true lease and not a disguised installment sale contract. The regulation should then provide a series of objective tests designed to assure that:

(1) The purchaser-lessor has a substantial amount of "at risk" capital committed to the property;

(2) The benefits of appreciation and risks of depreciation of the property accrue to the purchaser-lessor; and,

(3) The transaction has an acceptable minimum of the characteristics of a mortgage loan.

The regulation also should require that the seller-lessee demonstrate a business purpose other than the avoidance for entering into the sale and leaseback transaction. If the transaction meets these five requirements—true sale and leaseback, "at risk" capital, appreciation accruing to lessor, an acceptable minimum of loan characteristics, and business purpose—the possibilities of tax abuse are greatly minimized. The regulation should therefore provide that if the transaction meets these requirements, the Service will consider it a valid sale and leaseback and will not attack any deductions flowing from that characterization.

The following list sets forth in outline form the important considerations that should be incorporated into the objective tests to assure that the transaction meets these requirements.

(1) At risk capital:

a) The purchaser-lessor does not have a contractual right to sell the property to the seller-lessee or a related party;

b) The purchaser-lessor is primarily liable on all financing related to the purchase of the property, and all loans are full recourse;

c) No loans of the purchaser-lessor are guaranteed by the seller-lessee or a related party; and,

d) The seller-lessee has not guaranteed the purchaser-lessor a return of his "at risk" capital.

(2) Appreciation to purchaser-lessor:

a) The seller-lessee does not have the right to reacquire the property (by any means) at a price below the fair market value of the property at the time of reacquisition (except that a set-price repurchase option in which the price can be shown to be a valid estimate of the fair market value of the property on the option date should satisfy the test); and,

b) Any gain from a condemnation award should accrue to the purchaser-lessor.

(3) Minimum Loan Characteristics:

a) The sales price of the property is equal to its fair market value;

b) The rental payments under the lease are equal to the property's fair rental value; and,

c) The lease is not structured so as to provide the purchaser-lessor with a recoupment of his investment at a guaranteed rate of return.

Portions of this framework are similar to the provisions of Revenue Procedure 75-21, 1975-1 C.B. 715, that set out the requirements a taxpayer must meet before the Service will issue a ruling that a leveraged lease will be considered a lease for tax purposes. Revenue Procedure 75-21, however, is very restrictive in its application and limited in its coverage, and also requires that a taxpayer obtain a revenue ruling in order to be certain of the tax consequences of the lease. The regulation advocated by this Note is much more liberal in application and much broader in coverage.

tax abuse possibilities of a sale and leaseback while providing certainty of tax consequences in a broad area. In light of the significant problems stemming from the present tax treatment of sale and leaseback transactions, the benefits of tax certainty and minimized litigation obtainable from this approach would outweigh any small costs resulting from this trade-off.

## IV. Conclusion

Determining the proper tax characterization of a sale and leaseback transaction presents a recurring problem for the courts, the Service, and tax planners. For over thirty-five years the judiciary has attempted without success to formulate standards for determining the tax treatment of a sale and leaseback. This continual formulation and reformulation process has left the law in a state of confusion. As a result the utility of this business tool has been undermined. Much of this confusion, however, is unnecessary and could be eliminated through a proper analysis of sale and leaseback transactions. Courts must recognize that a sale and leaseback is only a structural "form" for a transaction and must analyze the sale and leaseback to determine its true economic substance. An economic substance analysis reveals that the conflict between the decision in *Century Electric* and those in *Jordan Marsh* and *Leslie* should not exist, and serves to eliminate the confusion surrounding these cases. Even if this confusion is eliminated, however, significant problems remain in the tax treatment of sale and leaseback transactions, especially those that the Service chooses to attack through recharacterization as a mortgage loan. The totality of the transaction approach that courts have adopted to determine the recharacterization issue in recent cases has caused great uncertainty for tax planners. Part of this uncertainty is inherent in the complex nature of modern sale and leaseback transactions and cannot be eliminated by the courts. Thus only the Service's power to promulgate regulations provides an efficient means of eliminating the uncertainty connected with the determination whether a sale and leaseback should be recharacterized as a mortgage loan. In the final analysis,

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Regarding the first requirement of the proposed regulatory framework, an existing body of tax law addresses the question whether a lease is a disguised installment sale contract. *See, e.g.*, Rev. Rul. 72-408, 1972-2 C.B. 86; Rev. Rul. 60-122, 1960-1 C.B. 56; Rev. Rul. 57-371, 1957-2 C.B. 214; Rev. Rul. 55-542, 1955-2 C.B. 59; Rev. Rul. 55-541, 1955-2 C.B. 19; Rev. Rul. 55-540, 1955-2 C.B. 39. In formulating tests to assure compliance with this requirement, the regulation should incorporate the tests developed in this body of law.

Regarding the parenthetical to consideration (a) listed under "Appreciation to the purchaser-lessor," the taxpayer should bear the burden of proof of the validity of the estimate.

neither the courts nor the Service can totally eliminate the confusion and uncertainty surrounding the tax treatment of a sale and leaseback. In conjunction, however, they could go far in eliminating many of the problems that exist. This Note urges that both the Service and the judiciary reevaluate their present approach to the determination of the proper tax characterization of a sale and leaseback transaction in an attempt to provide certainty of tax consequences and a tax treatment in accord with the economic substance of each transaction.

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