

Sale-Leasebacks: A Search for Economic Substance

INTRODUCTION

The levered sale-leaseback is a relatively new transaction. Although it was used by the railroads as early as the 1850's,¹ it did not come into widespread use as a financing tool until the middle of this century.² As the name implies, a sale-leaseback involves nothing more than the sale of an asset by one party, the seller-lessee, to another party, the buyer-lessor, who in turn leases the property back to the seller-lessee. Both parties benefit by the transaction; the seller-lessee receives immediate financing in an amount equal to the sales price and retains beneficial use of the asset for the term of the lease. The buyer-lessor receives legal title to the asset and the seller-lessee's promise to make lease payment over a term of years.³

Leverage refers to the buyer-lessor's use of debt to finance her purchase.⁴ Often the buyer-lessor is unwilling or unable to pay the entire purchase price herself at the time of the transfer. Instead, she may obtain funds from a financial institution, so that in a typical modern sale-leaseback the buyer-lessor may pay only a small fraction of the purchase price herself, financing the rest of the purchase with debt.⁵ When debt financing is used the parties will commonly structure the lease payment schedule to coincide with the

1. P. ELGERS & J. CLARK, *THE LEASE/BUY DECISION* 112-14 (1980). The railroads did not use levered leasing as a financing tool. For them the transaction was a way of circumventing state laws which did not recognize the seller's retention of title in a conditional sales contract as a defense against the buyer's creditors who lacked knowledge of the contract. *See id.*

2. *See* Kronovet, *Recharacterization of Real Estate Leases: An Analysis and Proposal*, 32 *TAX LAW.* 757, 760-62 (1979); *see also* Cook, *Sales and Leasebacks*, *TAX MGMT.* (BNA) No. 36, at A-1 (3d ed. 1981).

3. For a discussion of sale-leaseback financing generally, *see* Carey, *Corporate Financing Through a Sale and Leaseback of Property: Business, Tax, and Policy Considerations*, 62 *HARV. L. REV.* 1 (1948) [hereinafter cited as Carey, *Corporate Financing*]; Carey, *Tax Aspects of the Sale and Lease-Back of Corporate Property*, 7 *N.Y.U. INST.* 599 (1949) [hereinafter cited as Carey, *Tax Aspects*]; Weinstein & Silvers, *The Sale and Leaseback after Frank Lyon Company*, 24 *N.Y.L. SCH. L. REV.* 337, 338-42 (1979). For a discussion of financial planning aspects of lease financing in general, *see* W. BRUEGGMAN & L. STONE, *REAL ESTATE FINANCE* 408-35 (7th ed. 1981); J. VAN HORNE, *FINANCIAL MANAGEMENT AND POLICY* 254-71 (6th ed. 1968).

4. *See generally* W. BRUEGGMAN & L. STONE, *supra* note 3, at 370-76.

5. Fuller, *Sales and Leasebacks and the Frank Lyon Case*, 48 *GEO. WASH. L. REV.* 60, 61 (1979).

loan interest and amortization schedule.⁶ The seller-lessee's rental payments will be set at an amount equal to the buyer-lessor's debt obligations. In that situation, the buyer-lessor may, in effect, be nothing more than a conduit, funneling payments from the seller-lessee to a financial institution.⁷

This Note is divided into three sections. The first section discusses the economic aspects of sale-leaseback financing, beginning with a description of some provisions of the modern sale-leaseback which make it closely resemble a secured financing arrangement.⁸ Despite the functional resemblance of the modern sale-leaseback to more traditional forms of financing, it offers distinct nontax and tax related benefits which make it a valuable financing tool.⁹ After discussing these benefits, the first section of the Note concludes with an example of a modern sale-leaseback designed to illustrate that the transaction, analyzed on a pre-tax basis, rarely is a profitable proposition for the buyer-lessor.¹⁰ Taxes, specifically the depreciation tax deduction and the investment tax credit, are what make the transaction a profitable investment.¹¹ From the buyer-lessor's perspective, the transaction yields no pre-tax profit.

The second section of this Note focuses on judicial treatment of sale-leaseback transactions for tax purposes.¹² In this context the issue often becomes whether the transaction more closely resembles a secured financing arrangement or a sale coupled with a lease. This section of the Note focuses on three recent decisions in which the courts have applied a pre-tax profit requirement before they would uphold the transaction as styled by the parties.¹³

The third section of this Note contains a criticism of judicial analysis, especially of the emerging pre-tax profit requirement.¹⁴ The analysis is too narrow and ignores the substantial social and economic benefits which sale-leaseback financing offers. The Note concludes with a proposed mode of analysis which would explicitly consider these benefits.¹⁵

6. See, e.g., Slater, *Capital Accumulation in an Age of Scarcity: A Requiem for the American Corporation*, 12 MEM. ST. U.L. REV. 429, 444 (1982).

7. See, e.g., *Frank Lyon Co. v. United States*, 435 U.S. 561, 573 (1978), *rev'g* 536 F.2d 746 (8th Cir. 1976).

8. See *infra* notes 16-39 and accompanying text.

9. See *infra* notes 40-78 and accompanying text.

10. See *infra* notes 79-107.

11. The similarity of the sale-leaseback to secured financing is by no means the only issue to arise in sale-leaseback litigation. For a good discussion of some of these issues, see generally Cook, *supra* note 2.

12. See *infra* notes 108-230 and accompanying text.

13. *Estate of Thomas v. Commissioner*, 84 T.C. 412 (1985); *Rice's Toyota World, Inc. v. Commissioner*, 81 T.C. 184 (1983), *aff'd in part, rev'd in part*, 752 F.2d 89 (4th Cir. 1985); *Hilton v. Commissioner*, 74 T.C. 305 (1980), *aff'd*, 671 F.2d 316 (3d Cir. 1982).

14. See *infra* notes 231-48 and accompanying text.

15. See *infra* notes 249-53 and accompanying text.

I. ECONOMIC ASPECTS OF SALE-LEASEBACKS

A. *Similarity to a Mortgage*

The simple sale-leaseback closely resembles traditional forms of secured financing, with the buyer-lessor standing in the shoes of the secured creditor, and the seller-lessee standing in the shoes of the debtor.¹⁶ Tax considerations aside, the primary difference between the two transactions is that in the secured financing arrangement legal title does not pass to the creditor.¹⁷

Despite the similarity of secured financing to sale-leasebacks, two sets of factors exist by which one can distinguish between them. Both sets of factors are the logical consequences of the passage of legal title in the sale-leaseback arrangement. First, in the sale-leaseback, the buyer-lessor bears the risks and burdens of ownership. As owner, the buyer-lessor must pay all expenses normally associated with asset ownership, namely, taxes, insurance and maintenance costs. If the property is destroyed or condemned, she suffers the loss, and if insurance or condemnation proceeds are made available, they inure to her benefit. The second distinguishing factor is that at the end of the lease term, the buyer-lessor gets the reversionary interest in fee.¹⁸

Although the simple sale-leaseback is easily distinguished from a secured financing transaction, such is not the case for the more typical modern sale-leaseback. The modern sale-leaseback may incorporate any combination of features whose purpose and effect is to make the buyer-lessor's investment in real property practically indistinguishable from a passive secured financing

16. See generally Note, *Some Economic and Legal Aspects of Leaseback Transaction*, 34 VA. L. REV. 686, 692-94 (1948); Weinstein & Silvers, *supra* note 3, at 338-41. In both articles, the discussion is framed in terms of the similarity of the sale-leaseback to mortgage financing. Because mortgage financing is just a type of secured financing, the broader comparison is appropriate.

17. In the typical secured transaction the creditor gives the debtor financing and in exchange receives the debtor's promise to make a series of payments over a term of years. The creditor retains a security interest in an asset belonging to the debtor, but the debtor retains use of the asset.

18. See generally Note, *Problems of Judicial Interpretation of Real Estate Sale and Leaseback Taxation: Description, Analysis, and Proposal*, 33 TAX LAW. 237, 239-43 (1979-1980). The thesis of the article is that a relational logic underlies attempts by the courts to recharacterize sale-leasebacks. Applying this logic, the courts compare the characteristics of the relationship between the buyer-lessor and the seller-lessee in a particular transaction to the characteristics of the more traditional relationships existing between buyer and seller, lessor and lessee, and mortgagor and mortgagee. The court will recharacterize the transaction as a mere financing arrangement if the relationship between the buyer-lessor and the seller-lessee more closely resembles the relationship between mortgagor and mortgagee than it does the other two traditional relationships. The article proposes that the relational logic is inadequate when applied to sale-leasebacks because these transactions, in their modern form, do not conform to any of the traditional relationships. *Id.* at 243-44. See generally Kronovet, *supra* note 2.

investment.¹⁹ These provisions fall into two broad categories which parallel the factors by which one can distinguish the simple sale-leaseback. The first category consists of provisions which relieve the buyer-lessor of all or most of the costs and risks of asset ownership, and the second consists of those provisions which affect the buyer-lessor's claim to the reversionary estate.²⁰

Most sale-leasebacks incorporate clauses which shift the risks and burdens associated with asset ownership to the seller-lessee;²¹ the net lease is one such clause.²² A net lease simply requires the seller-lessee to pay taxes, insurance and operating expenses, assuring that the buyer-lessor's rental payments will remain constant, unaffected by unanticipated fluctuations in those costs.²³ The modern sale-leaseback may also contain specific provisions allocating the risk of total or partial destruction and condemnation.²⁴ These provisions lend themselves to creative drafting and vary considerably from case to case, but their ultimate effect is to shift all or most of the ownership risks away from the buyer-lessor and to the seller-lessee. For example, the buyer-lessor, through lease provisions relating to allocation of insurance and condemnation proceeds, may secure payment of an amount sufficient to cover her equity investment plus a specified rate of return. The lease would allocate any excess funds to the seller-lessee.²⁵ Alternatively, the lease could provide that the seller-lessee would be held absolutely liable for the rent even if the asset is destroyed or condemned.²⁶

Another common set of provisions which further blurs the distinction between a valid sale-leaseback and secured debt financing are those relating to disposition and control of the buyer-lessor's reversionary interest. These include the repurchase option, the long-term lease and the renewal option. A repurchase option simply gives the seller-lessee the right to purchase the property at the end of the lease term.²⁷ If the option price is close to the estimated fair market value of the property at the end of the lease, the repurchase option provides little analytic difficulty; disposition of the property at fair market value is not inconsistent with the buyer-lessor's owner-

19. See Note, *supra* note 18, at 243-45.

20. *Id.*

21. *Id.* at 241; see also Note, *Sale-Leaseback v. Mere Financing: Lyon's Roar and the Alternative*, 1982 U. ILL. L. REV. 1075, 1077.

22. See W. BRUEGGMAN & L. STONE, *supra* note 3, at 316.

23. *Id.* The buyer-lessor's return is constant over the term of the lease because she receives rentals free and clear of any additional costs. The only risk which she faces with respect to that return is that the buyer-lessor will default. The buyer-lessor can minimize this risk through careful selection of a credit-worthy seller-lessee.

24. See, e.g., *Frank Lyon Co. v. United States*, 536 F.2d 746, 749 (8th Cir. 1976), *rev'd*, 435 U.S. 561 (1978).

25. *Id.*

26. *Id.*

27. E.g., Note, *supra* note 21, at 1077 n.9.

ship.²⁸ Conversely, if the option price is significantly lower than the currently estimated fair market value at the end of the lease, the transaction becomes more difficult to distinguish from secured financing. In that situation the seller-lessee would make an imprudent business decision if he chose not to exercise his repurchase option. He would be economically compelled to do so,²⁹ thereby depriving the buyer-lessor of her reversionary interest at a fraction of its value. Thus, what began as a simple sale-leaseback, easily distinguished from secured financing by the fact that the buyer-lessor retained an unencumbered reversionary interest, becomes more difficult to distinguish when a bargain purchase option is added.³⁰

Long-term leases are another feature of modern sale-leasebacks which affect the buyer-lessor's right to enjoy her reversionary interest. If the term of the lease extends beyond the economic life of the asset, the buyer-lessor's reversionary interest is worthless, and the transaction again becomes difficult to distinguish from secured or mortgaged financing.³¹ Although the buyer-lessor retains legal title, the seller-lessee retains beneficial use of the asset. This resembles secured financing in which the debtor retains both legal and equitable title to the asset and the creditor's only interest consists of the income from loan repayments and the right to repossess in the event of the debtor's default.³²

The leaseback may contain a provision giving the seller-lessee the option to renew his lease at the end of the primary term at a specified rent and

28. See, e.g., Note, *Taxation of Sale and Leaseback Transaction—A General Review*, 32 VAND. L. REV. 945, 970 (1979). If the repurchase option price is commensurate with the property's fair market value, the buyer-lessor is still in a position to realize the benefit of appreciation. The true owner of a piece of property which has appreciated in value is in a position to realize the benefit of that appreciation; he can sell the property, realizing the benefit directly, or he can continue to operate and manage the property, realizing the benefit over time. The buyer-lessor of an asset subject to an option to purchase at a price close to fair market value stands in the same position. Whether or not the seller-lessee elects to exercise the option, the buyer-lessor is in a position to realize the benefit of the asset's appreciation.

29. *Id.*; see also Harmelink & Shurtz, *Sale-Leaseback Transactions Involving Real Estate: A Proposal for Defined Tax Rules*, 55 S. CAL. L. REV. 833, 840-41 (1982) (a useful discussion of judicial application of the economic compulsion doctrine).

30. See generally Note, *supra* note 28; see also Del Cotto, *Sale and Leaseback: A Hollow Sound When Tapped*, 37 TAX. L. REV. 1, 32-33 (1981).

31. Cf. Note, *supra* note 18, at 244-45, in which the author states that use of a long-term lease makes the seller-lessee's position more closely resemble that of a traditional lessor. In the overall context of the discussion, however, long-term leases also clearly make the lessee's position closely resemble the position of a mortgagor. One of the characteristics of mortgagor status is that the mortgagor's position vis-à-vis beneficial use of the property remains unchanged so long as the mortgagor continues to make mortgage payments. *Id.* at 242. The long-term lessee stands in much the same position; his position vis-à-vis beneficial use of the property remains unchanged so long as he continues to make lease payments. At the end of the lease, equitable title reverts back to the buyer-lessor. If the lease extends beyond the asset's useful life, however, the lessor receives nothing of economic value, and the lessee gives up nothing of economic value.

32. *Id.* at 242-45.

for a specified period.³³ The document may also provide for more than one renewal option.³⁴ These renewal options combine some of the analytic difficulties of both repurchase options and long-term leases. If the renewal rentals are set at a price commensurate with a reasonable estimate of what the fair market rental will be at the end of the primary lease, the renewal provision clause provides little difficulty. The seller-lessee would not be economically compelled to exercise the option, and the buyer-lessor would not be precluded from realizing the full economic value of the leased property. Even if the parties set the renewal rentals significantly below the estimated future fair market rental, so that the seller-lessee would be economically compelled to exercise his renewals, no problem exists so long as the renewal periods do not extend beyond the asset's useful life. The buyer-lessor may not be getting fair market rental value, but her reversion is still economically valuable. If, however, the seller-lessee's ability to obtain bargain renewal rentals extends beyond the asset's useful life, the buyer-lessor's reversion will be worthless and the transaction will be difficult to distinguish from a secured financing arrangement.³⁵

Modern sale-leasebacks may incorporate several of these features, the net effect of which is to put the putative buyer-lessor in the same position as a secured creditor.³⁶ Despite the resemblance of the modern sale-leaseback to secured financing, it still has many characteristics which make it worthwhile for the parties to use this form of financing.³⁷ Many of the advantages which make the sale-leaseback a valuable financing tool are independent of tax considerations.³⁸ The most important advantages of the sale-leaseback, however, lie in its tax consequences, which make the modern leveraged sale-leaseback profitable for the parties involved.³⁹

B. Nontax Benefits

Sale-leaseback financing offers nontax advantages over ordinary secured financing to both parties to the transaction. One of the major nontax

33. See Weinstein & Silvers, *supra* note 3, at 339.

34. See, e.g., Frank Lyon Co. v. United States, 435 U.S. 561, 566 (1978), *rev'g* 536 F.2d 746 (8th Cir. 1976) (the lease contained eight five-year renewal terms).

35. For a good discussion of the relationship between the repurchase option price, the renewal option price, the renewal option period, the economic life of the asset, and the buyer-lessor's interest in the reversion, see Harmelink & Shurtz, *supra* note 29, at 841.

36. See, e.g., Note, *supra* note 28, at 948-49.

37. See, e.g., Carey, *Tax Aspects*, *supra* note 3, at 601-02; Fuller, *supra* note 5, at 60-63; Slater, *supra* note 6, at 444-47; Note, *supra* note 21, at 1075-83.

38. See *infra* notes 40-59 and accompanying text.

39. See *infra* notes 60-107 and accompanying text; see also Carey, *Tax Aspects*, *supra* note 3, at 602 ("While general business and legal considerations have bulked large in determining whether to enter into a sale and lease-back agreement, there can be no question that the tax aspect has been an important, and in many cases a controlling, factor.").

advantages of the sale-leaseback to the borrowing seller-lessee is that it allows him to realize 100% of the asset's cash value;⁴⁰ in a secured financing transaction the borrower can realize only 75-80% of his asset's value.⁴¹ The transaction also provides a way for the seller-lessee to avoid existing debt covenants⁴² or, if new financing is required, to avoid the possible imposition of new ones.⁴³ The sale-leaseback also provides a way to raise new capital for economic entities whose capacity to issue debt or own property is legally restricted.⁴⁴

In addition, the sale-leaseback has the potential of improving the seller-lessee's balance sheet; if the lease meets certain financial accounting criteria, the seller-lessee can obtain financing without having to report a liability on the balance sheet.⁴⁵ Even if the transaction does not meet those accounting

40. See, e.g., Carey, *Tax Aspects*, *supra* note 3, at 601; Cook, *supra* note 2, at A-1; Shurtz, *A Decision Model for Lease Parties in Sale-Leasebacks of Real Estate*, 23 WM. & MARY L. REV. 385, 385-89 (1982). But see Carey, *Corporate Financing*, *supra* note 3, at 8.

41. E.g., Cook, *supra* note 2, at A-1; Note, *supra* note 28, at 949.

42. Carey, *Corporate Financing*, *supra* note 3, at 14-15. Often creditors will impose upon borrowers restrictions intended to assure the continued ability of the borrowers to meet their debt obligations. These restrictions may take the form of limitations on the borrower's ability to incur more debt, or a requirement that the borrower maintain a minimum working capital level, or certain financial ratios. Such restrictive debt covenants may appear in loan agreements or bond indentures. See also Cook, *supra* note 2, at A-1; Shurtz, *supra* note 40, at 389.

43. Carey, *Corporate Financing*, *supra* note 3, at 15.

44. *Id.*; see also *Frank Lyon Co. v. United States*, 435 U.S. 561, 563-64 (1978). In *Frank Lyon*, the buyer-lessor was a bank whose ability to incur debt and own land was restricted by state and federal regulations. The sale-leaseback was the best alternative financing arrangement for the buyer-lessor. *Id.* For a discussion of *Frank Lyon*, see *infra* notes 117-42 and accompanying text.

45. This practice is referred to as off-balance-sheet financing. In 1976, the Financial Accounting Standards Board ("FASB") issued *Statement of Financial Accounting Standards No. 13, Accounting for Leases* ("SFAS No. 13"), which restricted the lessee's ability to use leases for off-balance-sheet financing. The principle underlying the SFAS No. 13 requirements is that if the lease transfers all or most of the risks and benefits of ownership to the lessee, he should report the value of the leasehold estate as an asset, and the corresponding lease obligation as a liability. Such a lease is referred to as a capital lease. From the seller-lessee's perspective, if any one of four criteria established by SFAS No. 13 are met, the lease should be classified as a capital lease. The four criteria are:

1. The lease transfers the asset to the lessee by the end of the lease period.
2. The lease contains a bargain-purchase option.
3. The lease term is equal to or greater than 75% of the estimated economic life of the asset.
4. At the beginning of the lease, the present value of the minimum lease payments equals or exceeds 90% of the fair market value of the leased property.

STATEMENT OF FIN. ACCOUNTING STANDARDS NO. 13 (Financial Accounting Standards Bd. 1976). If the lease does not meet any one of these four requirements it should be classified as an operating lease, in which case the lessee will not have to report the lease as a liability. See, e.g., *How Sale Leasebacks Beat the High Cost of Money*, BUSINESS WEEK, Jan. 12, 1981, at 26-27 (Anheuser-Busch financed the construction of a new office building in St. Louis without having to report the lease as a liability because it satisfied SFAS No. 13 requirements). See generally J. VAN HORNE, *supra* note 3, at 259-62 (discussing generally the accounting treatment of leases and illustrating the present value and amortization calculations required); see also

requirements, it will improve the seller-lessee's working capital position by converting a fixed asset into cash.⁴⁶ Finally, the interest rate implicit in leaseback rentals is fixed over time. In a period when most debt obligations contain floating interest rate provisions, the fixed-interest feature of the sale-leaseback could be an advantage, depending upon the future course of interest rates.⁴⁷

The buyer-lessor also realizes certain nontax benefits from the sale-leaseback. First, she acquires a piece of rental property with a built-in tenant, and an investment with cash flows established by contract.⁴⁸ At the end of the lease she gets the reversionary interest,⁴⁹ although the extent and value of that interest depend upon the specific provisions of the lease.⁵⁰ Also, because the buyer-lessor holds legal title to the asset, she avoids much of the time delay and expense associated with foreclosure, and in case of the seller-lessee's bankruptcy, the buyer-lessor stands in a better position than if she were an ordinary secured creditor.⁵¹

Thus, the sale-leaseback has nontax benefits which make it an attractive alternative to conventional financing techniques. In a tight money market, when credit is difficult to obtain at reasonable rates, lenders may be more willing to buy and lease back an asset than they would be to purchase debt.⁵² The asset provides a hedge against inflation and, because the lending buyer-lessor retains legal title, she eliminates the legal problem associated with foreclosure.⁵³ Real estate developers have also successfully employed sale-leaseback arrangements. A developer may have significant real estate holdings but insufficient capital to develop them. A sale-leaseback allows him to immediately realize 100% of the property's value in cash, which he could then redeploy to other productive development projects.⁵⁴ The sale-leaseback

Harmelink & Shurtz, *supra* note 29, at 870-78 (discussing the accounting standards for the lessor and the lessee and how those standards relate both to the judicial treatment of leases and to a proposed standard for judicial treatment of leases).

46. See Note, *supra* note 28, at 950; see also Mandell, *Tax Aspects of Sales and Leasebacks as Practical Devices for Transfer and Operation of Real Property*, 18 N.Y.U. INST. 17, 18 (1960) (discussing the balance sheet effects of the sale-leaseback of real property already subject to a mortgage).

47. If the buyer-lessor expected future market rates to rise, she would look more favorably upon a sale-leaseback financing opportunity, which would lock in a lower interest rate, rather than upon a debt financing opportunity for which the interest rate charged would rise with the market.

48. P. ANDERSON, *TAX FACTORS IN REAL ESTATE OPERATIONS* 332 (6th ed. 1980).

49. See *supra* note 18 and accompanying text; see also W. BRUEGGMAN & L. STONE, *supra* note 3, at 311.

50. See *supra* notes 27-35 and accompanying text.

51. See J. VAN HORNE, *supra* note 3, at 495-96.

52. See Note, *supra* note 28, at 950; Mandell, *supra* note 46, at 18.

53. Note, *supra* note 28, at 950.

54. See, e.g., Posner, *Renting Money, Inc.*, Apr. 1983, at 121-27. The article chronicles the story of how a small Arkansas entrepreneur, using sale-leasebacks, financed the expansion

is also a useful means of expanding plant capacity in capital intensive industries.⁵⁵ Rapidly expanding firms require substantial investments of working capital into their growing base of fixed assets.⁵⁶ Often, their growth rate will exceed their capacity to generate working capital internally.⁵⁷ In that situation, the sale-leaseback is a useful tool by which to generate additional working capital. The retail industry has used the sale-leaseback in this manner. Retail chain stores such as Safeway⁵⁸ have been able to rapidly increase the number of their locations by building facilities to their own specifications and then selling them to investors.⁵⁹

C. Tax Benefits

In addition to the substantial nontax benefits, leveraged sale-leasebacks offer tax benefits as well.⁶⁰ The fully deductible rental payments⁶¹ and the treatment of any gains or losses resulting from the sale⁶² are two tax benefits to the seller-lessee arising out of a valid sale-leaseback.⁶³ When a borrower uses secured financing, only that portion of each payment which represents interest is deductible⁶⁴—the remaining portion is not.⁶⁵ When sale-leaseback financing is employed, however, any payment made as a condition to the continued use of an asset in which the seller-lessee has no equity is fully deductible.⁶⁶

The value of the rental deduction varies inversely with the depreciable nature of the asset sold.⁶⁷ When the seller-lessee gives up title to the asset, any depreciation deduction which he may have been able to claim goes with it. He must weigh the value of the fully deductible rentals against the value

of his single Waffle House restaurant into a chain of 14 restaurants with combined assets of over \$7 million. The sale-leaseback allowed him to invest his limited resources into productive working capital as opposed to tying it up in real estate.

55. Note, *supra* note 28, at 950.

56. *Id.*

57. *Id.*

58. See, e.g., *Dunlap v. Commissioner*, 74 T.C. 1377, 1400 (1980), *rev'd*, 670 F.2d 785 (9th Cir. 1982). Safeway is not the only large retail chain to finance its expansion using the sale-leaseback. Allied Stores, Federated Department Stores, Gimbels, Sears Roebuck and Montgomery Ward have also successfully used sale-leaseback financing. Carey, *Corporate Financing*, *supra* note 3, at 2 n.4.

59. Note, *supra* note 28, at 950.

60. For a general discussion of all aspects of lease taxation, see generally Cook, *supra* note 2.

61. Note, *supra* note 28, at 952.

62. *Id.*

63. A complete discussion of depreciation recapture is beyond the scope of this Note.

64. I.R.C. § 163(a) (West 1978).

65. *Id.* at § 263.

66. *Id.* at § 162 (a)(3). No requirement exists that the rental payments be reasonable in order for them to be deductible.

67. See Carey, *Corporate Financing*, *supra* note 3, at 18.

of the depreciation lost when deciding whether or not to use sale-leaseback financing.⁶⁸ When the seller-lessee sells a newly constructed, fully depreciable asset, he is merely exchanging the depreciation deduction he could have had for the rental deduction. The net advantage or disadvantage of this exchange depends upon the size of the deductions, the term of the lease, and the depreciable life of the asset. If the asset sold and leased back consists of entirely nondepreciable real estate, or of a fully depreciated asset, the seller-lessee creates a depreciation-like rental deduction where none existed before.⁶⁹

The sale-leaseback is also a useful tax planning device by which the seller-lessee can manipulate the timing and recognition of capital gains and losses.⁷⁰ Suppose a taxpayer owned a capital asset whose book value greatly exceeded its fair market value and also had a large capital gain for the period. By selling the asset subject to a leaseback, the taxpayer could generate the capital loss needed to offset his capital gain and still retain use of the asset. Conversely, suppose the taxpayer had an asset whose fair market value exceeded its book value. He could avoid capital gain recognition upon sale and leaseback of the asset simply by making the leaseback for a term exceeding thirty years. In that situation the sale-leaseback would be treated as a tax-free, like-kind exchange.⁷¹

The major tax consequences to the buyer-lessor of a valid sale-leaseback are the availability of the investment tax credit at the inception of the lease, except to the extent that the purchased assets consist of real estate,⁷² and the recognition of rental income offset by the depreciation deduction over the term of the lease.⁷³ When the buyer-lessor finances her purchase with debt, she may also deduct her interest payments.⁷⁴ When accelerated depreciation methods are used, the depreciation deduction may well exceed rental income during the early years of the lease. During those years tax losses

68. If the asset sold were eligible for an accelerated method of depreciation, the value of the depreciation lost could exceed the value of the rental deduction gained, at least during the early years of the asset's life.

69. Note, *supra* note 28, at 952 ("If the property consists primarily of a non-depreciable asset, such as land, the full rental deduction has the effect of allowing a depreciation deduction for the non-depreciable portion of the property.').

70. See generally Note, *supra* note 28, at 952-53.

71. See I.R.C. § 1031(a)-(c) (West 1985). No capital gain or loss will be recognized on an exchange of property held for productive use in a trade or business for property of like-kind. When the exchange is for property of like-kind, plus other property not of like-kind, only a gain would be recognized, but only to the extent of the value of the other property. Treas. Reg. § 1.1031(a)-1(c) (1956) (an exchange of real estate for a leasehold of 30 years or more is eligible for treatment as a like-kind exchange under I.R.C. § 1031). This section of the code and the accompanying regulation has been one source of sale-leaseback litigation. The issue in these cases has been the capital gain or loss treatment of gains or losses on the sale of the asset. For a good discussion of this line of litigation, see Del Cotto, *supra* note 30, at 10-23 and cases cited therein. See also Note, *supra* note 28, at 956-68 and cases cited therein.

72. See Cook, *supra* note 2, at A-29 to A-32.

73. *Id.* at A-19 to A-29, A-32 to A-33.

74. See I.R.C. § 163(a) (West 1978).

will result.⁷⁵ When the buyer-lessor has sufficient income from other sources, however, she can use the tax loss to reduce the amount of that income subject to tax, thereby reducing her overall tax payment. Thus, a valid sale-leaseback has tax-shelter potential which produces an economic benefit to the buyer-lessor.

For both parties, tax considerations play an important role in the decision of whether to enter into sale-leaseback agreements.⁷⁶ For the seller-lessee to enter into the arrangement, the value of fully deductible rental payments, plus other nontax benefits, must outweigh the value of the depreciation deduction foregone and the loss of legal title.⁷⁷ For the buyer-lessor to enter into the transaction, the value of the rental income plus the depreciation and interest tax benefit must exceed the value of other investment opportunities foregone.⁷⁸

D. Illustration of the Vital Role Played by Taxes

Tax considerations clearly play an important role in the unleveraged sale-leaseback decision, but when one considers the leveraged sale-leaseback, taxes play a crucial, if not determining, role.⁷⁹ The availability of the interest and depreciation deductions and the investment tax credit to the buyer-lessor are the foundation upon which the economic viability of the leveraged sale-leaseback rests.⁸⁰ The introduction of leverage into the transaction does not change the role which tax considerations play in the seller-lessee's decision,⁸¹ except perhaps to the extent that it affects the size of the rental payments.⁸² When the buyer-lessor uses debt to finance her purchase, however, the availability of the tax benefits is quite often the only reason the transaction is a profitable proposition.⁸³ An analysis of the profitability of a typical modern levered sale-leaseback investment on a before-and-after tax basis illustrates the preeminence of tax considerations to the buyer-lessor's decision.

75. See *infra* notes 96-99 and accompanying text.

76. See Kronovet, *supra* note 2, at 759 ("The fact is that the decision of the parties concerning [what form of financing to adopt] is a tax decision pure and simple."). See also Carey, *Corporate Financing*, *supra* note 3, at 16-17.

77. See Carey, *Corporate Financing*, *supra* note 3, at 18.

78. If the investor had not invested her funds in the sale-leaseback, presumably she would have been able to invest them elsewhere. The return which the next best investment use may have provided is, therefore, the standard against which her sale-leaseback investment should be judged.

79. See *infra* notes 86-99 and accompanying text.

80. See P. ELGERS & J. CLARK, *supra* note 1, at 107-08.

81. See J. VAN HORNE, *supra* note 3, at 479.

82. When leverage is used, rental payments are geared to the buyer-lessor's interest and principal amortization schedule, so the rentals bargained for may be slightly different in the levered sale-leaseback context than in the unlevered sale-leaseback context.

83. See *infra* notes 96-99 and accompanying text.

Consider a firm that needs to purchase a fully depreciable asset costing \$1,250,000 with a depreciable life, for tax purposes, of five years. After conducting an independent analysis, the firm decides that a sale-leaseback would be the most desirable financing alternative.⁸⁴ A potential buyer-lessor is willing to pay \$250,000, or 20% of the purchase price, out of her own working capital. She is able to finance the remaining portion at a 10% annual rate of interest over fifteen years. After serious arms-length negotiations, the parties settle on a leaseback for fifteen years at an annual rent of \$131,474, an amount equal to the loan interest and amortization payments.⁸⁵ At the end of the lease the buyer-lessor will retain full control of the asset which is projected to have a fair market value at that time of \$625,000, 50% of its original cost. Before the buyer-lessor will enter into the transaction, she must analyze it to see whether it would be a profitable use of her funds.

Her analysis will focus on the after-tax cash flows which the investment produces.⁸⁶ Only if the present value⁸⁷ of the after-tax cash inflows exceeds

84. Perhaps the buyer-lessor is legally restricted in her ability to assume new debt. See *supra* notes 42-44 and accompanying text. Or perhaps alternative techniques would not yield sufficient funds, or would yield sufficient funds but at too high a cost. See *supra* notes 41-42.

85. This example assumes a net lease so that the buyer-lessor's cash flows are net of any operating expenses. See also *supra* note 96.

86. Cash, not accounting income, is central to all investment decisions. Cash is used to pay current expenses and for further investment. A firm's accounting records may reflect healthy income even though the firm does not have enough cash on hand to meet current expenses. In addition, any investment analysis which ignores tax considerations is woefully inadequate and bound to mislead the investor. Cash available after taxes have been extracted is the relevant consideration for the taxable investor. Pre-tax cash flows are included in this example only to illustrate how difficult it would be for a leveraged sale-leaseback to produce a pre-tax profit.

87. The present value concept recognizes that a rational investor would prefer receiving \$1 today over receiving \$1 a year from now. The investor could invest the \$1 received today at a specified rate of return and have more than \$1 in a year. For example, suppose an investor could invest the \$1 she receives today in a bank account earning 10% interest. In one year, that \$1 investment would be worth \$1.10; in two years, it would be worth \$1.21. The investor should be indifferent to the right to receive \$1 today and \$1.10 in one year, or \$1.21 in two years. In common parlance, \$1 is said to be the *present value* of \$1.10 in one year at 10%, or of \$1.21 in two years at 10%. The interest rate used, in this example 10%, is referred to as the *discount rate*. The present value of a particular future amount can be expressed as a simple mathematical relationship between the future amount, the discount rate, and the amount of time until the future amount is received.

$$PV(X) = X \frac{1}{(1 + k)^n}$$

X = sum of money received in the future

n = number of periods into the future when X will be received

k = discount rate

PV(X) = present value of X

Present value calculations allow the analyst to compare on an equal basis sums of money received or expended at different points in the future. Fortunately, tables are available which relieve the analyst of the tedium of calculation. See, e.g., H. BIERMAN & S. SMIDT, *THE CAPITAL BUDGETING DECISION, ECONOMIC ANALYSIS AND FINANCING OF INVESTMENT PROJECTS* 369-85 (2d ed. 1966).

the present value of the after-tax cash outflows will the transaction be justified.⁸⁸ In this example, because the annual rental income which the buyer-lessor receives is precisely offset by her debt repayment obligation, the net present value of the pre-tax cash flows generated by her investment is zero.⁸⁹ Thus, during the primary term of the lease, her \$250,000 cash investment will produce no cash benefits; the only source of pre-tax return on her investment is the value of her reversionary interest, or the residual

88. This mode of investment analysis is referred to as net present value analysis. See generally J. VAN HORNE, *supra* note 3, at 111-12. For a good discussion of other methods of investment analysis see *id.* at 108-17; H. BIERMAN & S. SMIDT, *supra* note 87, at 13-33. Basically, this technique compares the present value of all cash outflows required for a particular investment with the present value of all cash inflows which that investment is expected to produce. If the present value of the cash inflows is greater than the present value of the cash outflows, the investment will be profitable. That is, the cash returns which the investment is expected to produce should justify the cash investment required. If the present value of the cash inflows is less than the present value of the cash outflows, the investment is not justified.

89.

	Years 1-15	End of Year 15
Rent	\$131,474	
Loan Repayment	\$131,474	
Residual	—	\$625,000
Total	-0-	\$625,000
Present Value	-0-	\$149,620

In sale-leaseback net present value analysis, the timing and magnitude of the cash flows are easily determined. Rent and loan payments are determined by contract, and tax deductions are established by law. All that needs to be estimated is the value of the buyer-lessor's reversionary interest. In the example now under consideration, the reversion is worth \$625,000. The discount rate used should simply reflect the buyer-lessor's cost of money. There are many theories and factors which one must consider to determine what the appropriate discount rate should be. See, e.g., J. VAN HORNE, *supra* note 3, at 90-205. For the purpose of this Note, however, setting the discount rate equal to the buyer-lessor's after-tax cost of capital is a good approximation. If the buyer-lessor borrowed all the funds which she has invested in the sale-leaseback (*i.e.*, \$250,000), the investment would have to earn a return just equal to the interest rate on the loan for the buyer-lessor to break even.

For analyzing pre-tax cash flows, the pre-tax cost of capital should be used; for after-tax cash flows, the after-tax cost of capital is appropriate. *Cf.* J. VAN HORNE, *supra* note 3, at 219-20. The author illustrates the calculation of the discount rate used to evaluate the after-tax cash flows generated by a bond. These cash flows are closely analogous to the cash flows generated by a lease. The interest payments over the term of the bond are analogous to the rental payments over the term of the lease; the payment of principal at the end of the bond's life is analogous to the receipt of the reversionary estate at the end of the lease. Given the similar nature of bond and lease cash flows, the adjustment to the discount rate for taxes should also be similar. If the variables are defined as

t = tax rate,

r = after-tax discount rate, and

k = before-tax discount rate,

then

$$k = \frac{r}{(1-t)}$$

is a close approximation of the before-tax discount rate. *Id.*

value of her investment.⁹⁰ When that figure is discounted to reflect its present value,⁹¹ the transaction is not justified based only on its pre-tax cash flows.⁹²

The importance of residual value to the pre-tax profitability of the modern leveraged sale-leaseback should be apparent; where rental payments are offset by loan amortization payments, the only source of pre-tax return available to the potential buyer-lessor is the residual. For this particular transaction to be justified, the residual would have to have been worth \$1,044,312.⁹³ To expect a depreciable asset to hold nearly all of its value for fifteen years, not considering the effects of inflation,⁹⁴ is an unreasonable expectation in

90. Residual value refers to the value of the lessor's reversionary interest. It is a generic term used in financial analysis to refer to the value of a lump sum, usually the value of an asset, to be received at the end of a period of cash flows.

$$91. PV(\$625,000) = \$625,000 \frac{1}{(1 + .10)^{15}} = \$149,620.$$

See *supra* note 87 for the formula. The residual value was discounted at its after-tax discount rate, 10%, even though the analysis is of pre-tax cash flows. It makes little sense to discount the value of an asset on a pre-tax basis. Conceptually, the value of an asset simply represents the market's valuation of the after-tax cash flows which that asset is likely to produce. See generally B. BOYCE & W. KINNARD, APPRAISING REAL PROPERTY 435-58 (1984). It would be inconsistent to discount an after-tax residual value at the pre-tax discount rate.

It is not inappropriate to note, however, that by using the lower, after-tax rate to discount the value of the residual, the analysis creates a bias in favor of accepting the proposed transaction. For a given residual value, the lower the discount rate, the higher the present value. See *supra* note 87. Thus, a pre-tax cash flow analysis using an after-tax discount rate is more likely to show a pre-tax profit than one which uses the higher pre-tax discount rate. Even using the lower after-tax discount rate, only a sale-leaseback with an exceptionally high residual value will yield a positive net present value. See *infra* note 93 and accompanying text; see also *infra* notes 175-76 and accompanying text.

92. The project is not justified on a pre-tax basis because the initial cash investment, \$250,000, is greater than the present value of the pre-tax cash flows which that investment is expected to produce, \$149,620. See *supra* notes 87-91.

93. This figure represents the value which the residual would have to have so that its present value would equal the \$250,000 initial investment. If the residual were worth this much, or more, the cash flows would have a positive net present value and the transaction would have been justified. Algebraically, the value would be expressed as follows:

$$\$250,000 = X \frac{1}{(1 + .10)^{15}}$$

$$X = \$1,044,312$$

See *supra* note 87 for the formula. If the pre-tax discount rate had been used, the residual value required to justify the transaction would be much higher. Assuming the taxpayer is in the 40% tax bracket, the pre-tax discount rate is:

$$\frac{.10}{(1 - .40)} = .167$$

See *supra* note 89 for the formula. Using this discount rate the residual value required to justify the transaction would have been:

$$\$250,000 = X \frac{1}{(1 + .167)^{15}}$$

$$X = \$2,524,305$$

Thus, using the pre-tax discount rate yields even a higher required residual value than an analysis using the after-tax discount rate.

94. Present value analysis is designed to facilitate the comparability of sums of money received at different times in the future. Inflation affects the value of money received in the

most instances. Yet, if the buyer-lessor were to limit her analysis to pre-tax returns, that is precisely what would have to occur before the transaction could be considered profitable.

An after-tax analysis of the proposed investments should make clear how vital tax considerations are in investment analysis. The analysis assumes that the buyer-lessor elected to use the Accelerated Cost Recovery System (ACRS)⁹⁵ of depreciation for five-year property.⁹⁶ In this example the imposition of income taxes converts what was an unprofitable investment into a profitable one. This change results primarily from the availability of the depreciation tax deduction, although one should not ignore the importance of the interest

future, so present value analysis must account for its effects. This can be accomplished in one of two ways. Cash flows can be expressed in constant, uninflated dollars, in which case no adjustment need be made to the discount rate. This Note has adopted that approach, so that all future amounts are expressed in constant dollars. For the transaction under consideration, the residual value required to justify the transaction on a pre-tax basis, \$1,044,312, see *supra* note 93 and accompanying text, is expressed in constant dollars, unaffected by inflation.

An alternative method to account for the effects of inflation is to express future cash flows in inflated future dollars. If this were done, the discount rate would have to be adjusted so that when the future, inflated amounts were discounted back to the present, the resulting figure would be expressed in constant dollars. For a good discussion of the effects of inflation on present value analysis, and the adjustments to the discount rate made necessary by inflation, see generally J. VAN HORNE, *supra* note 3, at 504-11.

95. See generally I.R.C. § 168 (West 1985).

96.

Year	Loan Interest and Amortization Schedule			ACRS Depreciation In 5 Year Property See I.R.C. § 168(b)(1).
	Total Payment	Principal	Interest	Depreciation
1	131,474	31,474	100,000	187,500
2	131,474	34,621	96,853	275,000
3	131,474	38,083	93,391	262,500
4	131,474	41,891	89,582	262,500
5	131,474	46,080	85,393	262,500
6	131,474	50,688	80,785	
7	131,474	55,758	75,716	
8	131,474	61,334	70,140	
9	131,474	67,467	64,006	
10	131,474	74,214	57,260	
11	131,474	81,653	49,839	
12	131,474	89,798	41,676	
13	131,474	98,778	33,696	
14	131,474	108,656	22,818	
15	131,474	119,522	11,952	

deduction.⁹⁷ During the first five years of the lease term the transaction would produce tax losses, which represent cash inflows in the sense that they reduce the buyer-lessor's tax liability on income from other sources. During the remaining term of the lease, the transaction would produce taxable income, increasing the buyer-lessor's overall tax liability. These tax-related cash flows discounted to a common present value basis yield a net cash inflow to the investor of \$202,963.⁹⁸ When this amount is added to the present value of the residual, the transaction clearly is profitable on an after-tax cash flow basis.⁹⁹

The foregoing hypothetical, designed to typify a modern levered sale-leaseback, would not have occurred if the buyer-lessor were unable to take the depreciation deduction. Without the deduction, no buyer-lessor would have found the transaction profitable, and the seller-lessee would have been unable to find a cooperative investor willing to finance his investment project using a sale-leaseback. The seller-lessee would have had to resort to other, less desirable financing alternatives or forego the investment project entirely. Anything which might cast a shadow of doubt over the availability of the

97.

After Tax Cash Flow Analysis

Col. No.	(1) Rent	(2) Principle and Interest (See note 96)	(3) Interest (See note 96)	(4) Depreciation (See note 96)	(5) Taxable Income (1)-(3) + (4)	(6) Tax Effect (5) × .40	(7) After Tax Cash Flow (1) - (2) - (6)	(8) Present Value of After Tax Cash Flow
1	131,474	131,474	100,000	187,500	156,026	-62,410	62,410	56,491
2	131,474	131,474	96,853	275,500	240,364	-96,145	96,145	79,459
3	131,474	131,474	93,391	262,500	224,417	-89,766	89,766	67,442
4	131,474	131,474	89,582	262,500	220,608	-88,243	88,243	60,271
5	131,474	131,474	85,393	262,500	216,419	-86,567	86,567	53,751
6	131,474	131,474	80,785		50,689	20,275	-20,275	-11,445
7	131,474	131,474	75,716		55,758	22,303	-22,303	-11,445
8	131,474	131,474	70,140		61,334	24,533	-24,533	-11,445
9	131,474	131,474	64,006		67,468	26,987	-26,987	-11,445
10	131,474	131,474	57,260		74,214	29,685	-29,685	-11,445
11	131,474	131,474	49,839		81,635	32,654	-32,654	-11,445
12	131,474	131,474	41,676		89,798	35,919	-35,919	-11,445
13	131,474	131,474	32,696		98,778	39,511	-39,511	-11,445
14	131,474	131,474	22,818		108,656	43,463	-43,642	-11,445
15	131,474	131,474	11,952		119,522	47,808	-47,808	-11,445

Total Present Value of After Tax Cash Flows 202,963

Present Value of Residual (See *supra* note 87) 149,620

Present Value of Investment 352,583

98. See *supra* note 97.

99. The transaction is clearly justified because the present value of the cash inflows produced, \$291,174, is greater than the present value of the cash outflows required, \$250,000.

depreciation deduction would inhibit potential investors for fear that the transaction, once entered into, would be denied its major source of profitability.

Unfortunately, the similarity of the sale-leaseback to secured financing creates just that shadow of doubt. One issue which often arises in sale-leaseback litigation is how closely the transaction resembles a secured financing agreement.¹⁰⁰ If the court concludes that the transaction looks more like a secured financing arrangement than a valid sale-leaseback, the court will recharacterize it, treating the buyer-lessor as a secured creditor and the seller-lessee as an ordinary debtor. The tax consequences are devastating; the buyer-lessor loses the depreciation deduction, and recognizes as income only that part of each rental payment which represents interest. The seller-lessee loses the full rental deduction, but may continue to deduct the interest portion of each rental payment. The lost rental deduction would be offset by the regained depreciation deduction.¹⁰¹

Tax planners and business persons should be aware of the threat of judicial recharacterization whenever they consider a sale-leaseback.¹⁰² The courts have never clearly defined the characteristics or features of a sale-leaseback that would trigger recharacterization.¹⁰³ Tax planners have no clear standards against which to judge sale-leasebacks in order to accurately assess the risk of recharacterization. As long as this uncertainty exists, the sale-leaseback will be a suspect transaction in the eyes of the business community.

In 1978, the United States Supreme Court in *Frank Lyon Co. v. United States*,¹⁰⁴ analyzed a sale-leaseback transaction for only the second time in its history.¹⁰⁵ In that case, the Court established a set of very general criteria¹⁰⁶

100. See, e.g., *Rice's Toyota World, Inc. v. Commissioner*, 81 T.C. 184 (1983), *aff'd in part, rev'd in part*, 752 F.2d 89 (4th Cir. 1985) (discussed *infra* at notes 189-209 and accompanying text); *Narver v. Commissioner*, 75 T.C. 53 (1980), *aff'd*, 670 F.2d 855 (9th Cir. 1982) (discussed *infra* at notes 181-88 and accompanying text); *Dunlap v. Commissioner*, 74 T.C. 1377 (1980), *rev'd*, 670 F.2d 785 (9th Cir. 1982); *Hilton v. Commissioner*, 74 T.C. 305 (1980), *aff'd*, 671 F.2d 316 (9th Cir. 1982) (discussed *infra* at notes 142-80 and accompanying text); *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978), *rev'g* 536 F.2d 746 (8th Cir. 1976) (discussed *infra* at notes 117-41 and accompanying text); *Sun Oil Co. v. Commissioner*, 562 F.2d 258 (3d Cir. 1976), *cert. denied*, 436 U.S. 944 (1978); *American Realty Trust v. United States*, 491 F.2d 1194 (4th Cir. 1974), *aff'g* 33 A.F.T.R. 2d (P-H) ¶ 74-393 (E.D. Va. 1973); *Helvering v. Lazarus*, 308 U.S. 252 (1939).

101. See generally *Shurtz*, *supra* note 40, at 392; Note, *supra* note 21, at 1083.

102. See *Hobbet, Estimating the Risk of Failure When a Tax Shelter Investment is Being Evaluated*, 74 J. TAX. 74 (Aug. 1984). The author suggests a framework for evaluating the risk of recharacterization of various tax shelter investments using as an example *Rice's Toyota World, Inc. v. Commissioner*, 81 T.C. 184 (1983), *aff'd in part, rev'd in part*, 752 F.2d 89 (1985). For a discussion of *Rice*, see *infra* notes 189-209 and accompanying text.

103. See, e.g., Note, *supra* note 21, at 1083-96.

104. 435 U.S. 561 (1978), *rev'g* 536 F.2d 746 (8th Cir. 1976).

105. The Court first considered a sale-leaseback in *Helvering v. Lazarus*, 308 U.S. 252 (1939).

106. 435 U.S. at 583-84.

to which the lower courts have looked in subsequent sale-leaseback decisions. The judiciary's efforts to give meaning to the broad standards established in *Frank Lyon* have led it down the road toward a judicial standard, which, if faithfully applied, would result in the recharacterization of most, if not all, sale-leasebacks.¹⁰⁷ What the Court apparently may now require to uphold a sale-leaseback transaction is a pre-tax profit on the buyer-lessor's investment.

II. JUDICIAL TREATMENT OF SALE-LEASEBACKS

The judicial treatment of sale-leasebacks can best be characterized as a search for economic substance. The Supreme Court first analyzed a sale-leaseback in 1939 in *Helvering v. Lazarus*.¹⁰⁸ Lazarus transferred property to a bank as trustee, and leased the property back for ninety-nine years with an option to renew or repurchase.¹⁰⁹ Although *Lazarus* differs from the typical sale-leaseback case in that the seller-lessee claimed the depreciation deduction and sought to have the transaction recharacterized as a mortgage, the holding in *Lazarus* is noteworthy because it established the standard by which courts since have evaluated sale-leasebacks. The Supreme Court, dismissing the Commissioner's argument that depreciation should follow legal title,¹¹⁰ held, "[i]n the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities and formal documents are not rigidly binding."¹¹¹

The decision in *Lazarus* gave very little guidance concerning what "substance and realities" would be required to validate a sale-leaseback in the future. Perhaps the fact that the Supreme Court's decision affirmed the analysis used by the two lower courts which considered the case offers some guidance. Their analysis was based on two factors: the intent of the parties,¹¹² and the allocation of the risks and benefits of ownership which resulted from the transaction.¹¹³ After *Lazarus*, and through *Lyon*,¹¹⁴ the Commissioner and the courts have focused their analysis of sale-leasebacks on these two factors. The Commissioner generally favored the risk-benefit analysis,¹¹⁵

107. See *infra* notes 142-209 and accompanying text.

108. 308 U.S. 252 (1939).

109. *Id.* at 253.

110. *Id.*

111. *Id.* at 255.

112. *Commissioner v. F. & R. Lazarus & Co.*, 101 F.2d 728 (6th Cir. 1939), *aff'g* 32 B.T.A. 633 (1935).

113. *Id.* at 730.

114. *Id.* at 729-31.

115. The Commissioner's position is illustrated by Rev. Rul. 68-590, 1968-2 C.B. 66. There the Service considered a sale-leaseback transaction in which a corporation proposed to sell a project to a political subdivision for a price not to exceed the proceeds from the political

while the courts favored neither.¹¹⁶

After *Lazarus*, the Supreme Court did not hear a sale-leaseback case for thirty-nine years, until *Frank Lyon Co. v. United States*.¹¹⁷ The facts of *Frank Lyon* are quite complex, but the final form of the transaction is typical of the modern sale-leaseback. Worthen, an Arkansas bank, elected for compelling business reasons¹¹⁸ to use a sale-leaseback transaction to finish the construction of its new banking headquarters. After a protracted search the bank selected Lyon, an Arkansas corporation seeking to diversify its investment portfolio, to act as the buyer-lessor.¹¹⁹ Lyon used \$500,000 of his own money to purchase the building and borrowed the remaining \$7,140,000 of the purchase price from the New York Life Insurance Com-

subdivision's sale of industrial development bonds. The political subdivision would then lease the property back to the corporation under the terms of a net lease. The lease provided for a 20-year term, a repurchase option and rentals which would just cover payments on the bond. The corporation would receive any insurance or condemnation proceeds in excess of amounts outstanding on the bonds. Citing *Lazarus*, 308 U.S. 252 (1939), the Service analyzed the risk-benefit allocation provided for by the proposed transaction, and on that basis held that the corporation should be treated as owner for tax purposes:

The corporation has all the burdens and benefits of ownership. The corporation is obligated to repay the principal cost of the project plus interest in the form of basic rentals. It is also obligated to pay the normal costs of operating the project plus the financing expenses in the form of additional rent. In the event of default, casualty, or condemnation, the corporation has the same substantive rights and obligations as a mortgagor. It is clear that the parties intend legal title to the project to pass to the corporation. The existence of an option to renew does not negate this intent since rental during any renewal periods is nominal and the corporation still retains the right to acquire legal title upon payment of a nominal sum. . . . Accordingly, the corporation is considered to be the owner of the project for Federal income tax purposes.

Id. at 68.

116. The two major sale-leaseback cases decided before *Frank Lyon Co.*, *American Realty Trust v. United States*, 491 F.2d 1194 (4th Cir. 1974), *aff'g* 33 A.F.T.R. 2d (P-H) ¶ 74-393 (E.D. Va. 1973), and *Sun Oil Co. v. Commissioner*, 562 F.2d 258 (3d Cir. 1977), *cert. denied*, 436 U.S. 944 (1978), illustrate the two approaches taken by the courts.

In *American Realty Trust*, the Commissioner sought to recharacterize the sale-leaseback as a secured financing agreement, basing his arguments on the risk-benefit analysis suggested by *Lazarus*, 308 U.S. 252, and on the contention that the buyer-lessor was economically compelled to exercise a repurchase option contained in the lease. *See supra* notes 27-30 and accompanying text. The Fourth Circuit rejected these arguments and upheld the transaction as styled by the parties based upon the conclusion that they had intended a valid sale-leaseback.

In *Sun Oil Co.*, the Third Circuit recharacterized a sale-leaseback as a secured financing transaction. After listing a series of findings of fact indicating that the seller-lessee bore all the risks and burdens of ownership, the court concluded that the whole transaction was nothing more than a financing agreement disguised as a sale-leaseback. 562 F.2d at 265-68.

117. 435 U.S. 561 (1978).

118. *Id.* at 563-64.

119. *Id.* at 564-65.

pany.¹²⁰ Lyon leased the building back to Worthen under a net lease for an initial term of twenty-five years with successive options to renew, totaling forty years, at greatly reduced rentals.¹²¹ Upon the insistence of the State Banking Commission, the lease gave Worthen the option to purchase the building at the end of the eleventh, fifteenth and twentieth years of the primary lease term.¹²²

The Commissioner disallowed Lyon's claimed depreciation deduction for 1969 and assessed an income tax deficiency of \$280,387.¹²³ The government, contending that Worthen, not Lyon, was the true owner of the building for income tax purposes, attempted to recharacterize the transaction as two separate loans to Worthen:¹²⁴ one by New York Life for \$7,140,000 for which Lyon was merely a conduit, funneling payments from Worthen to the insurance company,¹²⁵ the other from Lyon for \$500,000 at 6%. The lower courts' treatment of the *Frank Lyon* case clearly illustrates the divergent approaches taken by the courts after *Lazarus*: the tax court upheld the transaction applying a strict intent-of-the-parties analysis,¹²⁶ while the Eighth Circuit Court of Appeals reversed the tax court based on a risk-benefit analysis.¹²⁷

120. *Id.* at 568. The loan from New York Life was for a term of 25 years at 6.75%, and was secured by a deed of trust to the land and buildings plus an assignment of Lyon's interest in the lease. *Id.*

121. *Id.* at 566.

122. *Id.* at 564, 567.

123. *Id.* at 568.

124. *Id.* at 569.

125. *Id.*

126. See *Frank Lyon Co. v. United States*, 75-2 U.S. Tax Cas. (CCH) ¶ 9545, at 87,592 (E.D. Ark. 1975). The tax court applied an intent-of-the-parties test. Its analysis and holding is best expressed in a Letter of Memorandum, dated May 16, 1975, reproduced in the tax court's opinion:

After having heard the evidence and the arguments and after having read the excellent briefs filed by the parties, the Court finds that it was the intention of the parties, as evidenced by their written agreements, read in the light of attending facts and circumstances existing at the time the agreement was executed, that the transaction be exactly what the language and form of the transaction indicate, that is, a sale-leaseback with option to repurchase. This was both the "subjective" intent of the parties, and it is also the "objective" intent as expressed by the clear, unambiguous language of the written instruments involved. The Court also finds and concludes that, objectively, the transaction was in substance, as well as in form, a sale-leaseback with option to repurchase. Any other view of the case would not only bring strange and untenable results, but would be both unjust and contrary to the intent and purpose of our tax laws.

127. See *Frank Lyon Co. v. United States*, 536 F.2d 746 (1978). On appeal, the Eighth Circuit specifically rejected the tax court's intent analysis, saying that the subjective intent of the parties is important only to the extent that it affects the objective allocation of ownership interests provided for in the documents. *Id.* at 751. The court interpreted the issue presented to be whether "the taxpayer has demonstrated that it possesses genuine interests in the property to establish its legal right to be considered the owner for tax purposes." *Id.* at 752. It then analogized ownership of property rights to a bundle of sticks, and concluded Lyon "totes an

The Supreme Court granted certiorari¹²⁸ to resolve the apparent conflict between the intent-of-the-parties analysis adopted by the Fourth Circuit,¹²⁹ and the risk-benefit analysis adopted by the Eighth Circuit in *Lyon*. The Supreme Court considered the transaction as a whole, not limiting its analysis solely to a consideration of the parties' intent, or to the allocation of risks and benefits between them. The final holding in *Lyon* did not add much to the sale-leaseback analysis; it only combined the two existing modes of analysis, risk-benefit and intent, under the general rubric of economic substance. *Frank Lyon* is noteworthy not so much for what it said as for how courts have treated it since.¹³⁰

After recapitulating the facts of the case,¹³¹ the Court began its analysis with the frequently repeated platitude: "[i]n applying the doctrine of substance over form the court has looked to the objective economic realities of the transaction rather than to the particular form the parties employed."¹³² Although the Court recognized that the transaction was nothing more than a financing arrangement,¹³³ it discussed several factors which indicated that the objective economic realities of the transaction were those of a valid sale-leaseback. The Court considered persuasive the fact that the transaction involved three parties instead of two, but it never clearly explained why.¹³⁴ The Court also emphasized the fact that Lyon was personally liable on the mortgage notes.¹³⁵ The effect on Lyon of these liabilities went beyond the "abstract possibility" that Worthen would for some reason be unable to pay the rent.¹³⁶ Lyon reported the obligations on its balance sheet, which affected its financial position and its future ability to borrow. Again, the Court did not give a satisfactory explanation of why this was the substance of a valid sale-leaseback.

The Court also rejected the government's argument that Lyon's \$500,000 equity investment was nothing more than a loan at 6%.¹³⁷ "There [were] simply too many contingencies including variations in the value of real estate, in the cost of money, and in the capital structure of Worthen" to make the argument plausible.¹³⁸

empty bundle." *Id.* at 751. The court listed a series of factors which indicated that Worthen toted most of the sticks, but gave no indication of the relative weight to be placed on each. *Id.* at 752-53.

128. 429 U.S. 1089 (1977).

129. See *American Realty Trust*, 498 F.2d 1194.

130. See *Kronovet*, *supra* note 2, at 771.

131. *Frank Lyon*, 435 U.S. at 561-72.

132. *Id.* at 573.

133. See *id.* at 576.

134. *Id.* at 575.

135. See *id.* at 576-78.

136. *Id.* at 577.

137. *Id.* at 579.

138. *Id.*

At the end of its opinion, the Court listed twenty-six factors indicative of the substance and economic realities of a valid sale-leaseback transaction.¹³⁹ It concluded its analysis with a holding which attempted to summarize those factors. The Court stated:

In short, we hold that where, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the government should honor the allocation of rights and duties effectuated by the parties. Expressed another way, so long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes.¹⁴⁰

Commentators were quick to attack the Supreme Court's analysis and holding in *Lyon*.¹⁴¹ The Court neither explained why the genuine multiple-party requirement was important, nor gave any indication of what economic substance would constitute a valid sale-leaseback. In this regard the twenty-six listed factors provided little guidance; some related to the allocation of risks and benefits between the parties, and others related to the economic realities which compelled the final form of the transaction. The Court never clearly distinguished between risk-benefit and economic substance, and the holding quoted above was too broad and general to be of much assistance to tax planners or to the courts.

Nevertheless, the Supreme Court had spoken, and the lower courts had to give meaning to its holding, however vague and indefinite it may have been. Post-*Lyon* attempts to give meaning to economic substance have left intact elements of the intent and risk-benefit analysis. Since *Lyon*, however, these elements have assumed a smaller role in the analysis, as courts increasingly have focused on the pre-tax profit potential of sale-leaseback transactions.

Hilton v. Commissioner,¹⁴² decided two years after *Lyon*, involved the sale and leaseback of a department store in Bakersfield, California. In 1964 Broadway-Hale Stores, Inc. (Broadway) decided to construct several department stores in California. It chose to finance the project using a sale-leaseback and formed Fourth-Cavendish Properties, Inc. (Fourth Cavendish),

139. *Id.* at 582-83.

140. *Id.* at 583-84.

141. See, e.g., Fuller, *supra* note 5, at 60; Rosenberg & Weinstein, *Sale Leasebacks: An Analysis of These Transactions After the Lyon Decision*, 45 J. TAX. 146 (1976); Soloman & Fines, *Sale Leasebacks and the Shelter Oriented Investor: An Analysis of Frank Lyon Co., and Est. of Franklin*, 56 TAXES 618 (1979); Weinstein & Silvers, *supra* note 3, at 337; Wolfman, *The Supreme Court in the Lyon's Den: A Failure of Judicial Process*, 66 CORNELL L. REV. 1075 (1980-1981); Zarrow & Gordon, *Supreme Court's Sale-Leaseback Decision Lists Multiple Criteria*, 49 J. TAX. 42 (1978); Note, *supra* note 21, at 1075.

142. 74 T.C. 305 (1980), *aff'd*, 671 F.2d 316 (9th Cir. 1982).

a single-purpose financing corporation, to act as buyer-lessor to the transaction.¹⁴³ Fourth Cavendish funded the purchase through a group of five insurance companies.¹⁴⁴ Hilton and the other petitioners obtained an interest in the properties through a series of assignments to a complex set of tiered partnerships. Their investment came to \$334,000.¹⁴⁵

Fourth Cavendish simultaneously leased the property back to Broadway under a net lease with an initial term of thirty years and renewals totaling an additional sixty-eight.¹⁴⁶ Rent during the initial term of the lease was set at an amount equal to that required to amortize 90% of Fourth Cavendish's loan over thirty years.¹⁴⁷ Rent decreased substantially for the first twenty-three-year renewal period, then dropped even further for the remaining forty-five years.¹⁴⁸ Broadway's obligation to pay rent was absolute, except in the event of total destruction or condemnation of the property.¹⁴⁹

Broadway retained the right to terminate the lease at any time, but in order to do so, it had to make an irrevocable offer to pay Fourth Cavendish an amount equal to the unamortized portion of its outstanding loan.¹⁵⁰ Insurance or condemnation proceeds would inure to Broadway's benefit, either directly, or indirectly in the form of decreased rentals.¹⁵¹ If Fourth Cavendish found a purchaser of its interest in the Bakersfield property, Broadway had the prior right to repurchase that interest for \$50,000.¹⁵² Finally, Broadway retained the unrestricted right to sublet the property.¹⁵³

The *Hilton* court began its analysis by briefly viewing the transaction from the seller-lessee's point of view.¹⁵⁴ It recited the advantages of sale-leaseback financing to a seller-lessee,¹⁵⁵ and concluded that, from the seller-lessee's point of view, the transaction was compelled by economic realities, had

143. 74 T.C. at 314, 343. Broadway elected to use the intermediary financing corporation because it found through experience that it could obtain more favorable loan terms that way. *Id.* at 311.

144. *Id.* at 315. As security for the loan, Fourth Cavendish gave trustees for the insurance company a mortgage, a deed of trust, and assigned to them its interest in the lease.

145. *See id.* at 356.

146. *See id.* at 314.

147. *Id.* at 325. Rent during the initial term of the lease was \$198,603 per year. *Id.* at 314.

148. *Id.* Annual rent during the first renewal period was \$47,062 per year, and during the second it was only \$31,375. *Id.*

149. *Id.* at 326.

150. *Id.*

151. *See id.* Insurance or condemnation proceeds were to be first applied to the restoration of the property; any excess above that amount was to be retained by the lessor. Even if some of the proceeds were turned over to the lessors, Broadway would still benefit because, in that event, rent was to be reduced proportionately. *Id.*

152. *Id.* at 366-67.

153. *Id.* at 327.

154. *Id.* at 346-48.

155. *Id.* at 347. The advantages which the court specifically mentioned were the availability of 100% financing, the avoidance of debt covenants, and the fully deductible rent. *Id.*

economic substance and was imbued with tax-independent considerations.¹⁵⁶ The court recognized that from this viewpoint, the sale-leaseback, the provisions of which were in conformity with most modern sale leasebacks,¹⁵⁷ satisfied all but the genuine multiple-party requirement of *Lyon*. To analyze that requirement, the court turned its analysis to the economic bona fides of the transaction to the buyer-lessor.¹⁵⁸

Most of the tax court's opinion focused on the economic substance of the transaction from the buyer-lessor's point of view.¹⁵⁹ To satisfy the dictates of *Frank Lyon*, the buyer-lessors would have to "show not only that their participation in the sale-leaseback was not motivated or shaped solely by tax avoidance features that have meaningless labels attached, but also that there is economic substance to the transaction independent of its apparent tax shelter potential."¹⁶⁰ To find such economic substance in the buyer-lessor's position, the court looked not to the allocation of risks and benefits to the buyer-lessor, but rather looked to see whether the foreseeable value of the property would ever make abandonment imprudent.¹⁶¹ It characterized this as an extension of the imprudent abandonment test developed in *Estate of Franklin v. Commissioner*,¹⁶² but in applying this test, the *Hilton* court, in effect, converted it to a pre-tax profit potential analysis. Although it never clearly stated so, the court apparently believed that if the return on the investment which the transaction promised were sufficient to make abandonment imprudent, the transaction would possess the requisite economic substance.

The court focused its analysis on whether the transaction's pre-tax profit potential justified the original cash investment. It began this part of its analysis by identifying four sources of return to which the buyer-lessors might reasonably have looked to justify their investment: the proceeds resulting from selling the asset, refinancing the mortgage, or condemnation, and the cash income generated by the lease and residual value of the asset.¹⁶³ The court rejected all four as offering no reasonable hope of providing a

156. *Id.* at 347-48.

157. *Id.* at 347.

158. *See id.* at 348:

But what Broadway sees is a reflection from only one polygon of the prism. In the *Frank Lyon* case, the Supreme Court appraised not only the substance of the seller-lessee's interest, but also that of the buyer-lessor We, therefore, now turn to a consideration of the substance of the buyer-lessor's interest

159. *Id.* at 348-57.

160. *Id.* at 349-50.

161. *Id.* at 350.

162. 544 F.2d 1045 (9th Cir. 1977), *aff'g* 64 T.C. 752 (1975).

163. *Hilton*, 74 T.C. at 355. At trial, both the buyer-lessors and the commissioner presented the expert testimony of real estate appraisers concerning the pre-tax cash flows which the buyer-lessors could reasonably expect to earn on their investment. *Id.* at 336-38. The court considered the commissioner's witness the more expert of the two and relied heavily on his analysis. *Id.* at 353.

return to the buyer-lessors. Their right to profit from the sale of their interest in the asset was circumvented by the lease provision giving Broadway the prior right to purchase the interest for \$50,000.¹⁶⁴ The only way that the buyer-lessors could profit from refinancing the mortgage would be if interest rates fell substantially below the 5.125% charged on the Fourth Cavendish mortgage,¹⁶⁵ an occurrence which the court considered an unlikely eventuality.¹⁶⁶ Finally, the court dismissed the notion that buyer-lessors might have looked to condemnation proceeds as a source of profit by noting that "the possibility of condemnation for a substantial amount of money, sometime in the future, of a . . . department store building is not, in and of itself, the sort of speculative chance to which even incorrigible gamblers—which we assume these petitioners are not—would likely be attracted."¹⁶⁷

The only other potential source of profit to the buyer-lessors was the income generated by the lease and the residual value of the asset. The *Hilton* court rejected this source of return as well by using an analysis based on net present value and pre-tax cash flow concepts. The Commissioner's expert conducted an in-depth study of trends in population growth and retail merchandising, and of the probable future development of the area surrounding Broadway's Bakersfield location. On the basis of these studies the expert concluded, and the court agreed, that the seller-lessee would exercise only its first option to renew at the reduced rental.¹⁶⁸ The expert also assumed that the buyer-lessors would elect to refinance the unamortized principal remaining at the end of the primary lease term, and that they could do so at 5.125%.¹⁶⁹ Using these assumptions, the court calculated that the net cash flows to the buyer-lessors during the first renewal term would be \$23,000 annually.¹⁷⁰ At the end of the renewal term, the reversionary interest would have no net value.¹⁷¹

The *Hilton* court then expressly applied a pre-tax profitability test:

It goes without saying that the opportunity to earn \$23,000 annually, commencing 30 years from the inception of the transaction, would not

164. *Id.* at 357; see also *supra* note 152 and accompanying text.

165. *Id.* at 359.

166. *Id.* The mortgage allowed for pre-payment. Thus, if interest rates fell substantially, the lessors could borrow the amount outstanding on the original mortgage and satisfy that obligation. The lessors would still be receiving rentals calculated to satisfy the original 5.125% mortgage, but their new obligation would be at a lower rate. This differential in interest rates would be the source of profit through refinancing.

167. *Id.*

168. *Id.* at 355. Further renewals would not be justified because after the expiration of the primary term of the lease plus the first renewal in the year 2020, the property would not have economic value as a retail merchandising location. *Id.* at 354-55.

169. *Id.* at 355-56.

170. *Id.* at 356. Annual financing costs during the renewal period would be approximately \$23,000 per year. Rental income would be \$47,067.50, leaving approximately \$23,000 in pre-tax cash available for the buyer-lessors.

171. *Id.* at 354-55.

in and of itself appear to justify the \$334,000 original investment by the petitioners. . . .¹⁷²

“[A]n analysis of the cash flow from the rentals to be received when adjusted to reflect the financing costs indicates that there would be no cash available for distribution to [the buyer-lessors] until the 31st year of the lease term and that where *tax considerations are not taken into account* the return at that time is too small to justify the wait.”¹⁷³

Once the court settled on a pre-tax profit requirement, its conclusion was inevitable. Virtually no long-term levered sale-leaseback will produce a pre-tax profit.¹⁷⁴ Because leverage postpones pre-tax cash flows until the end of the lease term, only an exceptionally large residual value will justify the transaction. Under the *Hilton* court’s assumptions,¹⁷⁵ the department store building costing \$3,137,000 in 1967 would not only have had to have held its value for fifty-three years, it would also have to have appreciated in value, ignoring the effects of inflation, to \$4,446,235.¹⁷⁶

The *Hilton* court’s definition of economic substance in effect discarded traditional risk-benefit analysis and robbed the intent analysis of any practical effect. Had the court applied a risk-benefit analysis it could easily have reached the same result, for clearly the seller-lessee bore all the incidents of ownership.¹⁷⁷ Yet, the court held that the existence of a nonrecourse mortgage and net lease with rentals geared, not to fair market rentals, but to the buyer-lessor’s loan amortization schedule, were “nothing more than neutral commercial realities.”¹⁷⁸ The fact that destruction and condemnation pro-

172. *Id.* at 356.

173. *Id.* at 356-57 (emphasis added) (quoting expert’s report).

174. See *supra* notes 84-92 and accompanying text.

175. The *Hilton* court assumed that Broadway would exercise only its first 23-year renewal option. Under that assumption, the petitioners would not realize any residual value for 53 years. The cash flows produced by their investments could be divided into three periods. During the first 23 years of the lease there would be no net pre-tax cash flows. During the second 23 years there would be an annual cash flow of \$23,000. Finally, at the end of 53 years, the buyer-lessors would have realized the residual values which the court assumed would be zero.

176. The calculations assume that *Hilton* was taxed at a 40% rate and that the after-tax discount rate equals Fourth Cavendish’s cost of borrowing, 5.125%. The \$23,000 per year pre-tax cash flows commencing in 23 years were first discounted at the pre-tax discount rate (5.125% / (1 - .40)) or 8.542%, see *supra* note 89 for the formula, to their present value, \$19,533.824. This figure was then subtracted from the initial cash investment of \$344,000 to yield a net present value of \$314,466. This amount represents the present value which some residual to be received in 53 years, discounted at the after-tax discount rate of 5.125%, would have to have in order for the transaction to be justified.

$$PV(X) = 314,466 = X \frac{1}{(1 + .05125)^{53}}$$

$$X = 4,446,235.$$

See *supra* note 87 for the formula. The residual value which the *Hilton* court would have required in order to uphold the transaction would have been \$4,446,235.

177. See *supra* notes 142-53 and accompanying text.

178. *Id.* at 348.

ceeds would inure to the benefit of the buyer-lessor was a possibility too remote for the court to consider.¹⁷⁹ An assertion that the seller-lessee entered into the transaction to obtain the substantial nontax- and tax-related advantages of sale-leaseback financing constituted a showing of intent sufficient to satisfy the court.¹⁸⁰ The *Hilton* court apparently equated economic substance with a pre-tax profit potential.

In *Narver v. Commissioner*,¹⁸¹ decided in the same year as *Hilton*, the tax court declined to apply the same sort of cash-flow analysis. *Narver* included a sale-leaseback typical in all respects except one; the sales price, \$1,800,000,¹⁸² exceeded the fair market value of the property sold, which the court estimated to be \$412,000.¹⁸³ Once again the issue before the court was whether the buyer-lessors had an investment in the property sufficient to support the depreciation deduction.¹⁸⁴

The court disallowed the tax consequences of the transaction as structured, but not based on a comparison of the buyer-lessor's investment in the property to the pre-tax return which that investment could be expected to produce. Instead, the decision was based on the gross disparity between the sales and fair market prices, and on the close relationships among the parties. Using the imprudent abandonment test¹⁸⁵ developed in *Estate of Franklin*¹⁸⁶ and applied in *Hilton*, the court reasoned that "[e]ven after 15 years of principal payments, the outstanding debt would still be substantially more than the building's original fair market value."¹⁸⁷ The sales price and debt principal were so greatly inflated that the buyer-lessor's chosen method of payment would not yield an equity in the property quickly enough to justify the claimed depreciation deductions.¹⁸⁸

The *Narver* decision does not mean that the court had abandoned the pre-tax profitability analysis. All that *Narver* stands for is that where the sales price is highly inflated, the court can find lack of substance using other modes of analysis. In cases where the sales price does not so clearly exceed fair market value, the court presumably would still use the pre-tax cash flow analysis.

Three years after *Narver*, the tax court again considered a sale-leaseback in *Rice's Toyota World, Inc. v. Commissioner*.¹⁸⁹ Rice, a North Carolina

179. *Id.* at 359.

180. *Id.* at 346-47.

181. 75 T.C. 53 (1980), *aff'd*, 670 F.2d 855 (9th Cir. 1982).

182. *Id.* at 66.

183. *Id.* at 92.

184. *Id.* at 98.

185. See *supra* notes 161-62 and accompanying text.

186. 544 F.2d 1045 (9th Cir. 1976), *aff'g* 64 T.C. 752 (1975).

187. 75 T.C. at 100.

188. *Id.*; see also *Hilton*, 74 T.C. at 350.

189. 81 T.C. 184 (1983), *aff'd in part, rev'd in part*, 752 F.2d 89 (4th Cir. 1985).

Toyota salesman, purchased a 70% interest¹⁹⁰ in a six-year-old IBM computer for \$1,455,227.¹⁹¹ Rice paid for the machine by giving Finalco a \$250,000 recourse note, payable over three years,¹⁹² and two nonrecourse notes totaling \$1,205,227, payable over eight years.¹⁹³ Rice leased the computer back to Finalco for eight years with rents calculated so that the pre-tax cash flows to Rice, net of its nonrecourse obligation to Finalco, were \$10,000 per year over the term of the lease.¹⁹⁴ In fact, Finalco never actually paid rent, and Rice never actually paid its nonrecourse debt obligations; the only money ever to change hands was the \$10,000 annual cash flow to Rice, representing the excess of Rice's rental income over its debt obligations.¹⁹⁵

The tax court in *Rice* employed the *Lyon* "economic substance" analysis. It interpreted *Lyon* to require that Rice, the buyer-lessor, show two things for the transaction to withstand scrutiny: he would have to show first, that he was motivated by nontax considerations, or that he possessed a business purpose,¹⁹⁶ and second, that the transaction was supported by sufficient economic substance.¹⁹⁷ The *Rice* court equated "economic substance" with pre-tax profit potential. It would "analyze the transaction as a prudent businessman would to ascertain whether it had economic substance *apart from its beneficial tax consequences*. In other words, was there a 'realistic hope of [pre-tax] profit?' "¹⁹⁸ Although the first prong of this test kept alive the pre-*Lyon* subjective intent analysis, the *Rice* court's approach robbed it of any practical significance. Even if the tax court concluded that the buyer-lessor did not possess the requisite subjective intent, that he entered into the transaction solely to secure its beneficial tax consequences without considering the nontax profit potential, it would recognize the transaction as styled by the parties if the second prong of the test were satisfied.¹⁹⁹ Thus, even after reciting a litany of evidence to support its conclusion that Rice did not possess the requisite subjective intent,²⁰⁰ the court considered the pre-tax profit potential of the transaction.

190. Rice purchased the computer and leased it back to his seller for a term of eight years. At the end of the lease term, the seller retained a 30% interest in any proceeds which Rice might generate by sale or re-lease of the machine. *Id.* at 186, 192.

191. *Id.* at 186.

192. *Id.* at 192. The note was payable in four installments, the first one due on the day the note was made in June 1976.

193. *Id.*

194. *Id.*

195. *See id.* at 192-94.

196. *Id.* at 201.

197. *Id.* at 202.

198. *Id.* at 209 (emphasis added) (quoting *Dunlap v. Commissioner*, 74 T.C. 1377 (1980), *rev'd and remanded*, 670 F.2d 785 (8th Cir. 1982)).

199. *Id.* at 203.

200. *Id.* at 185-89. Rice first considered the transaction just a few months before he signed the final papers in June of 1976. *Id.* at 185. Finalco gave him a prospectus outlining the cash

The *Rice* court's analysis of pre-tax profit potential relied heavily upon expert testimony regarding the projected residual value of the computer at the end of the eight-year lease term.²⁰¹ The court calculated that Rice's initial investment came to \$280,000, comprised of the \$250,000 principal and the \$30,000 interest on the nonrecourse note.²⁰² The two sources of return on that investment were the net cash flows over the term of the lease, \$10,000 per year, plus 70% of the computer's residual value.²⁰³ After reviewing the testimony of several experts,²⁰⁴ the court assumed a residual value of \$150,000 for the computer; Rice's 70% share of that was \$105,000. Thus, the court concluded, even after assuming a discount rate of zero,²⁰⁵ the assumption most favorable to Rice, a return of \$185,000,²⁰⁶ did not justify Rice's initial \$280,000 investment.

The *Rice* court's interpretation of *Lyon's* economic substance requirement relegated the pre-*Lyon* intent and the *Narver* imprudent-abandonment analyses to roles of secondary importance. A showing that the buyer-lessor lacked the requisite intent would not be fatal to a transaction shown by objective economic analysis to possess an opportunity for profit.²⁰⁷ In only one instance would a showing of intent be relevant to the *Rice* court: where a taxpayer mistakenly believed that a transaction devoid of economic substance possessed a potential for profit.²⁰⁸ It is difficult to see, however, how a buyer-lessor could show that she possessed a reasonable hope for profit in a transaction devoid of objective indicia of economic substance.

The *Rice* court did not completely abandon the *Narver* imprudent-abandonment approach. It used that analysis only to show that Rice did not possess the requisite subjective profit motive. The tax court's failure to use imprudent abandonment, as it had in *Narver*, to completely invalidate the transaction is especially significant considering the fact that it easily could

flows which the transaction would generate, clearly showing that, during the first five years of the transaction, substantial tax losses would result from use of accelerated depreciation and interest deductions. *See id.* at 186-87. Despite the fact that his accountant informed him that the decision whether to enter into the transaction would depend upon Rice's assessment of the computer's residual value, Rice never seriously considered what the value might be. *See id.* at 188-89. In fact, Rice had in his possession a Stanford Research Institute Report, given to him by Finalco representatives, strongly indicating that the residual value of the computer would be negligible. *Id.* at 201.

201. *Id.* at 190-92, 205.

202. *Id.* at 206.

203. *Id.*

204. *Id.* at 190-92, 205.

205. *Id.* at 205-206.

206. Rice's return is comprised of the \$80,000 in net cash flows over the eight-year term of the lease and the residual value of \$105,000 at the end of the lease.

207. 81 T.C. at 203 n.17.

208. *Id.*

have. In *Rice*, just as in *Narver*, the price paid by the buyer-lessor clearly exceeded the fair market value of what she got in return.²⁰⁹

Estate of Thomas v. Commissioner,²¹⁰ decided by the tax court in 1985, involved a transaction which, at first glance, closely resembles the *Rice* sale-leaseback. In *Estate of Thomas*, however, the court found that the transaction possessed the requisite substance. An E.F. Hutton-formed partnership purchased²¹¹ IBM computers and leased them to financially sound lessees for a term of eight years.²¹² The partnership financed its purchase with \$8,124,561 of nonrecourse debt and \$945,673 of capital invested by the limited partners.²¹³ The rent payments to the partnership net of the partnership's nonrecourse debt obligations yielded a modest cash flow to the partnership over the term of the lease.²¹⁴ At the end of the lease term, the partnership retained the right to sell or re-lease the computers at fair market values.²¹⁵ The partnership's offering prospectus identified three sources of return to potential investors: the tax benefits, the modest cash flow over the life of the lease, and the residual value at the end of the lease.²¹⁶

The Commissioner attempted to recharacterize the transaction either as a sale to the seller-lessee or as a financing arrangement.²¹⁷ His basic argument was that the partnership's ownership of the computers was a sham, devoid of any economic substance.²¹⁸ The tax court employed a traditional risk-benefit analysis to refute the Commissioner's attempt to recharacterize the transaction as a sale. The court pointed out that the partnership's interest in the residual was substantial, and that the partnership bore the risk that the residual value would be inadequate to make the transaction profitable.²¹⁹

The court's analysis of the economic substance of the sale-leaseback as a financing arrangement was consistent with the pre-tax profit potential analysis employed in *Hilton* and *Rice*. "[A] reasonable potential for [pre-tax] profit . . . clearly constitutes the requisite substance."²²⁰ The court's focus was

209. Finalco purchased the computer for \$1,297,653, and shortly thereafter sold Rice a 70% interest in it for \$1,455,277. *Id.* at 192. Rice paid \$1,455,277 for $(\$1,297,653 \times .70 =)$ \$908,357 of value, a price clearly in excess of fair market value.

210. 84 T.C. 412 (1985).

211. The partnership played an insignificant role in the purchase process. The lessees placed orders directly with IBM for the systems they desired and the partnership played no role in helping the lessees select the package which would best suit their needs. The machines were delivered directly to the lessees and the partnership received only paper title. *Id.* at 421-22.

212. *Id.* at 417.

213. *Id.* at 422.

214. *Id.* at 416, 417-18, 424.

215. *Id.* at 425. Three of the leases gave the lessees the option to purchase or re-lease the equipment at fair market value. The other leases required the lessees to deliver the computers to locations specified by the partnership.

216. *Id.* at 416.

217. *Id.* at 432.

218. *Id.*

219. *Id.* at 433-35.

220. *Id.* at 437.

on the residual value of the machines as the primary determinant of pre-tax profit potential;²²¹ unlike the *Rice* court, however, it found that the residual value could reasonably have been expected to be high enough to justify the partnership's initial investment.²²²

Estate of Thomas is significant in two respects. First, it illustrates the willingness of the court to employ the post-*Lyon* profitability analysis. The transaction in *Estate of Thomas* was not a modern sale-leaseback, but rather a leveraged leasing arrangement.²²³ Yet, the tax court subjected the transaction to the same economic substance analysis previously applied to sale-leasebacks. Second, the case illustrates the potency of the analysis. In *Estate of Thomas*, by assuming a discount rate of zero the tax court illustrated how a residual value as low as 14% would have yielded a slight profit,²²⁴ while a residual value of 20% would have yielded an even greater one.²²⁵ By making a more realistic assumption of a discount rate greater than zero,²²⁶ however, the court could easily have invalidated the transaction. An assumed discount rate of only 3% in the 14% residual value example, and 6% in the 20% residual value example, would have shown the transaction to be unprofitable on a pre-tax basis.²²⁷ In *Rice*, the tax court did not have to

221. *Id.*; see also *id.* at 426-31 for the court's discussion of residual value.

222. *Id.* at 437.

223. The partnership purchased the computers from IBM, an unrelated third party, and leased them to the lessees. In a sale-leaseback the lessor purchases the asset from the lessee and leases it back. See *supra* notes 1-7 and accompanying text.

224. See 84 T.C. at 429 n.26.

225. See *id.* at n.27.

226. Because \$1 today is worth more than \$1 in one year, the discount rate will always be greater than zero. For a discussion of this time value of money concept and its relationship to discount rate, see *supra* note 87 and accompanying text.

227.

Year	Cash Inflows		Value 20%	Present Value of Cash Inflows	
	Net Rent (See 84 T.C. at 417-18)	Residual 14%		i = 3%	i = 6%
1975	0			0	0
1976	9,000			8,483	8,010
1977	9,000			7,996	7,556
1978	9,000			7,763	
1979	9,000			7,537	
1980	9,000			7,319	
1981	9,000			5,525	
		1,260,000		994,656	
			1,800,000		
		TOTAL		1,047,542	1,175,484
		LESS: INITIAL INVESTMENT		<1,200,000>	<1,200,000>
		NET PRESENT VALUE		< 152,458>	< 24,516>

Thus under both sets of assumptions, a 3% discount rate with a 14% residual value and a 6% discount rate with a 20% residual value, a negative net present value will be yielded. A negative net present value means that, when the time value of money is considered, the transaction is unprofitable. For a discussion of present value and net present value analysis, see *supra* notes 87-88.

assume a discount rate greater than zero to invalidate the transaction; in that case a zero discount rate was all that was required to show lack of pre-tax profit potential.²²⁸ A higher discount rate would only have made the transaction appear even more unprofitable.²²⁹ In *Estate of Thomas*, the tax court again declined to make the realistic assumption, but this time with the result of finding a pre-tax profit where none existed. Perhaps something else motivated the tax court.²³⁰

III. CRITICISM AND PROPOSED ANALYSIS

The foregoing review of the tax court's post-*Lyon* decisions illustrates that, although the tax court has not yet developed a unified approach to sale-leasebacks, it has developed a potent new weapon with which to challenge and recharacterize these often useful financing transactions. The pre-tax profitability requirement would, if consistently applied, result in the recharacterization of virtually all modern sale-leasebacks. As the net present value analysis has shown, the only way that the typical modern sale-leaseback could yield a pre-tax profit would be through an unusually high residual value.²³¹ Due to the time value of money, when a long-term lease is employed, the value of the asset at the end of the lease would usually have to exceed the value of the asset at the beginning of the lease for the present value of the pre-tax inflows to exceed initial cash investment.²³² Even when a short-term lease is used, the pre-tax profitability requirement could be prohibitive.²³³

The threat of recharacterization affects investors by giving them an incentive to structure their transactions to minimize the risk that their tax expectations will be frustrated.²³⁴ In the sale-leaseback context, where profitability to the investing buyer-lessor hinges on the availability of the desired tax consequences,²³⁵ that threat is especially potent. If the sale-leaseback, as structured, does not satisfy the Commissioner and the courts, the buyer-

228. See *supra* notes 202-07 and accompanying text.

229. See *supra* note 87.

230. See *infra* notes 245-46 and accompanying text.

231. See *supra* notes 89-96 and accompanying text.

232. *Id.*; see also *supra* notes 174-76 and accompanying text. But see *supra* notes 220-29.

233. See *Rice's Toyota World, Inc. v. Commissioner*, 81 T.C. 184 (1983), *aff'd in part, rev'd in part*, 752 F.2d 89 (4th Cir. 1985). For a discussion of *Rice*, see *supra* notes 192-209 and accompanying text.

234. See generally, e.g., Cook, *supra* note 2. The author discusses sale-leasebacks from the tax planners' perspective. He discusses the implications of the judicial treatment of sale-leasebacks on planning and structuring these transactions in the future.

235. See *supra* notes 96-103 and accompanying text.

lessor stands to suffer a substantial loss.²³⁶ The added risk makes the transaction less attractive than it otherwise might be.

Recharacterization is not necessarily a bad thing. By its very nature the sale-leaseback provides the investor with a tax shelter and is, therefore, often subject to abuse. Some sale-leasebacks serve no valid economic purpose other than to shelter the investor's income. These sale-leasebacks deserve to be recharacterized. *Rice's Toyota World, Inc. v. Commissioner*²³⁷ is a good example of a sale-leaseback which served no valid economic purpose. Finalco, a leasing company, sold Rice a computer which was already subject to a lease. Nothing in the facts of the opinion indicates that Finalco satisfied any legitimate financing requirements by entering into the transaction.²³⁸ The court also failed to indicate that Finalco reinvested the proceeds of the sale into productive investment projects. Apparently, the transaction created no new productive assets.

Not all sale-leasebacks deserve to be recharacterized. The transaction may not be merely a valuable tax sheltered investment for the buyer-lessor; it may also provide a valuable financing tool for the seller-lessee.²³⁹ It allows him to release capital locked up in fixed assets²⁴⁰ and to redeploy it to potentially more productive uses. In contrast to *Rice*, *Hilton*²⁴¹ exemplifies a sale-leaseback which should not have been recharacterized. Broadway was able to finance the construction of a new shopping area in Bakersfield. It could have used other financing methods, but the sale-leaseback possessed substantial tax and nontax benefits which made it the most attractive alternative. In addition, the funds which the transaction generated for Broadway were invested into new and productive assets.²⁴²

The pre-tax profit requirement is problematic because it does not distinguish between good and bad sale-leasebacks, between those that deserve to be recharacterized and those that do not. The analysis is too one-dimensional. By requiring nontax substance on that side of the transaction where none exists, the analysis condemns virtually all sale-leasebacks without even considering the socially desirable nontax benefits which flow from the seller-lessee's side.

In response to this shortcoming, Congress or the courts should adopt a broader perspective and develop an approach which analyzes the transaction

236. *Id.*

237. 81 T.C. 184 (1983), *aff'd in part, rev'd in part*, 752 F.2d 89 (4th Cir. 1985).

238. *See id.*

239. *See supra* notes 40-48 and accompanying text; *see also supra* notes 52-59 and accompanying text.

240. *See, e.g., Carey, Tax Aspects, supra* note 3, at 601; *Cook, supra* note 2, at A-1.

241. 74 T.C. 305 (1980), *aff'd*, 671 F.2d 319 (9th Cir. 1982).

242. *See id.*

in terms of social costs and social benefits.²⁴³ This Note has already discussed the social benefits²⁴⁴ which result from the utility of the sale-leaseback as a financing device and the use to which the funds that the sale-leaseback generate may be put. Among the benefits to be evaluated in *Hilton* are the construction and retail merchandising jobs which the project created, the other projects and stores which the newly constructed facility would attract, and the influx of cash into the local community which these two factors would generate. Perhaps a recognition of the social benefits of the transaction was what motivated the tax court in *Estate of Thomas*.²⁴⁵ The court considered significant the fact that the lessees were able to obtain lower rentals from the partnership than they would have been able to obtain by renting directly from IBM or other commercial lessors.²⁴⁶ The social benefits in *Rice* would have been more difficult to uncover. The seller-lessee built no new productive assets, the transaction generated no jobs or related investment projects, and no benefits flowed into the community.

The social costs should be expressed in terms of the decrease in treasury revenue incurred as a result of the sale-leaseback. This figure represents a societal investment in the transaction; the social costs are the amount of government services, expressed in dollar figures, which society sacrifices in order to achieve the social benefits which the transaction creates. If the social benefits outweigh the social costs, the transaction should not be recharacterized. Conversely, if the social costs outweigh the social benefits, the transaction should be recharacterized.

The social costs are simply the tax consequences of the sale-leaseback²⁴⁷ to the parties viewed from the Treasury's perspective. The net tax savings realized by the buyer-lessor and the seller-lessee are revenue losses to the Treasury. These losses result from two factors: new deductions which the transaction creates, and the tax rate differential between the seller-lessee and the buyer-lessor. Congress, the Commissioner or the courts should consider numerous factors in order to develop a sound and comprehensive social cost analysis.²⁴⁸

243. A detailed discussion of all the factors which the proposed analysis should consider is beyond the scope of this Note. The discussion which follows only highlights some of the more important factors which the proposed analysis should consider. See *supra* notes 244-53 and accompanying text. Because the analysis would require a careful weighing of countervailing social cost and benefit factors, formulation of a detailed test is best left in the hands of the legislature.

244. See *supra* notes 52-59 and accompanying text.

245. 84 T.C. 412 (1985).

246. *Id.* at 437.

247. See *supra* notes 60-78.

248. An in-depth discussion of all the factors which the analysis should consider is beyond the scope of this Note. See *supra* notes 249-52 for a brief review of the most important aspects which the analysis should encompass.

When the Supreme Court in *Lyon*²⁴⁹ noted that sale-leaseback financing does not create any new deductions,²⁵⁰ it failed to consider a few of the not so subtle nuances of the transaction. When the seller-lessee sells a newly constructed, fully depreciable asset, the transaction does not create any new deduction. The seller-lessee transfers only the depreciation deduction that he could have taken himself and replaces it with a rental deduction. Although the buyer-lessor may take the newly created rental deduction, the resulting loss to the Treasury is offset because the buyer-lessor must also recognize that amount as income. Viewed in this light, a sale-leaseback only shifts deductions from one party to another, or creates deductions for one party which are offset by concomitant income to the other.

In many situations, however, the transaction does create deductions. When the property sold consists of a fully depreciated asset, the seller-lessee does not give up any future depreciation deductions; he has already fully depreciated the value of the asset conveyed. The buyer-lessor, on the other hand, may depreciate his cost. Under this circumstance, the transaction does create a depreciation deduction. Similarly, if part of the property sold and leased back consists of real estate, the buyer-lessor can inflate the depreciation deduction shifted to him by allocating as much of his cost as possible to the depreciable asset.

Sale-leaseback financing may also result in lost tax revenue due to the income tax rate differential between the parties. Typically, the seller-lessee will be in a lower tax bracket than the buyer-lessor.²⁵¹ In that situation, even to the extent that the transaction results only in shifting deductions, revenue losses will ensue. The seller-lessee may have been in a position to fully realize the tax benefits of the depreciation deduction, but by shifting that deduction to a higher bracket buyer-lessor, the transaction results in a net loss of revenue, a social cost.²⁵² The tax rate differential will also result in an offsetting revenue gain, a social benefit which the analysis should not fail to consider. A rental deduction to the seller-lessee is rental income to the buyer-lessor. If the buyer-lessor were in a higher tax bracket than the seller-lessee, the net result of these offsetting items of income and expense would be additional revenue to the Treasury, a social benefit.

249. 435 U.S. 561 (1978), *rev'g* 536 F.2d 746 (8th Cir. 1976).

250. *See id.* at 580; *see also* Kronovet, *supra* note 2, at 257.

251. *See* J. VAN HORNE, *supra* note 3, at 497-98.

252. For example, suppose the seller-lessee is in a 40% tax bracket and the buyer-lessor is in a 60% tax bracket. Also assume that a \$100 depreciation deduction is at issue. If the seller-lessee keeps the deduction, the Treasury will lose ($\$100 \times .40 =$) \$40. If the deduction is shifted to the buyer-lessor by a valid sale-leaseback, the Treasury will lose ($\$100 \times .60 =$) \$60. The net revenue lost by allowing the sale-leaseback would be ($\$60 - \$40 =$) \$20.

CONCLUSION

The primary advantage of this proposed social cost-benefit analysis is that it distinguishes between those sale-leasebacks which are socially desirable and those which are not. Unlike the emerging pre-tax profitability requirement, the proposed analysis would not dismiss out-of-hand all but the most exceptional sale-leasebacks. It would not require an exceptionally high residual value before permitting the potential economically and socially desirable consequences of the transaction to inure to the community's benefit. The social cost-benefit analysis balances the competing interests of the Treasury and the business community, and resolves the conflict in favor of the side whose claim benefits society the most. So long as the transaction is supported by a project whose social benefits outweigh the revenue loss, the transaction would stand as structured. A social cost-benefit analysis would encourage tax planners and business persons to be sure that behind their transaction lies a socially desirable investment project, one which creates jobs, income, or otherwise benefits the community.

Finally, the analysis would allow the courts to explicitly analyze the policy considerations which underlie what is ultimately at issue in sale-leaseback recharacterization cases—who gets the depreciation deduction. One of the primary justifications for the deductibility of depreciation is that it encourages investment in productive assets.²⁵³ The intent, risk-benefit, and pre-tax profitability modes of analysis currently employed by the courts are lacking because they do not explicitly consider the policy justification for what is at stake. The proposed social cost-benefit analysis would, if adopted, give the courts a valuable tool with which to give effect to a clearly expressed legislative policy.

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253. *See generally*, CHRISTENSEN, FEDERAL INCOME TAXATION 129-41 (3d ed. 1982).