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Creative Financing

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CREATIVE FINANCING

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I. INSTALLMENT SALES

A. Applicability -- The installment method applies broadly to dispositions of property which yield a gain, and which call for at least one payment after the close of the taxable year of disposition. Secs. 453(a) and (b)(1), I.R.C., and Temp. Regs. §§15A.453-1(a),-(b)(1). It does not apply to receipts of compensation, rents or lease payments. However, where a lease is treated as a sale for Federal income tax purposes, the installment method may be used.

B. Exceptions -- Not all deferred payment dispositions qualify for the installment method.

1. Excepted Dispositions of Real Property -- Dispositions of real property are covered unless they are dealer dispositions (dispositions of real property held for sale to customers in the ordinary course of the taxpayer's trade or business). Secs. 453(b)(2)(A), (l)(1)(B), I.R.C.

2. Excepted Dispositions of Personal Property -- Taxpayers engaging in (i) dealer dispositions or (ii) dispositions of inventories of personal property may not use the installment method. Sec. 453(b)(2), I.R.C. In addition, dispositions of publicly traded property, such as stock or securities, are excepted. Sec. 453(k)(2), I.R.C.

a. A dealer disposition is any disposition by a person who regularly sells or otherwise disposes of personal property of the same type on the installment plan. Sec. 453(l)(1)(A), I.R.C.

b. The inventory exception essentially excepts dispositions of personal property that may be held by a taxpayer whose sales activity may not rise to that of a dealer, but which is more than just casual.

C. Consequences of Not Using Installment Method -- If a seller either does not qualify for the installment method or elects not to use it, that seller's nominal method of tax accounting-- the cash or an accrual method -- applies.

1. Cash Method Taxpayer -- Under the cash method of accounting, gross income, and consequently gain, is taxable when it is actually or constructively received. Reg. §1.451-1(a). Accordingly, cash basis sellers must generally recognize gain in full when they receive installment obligations, as long as those obligations have ascertainable fair market values. Property will be considered to have no fair market value only in "rare and extraordinary" cases. Neither the fact that the amount depends on material contingencies, nor that transferability is restricted, will render the obligation valueless. Temp. Reg.

§15A.453-1(d)(2)(iii). In no event will the fair market value of an obligation be considered less than the fair market value of the property sold (less any other consideration received by the seller on the sale). Temp. Reg. §15A.453-1(d)(2)(iii).

2. Accrual Method Taxpayer -- Under the accrual method, sellers must recognize gain when all the events have occurred which fix the right to receive income, and the amount thereof can be determined with reasonable accuracy. Reg. §1.451-1(a). Receiving an installment obligation at closing satisfies the receipt test and usually marks the point in time when the all-events test is met.

a. When the installment obligation is for a fixed amount, the amount realized by an accrual basis seller is the total amount payable on the obligation, not its fair market value. Temp. Reg. §15A.453-1(d)(2)(ii)(A).

b. Accrual basis sellers must recognize the fair market value of the obligation as the amount realized when the installment obligation is for a contingent amount. Temp. Reg. §15A.453-1(d)(2)(ii).

D. Election Out of the Installment Method -- The installment method applies unless a taxpayer elects not to use it. Sec. 453(d)(1), I.R.C.

1. Timing -- The election must be made no later than the due date of the return for the tax year in which the sale occurs, including extensions. Sec. 453(d)(2), I.R.C. and Temp. Reg. §15A.453-1(d)(3)(i). Exceptions are made only in rare circumstances where the taxpayer proves good cause for failing to make the election timely. Temp. Reg. §15A.453-1(d)(3)(ii).

2. Form of Election -- An election out of the installment method must generally be made on Schedule D (Capital Gains and Losses) of the relevant income tax return form, or on Form 4797 (Sale of Business Property), depending on the nature of the property sold or exchanged. Temp. Reg. §15A.453-1(d)(3)(i). But see Priv. Ltr. Rul. Mem. 9214005 (Dec. 9, 1991). Taxpayers can also elect out by simply reporting as the amount realized the selling price (including the full face amount of any installment obligation received) on the tax return filed for the tax year in which the sale occurs. S. Rep. No. 1000, 96th Cong., 2d Sess. 12 (1980).

3. Revoking the Election -- A valid election may be revoked only with the Service's consent. Revocation will not be permitted when one of its purposes is the avoidance of Federal income taxes, or when the tax year in which any payment was received has closed. Temp. Reg. §15A.453-1(d)(4).

a. It is clear that revocation will only be permitted in exceptional circumstances. Temp. Reg. §15A.453-1(d)(4).

b. It is unclear, however, under what circumstances revocation will be permitted, short of the tax-avoidance threshold. See Priv. Ltr. Rul. 9218012 (Feb. 3, 1992); Priv. Ltr. Rul. 9149044 (March 7, 1991); and Rev. Rul. 90-46, 1990-1 C.B. 107.

4. Strategy Regarding Electing Out -- The consequences of electing out can be identified on two levels, direct and indirect.

a. The direct consequences of electing out of the installment method, whether by an accrual or cash basis taxpayer, are foregoing deferral of gain recognition and accelerating tax.

b. At the same time, indirect effects may overcome the direct disadvantages of electing out. Identifying and assessing these indirect consequences is the most challenging aspect of the analysis.

(1) For example, it may be desirable to elect out in order to utilize passive losses. Sec. 469, I.R.C.

(2) Moreover, decreasing examination exposure by electing out, reporting the sale in one year, and thereby limiting the statute of limitations period may be sufficient justification.

E. Computing Taxable Gain -- Under the installment method, the seller recognizes gain over the term of the installment obligation as the payments are received. Temp. Reg. §15A.453-1(b)(2).

1. Each year the seller must report a portion of total payments received as taxable income. The taxable portion is the ratio that the seller's gross profit bears to the contract price, or the so-called "gross profit ratio".

a. Gross profit ratio is calculated:

$$\text{Gross Profit Ratio} = \frac{\text{Gross Profit}}{\text{Contract Price}}$$

b. "Gross profit" is the excess of the selling price over the seller's adjusted basis in the property sold. Temp. Reg. §15A.453-1(b)(2)(v).

(1) Any brokers' commissions and other selling expenses paid by the seller are added to basis in order to arrive at gross profit. Temp. Reg. §15A.453-1(b)(2)(v).

(2) "Selling price" is the gross sales price without any reduction to reflect existing mortgages or other encumbrances on the property that the purchaser assumes or to which the purchaser takes subject. Reg. §1.453-4(c) and Temp. Reg. §15A.453-1(b)(2)(ii).

(3) Neither interest, stated or unstated, nor original issue discount should be included in the selling price. Temp. Reg. §15A.453-1(b)(2)(ii).

(4) "Adjusted basis" is the cost or other basis of property, adjusted for a variety of items enumerated in Sec. 1016, I.R.C. Sec. 1011(a), I.R.C.

c. The "contract price" is the selling price minus any indebtedness the purchaser assumes, or to which the purchaser takes the property subject. Intuitively, it is the amount that the buyer is obligated to pay directly to the seller. Temp. Reg. §15A.453-1(b)(2)(iii).

d. Qualifications --

(1) Assumption of nonqualifying indebtedness constitutes payment.

(a) Qualifying indebtedness is (1) a mortgage or other indebtedness encumbering the property and (2) indebtedness not secured by the property, but incurred or assumed by the purchaser incident to the purchaser's acquisition, holding or operation of the property in the ordinary course of business or investment. Temp. Reg. §15A.453-1(b)(2)(iv).

(b) Qualifying indebtedness does not include an obligation of the seller incurred incident to the sale, such as legal fees, or an obligation of the seller "functionally unrelated to the acquisition, holding, or operating of the property", such as the seller's medical bills. Temp. Reg. §15A.453-1(b)(2)(iv).

(2) Qualifying indebtedness may not be subtracted from the selling price to arrive at the contract price to the extent that the indebtedness assumed exceeds the seller's basis in the property sold. Temp. Reg. §15A.453-1(b)(2)(iii).

F. Depreciation Recapture -- All depreciation recapture under Secs. 1245 or 1250, I.R.C. must be recognized in the year of sale, even if no payments are received in that year. Sec. 453(i)(1)(A), I.R.C. When a taxpayer using the installment

method recognizes depreciation recapture, the taxpayer's adjusted basis is increased by the amount of the recapture income to determine the portions of each payment that comprise gain and basis recovery.

G. Definition of Payment -- The Code takes an expansive view of "payment" and only makes the most obvious exception--the receipt of indebtedness of the person acquiring the property. Sec. 453(f)(3), I.R.C., and Temp. Reg. §15A.453-1(b)(3)(i).

1. Cash and Other Property --

a. Obviously, a receipt of cash will constitute payment.

b. Payment may also be received in other property, including foreign currency and marketable securities. Temp. Reg. §15A.453-1(b)(3)(i).

c. Receiving evidence of indebtedness of a person other than the person acquiring the property constitutes payment. See First Nat. Bank v. Comm'r, 921 F.2d 1081 (CA10 1990); Holmes v. Comm'r, 55 T.C. 53 (1970); Maddox v. Comm'r, 69 T.C. 854 (1978).

2. Purchaser Indebtedness Secured by Debt That Is Readily Tradable -- Receipt of a purchaser's bond, note or other evidence of indebtedness that is payable on demand or that is readily tradeable is payment. Sec. 453(f)(4), I.R.C., and Temp Reg. §15A.453-1(e)(1)(i).

a. An obligation is treated as "payable upon demand" if it is treated as such under applicable state or local law. Temp. Reg. §15A.453-1(e)(3).

b. "Readily tradeable" instruments are obligations issued by corporations or governmental agencies with interest coupons attached or in registered form, or in any other form designed to render such bond or other evidence of indebtedness readily tradeable in an established securities market. Temp Reg. §15A.453-1(e)(1)(i), (4).

3. Cash Escrow Deposits -- Escrow deposits may constitute payment if there are no substantial restrictions on the seller's ability to receive deposited funds or if the seller can look directly to the escrow deposit for full payment in case the purchaser defaults. This is true even though the escrow funds are not immediately subject to seller's demand. See Rev. Rul. 73-451, 1973-2 C.B. 158, and Rev. Rul. 77-294, 1977-2 C.B. 173, amplified by Rev. Rul. 79-91, 1979-1 C.B. 179.

4. Assumption or Cancellation of Seller's Nonmortgage Obligations -- A purchaser's assumption and payment of any obligations owed by a seller--such as brokerage commissions, interest expense or real estate taxes accrued prior to closing--are considered payments for installment method purposes. See Rev. Rul 76-109, 1976-1 C.B. 125; Bostedt v. Comm'r, 70 T.C. 487 (1978); and Ehlert v. Comm'r, TC Memo 1985-479.

5. Assumption of Mortgage for More Than Seller's Basis -- Payment is inferred, to the extent the unpaid principal balance of the obligation exceeds the seller's adjusted basis in the property. Temp. Reg. §15A.453-1(b)(3)(i).

6. Pledges of Installment Obligations -- If any indebtedness is secured by an installment obligation (which installment obligation arose out of a sale where the price exceeded $150,000 and the property sold was not used for or produced by farming or personal use property), the net proceeds of the indebtedness constitute payment as of the later of (1) the time the indebtedness is secured by the obligation or (2) the time the taxpayer receives proceeds of the indebtedness. Sec. 453A(d)(1), I.R.C.

a. The amount treated as payment once pledging or receipt of the borrowings occurs, cannot exceed the contract price, reduced by any portion of the contract price received before the time the proceeds are treated as payment. Sec. 453A(d)(2), I.R.C.

b. Once payment is deemed made under Sec. 453A, actual payments later received for that obligation are not taken into account until the total of the subsequent payments exceeds the amount already deemed paid. Sec. 453A(d)(3), I.R.C.

H. Items Not Considered Payments --

1. Guarantees -- No guarantee, not even that of a government agency, will render a purchaser's evidence of indebtedness "payment". Standby letters of credit are treated as third-party guarantees. Temp. Reg. §15A.453-1(b)(3)(i).

2. Assumptions of Ordinary-Course-of-Business Debt -- Where a buyer purchases a business in an installment sale, including ordinary liabilities of a going business, and the buyer pays such liabilities, such payment is not considered payment to the seller under the installment method. Irwin v. Comm'r, 390 F.2d 91 (CA5 1968). However, if the total of all the liabilities assumed exceeds the basis of the property, such excess is included as payment in the year of sale. See Rev. Rul. 73-555, 1973-2 C.B. 159.

3. Interest -- Interest payments, including original issue discount, are not payments that will trigger gain recognition under the installment method.

4. Wrap-Around Mortgages -- Wrapped debt does not constitute payment. A wrap-around mortgage is an agreement in which the buyer neither assumes nor takes subject to part or all of the mortgage or other indebtedness encumbering the property purchased, but, instead, the buyer issues an installment obligation to the seller which incorporates the principal amount of the wrapped indebtedness and the seller, in turn, agrees to apply a part of the payments received to service the wrapped indebtedness. See Stonecrest Corp. v. Comm'r, 24 T.C. 659 (1955), and Professional Equities, Inc. v. Comm'r, 89 T.C. 165 (1987), acq. 1988-2 C.B. 1, invalidating Temp. Reg. § 15A.453-1(b)(3)(ii).

I. Installment Method for Contingent Payment Sales -- Virtually all forms of contingent payment sales are categorized into three groups: (i) where a maximum selling price can be determined; (ii) where there is a fixed payment term and no maximum selling price can be determined, or (iii) where no maximum selling price can be determined and there is no fixed payment term.

1. Maximum Selling Price Determinable -- Where a "stated maximum selling price" exists for a contingent payment sale, that price will be treated as the selling price for computing gain under the installment method. Temp. Reg. §15A.453-1(c)(2)(i).

a. A stated maximum selling price is determinable if the maximum amount of the sale proceeds that a taxpayer may receive can be determined under the terms of the sale agreement as of the end of the taxable year in which the sale occurs. Temp. Reg. §15A.453-1(c)(2)(i).

b. The stated maximum selling price is determined by assuming that all contingencies in the agreement are resolved at the earliest possible date and in a manner which will maximize the selling price. Temp. Reg. §15A.453-1(c)(2)(i).

c. In the event that the maximum amount is later reduced, the gross profit ratio will be recomputed for payments received in or after the tax year in which an event requiring a reduction occurs. Temp. Reg. §15A.453-1(c)(2)(i).

2. No Maximum Selling Price, but Payment Period Is Fixed -- If there is no maximum selling price in a sale agreement, but the payment period is fixed, the taxpayer's basis is allocated ratably over the taxable years in which payments may

be received in equal annual increments. Temp. Reg. §15A.453-1(c)(3)(i).

3. Maximum Selling Price, and No Fixed Payment Period -- When neither a maximum selling price nor a fixed period is specified in a sale agreement, the Regulations question whether a sale has occurred, or whether the payments received are more accurately rent or royalty income. If, after scrutinizing the pertinent facts (including the nature of the property), the arrangement is determined to be a sale, the taxpayer's basis, including selling expenses, will be recovered ratably over 15 years commencing with the date of sale. Temp. Reg. §15A.453-1(c)(4). Any basis not recovered at the end of the 15th year will be carried forward to the next succeeding tax year, and thereafter from year-to-year, until all the basis is recovered or the future payment obligation becomes worthless.

4. Alternative Methods of Basis Recovery -- If a taxpayer demonstrates that application of the normal basis recovery rules set forth above substantially and inappropriately defer recovery of basis, the taxpayer may use an alternative method of basis recovery. To demonstrate that a deferral is inappropriate, the taxpayer must show that (1) the alternative method is reasonable, and (2) under the alternative method it is reasonable to conclude that, over time, the taxpayer is likely to recover basis at twice the rate at which basis would have been recovered under the otherwise applicable rules. Temp. Reg. §15A.453-1(c)(7).

J. Recognition Events for Installment Obligations -- Any satisfaction at other than face value, and any distribution, transmission, sale or other disposition of an installment obligation will trigger the immediate recognition of gain or loss. Sec. 453B, I.R.C.

1. Sale or Exchange -- The installment method terminates whenever an installment obligation is, in fact, sold or exchanged.

a. Satisfaction at other than face value is treated the same as a sale or exchange. A common example of this occurs when the buyer of property defaults on a deferred purchase money obligation, and the seller repossesses the property in satisfaction of that obligation. See Secs. 453B and 1038, I.R.C.

b. The amount recognized in a sale or exchange is the difference between the seller's basis in the obligation and the amount realized. Sec. 453B(a)(1), I.R.C.

(1) The seller's basis in the obligation is the unpaid balance of the obligation in excess of the amount of gain inherent in that unpaid balance. Sec. 453B(b), I.R.C.

(2) The character of gain or loss is determined by reference to the asset originally transferred. Sec. 453B(a), I.R.C.

2. Other Dispositions -- Nonsale-or-exchange dispositions include transactions such as gifts, cancellations and distributions.

a. If disposition occurs other than by sale or exchange, the amount of gain or loss recognized is the difference between the seller's basis in the obligation and the fair market value of the obligation at the time of disposition. Sec. 453B(a)(2), I.R.C.

b. A common technique for making gifts is contributing installment obligations to a trust. In this way, a donor can give a partial interest, such as a term-for-years or a remainder interest, or otherwise condition a gift, especially if the beneficiary will be a minor. Whether contribution of an installment obligation to a trust is a disposition depends on whether the grantor is deemed to retain substantial ownership under Secs. 671 through 679, I.R.C.

c. Cancellations are similar to gifts, the distinguishing characteristic being the identity of the donee as the obligor of the indebtedness. See Frane v. Comm'r, 98 T.C. 341 (1992).

d. For nonindividual, noncorporate taxpayers such as partnerships and trusts, distributions of installment obligations to owners or beneficiaries may constitute nonsale-or-exchange distributions in certain circumstances. Most corporate distributions of installment obligations constitute nonsale-or-exchange dispositions for the corporation.

K. Nonrecognition Events for Installment Obligations -- A number of events are not treated as dispositions. These include modifications of installment obligations, certain transfers to and from corporations or partnerships, and transfers incident to death or divorce.

1. Installment Obligation Modification --Modifying an installment obligation will not constitute a satisfaction or disposition unless the rights of the seller under the installment sale are substantially changed. See Rev. Rul. 82-122, 1982-1 C.B. 90.

2. Transfers to and from Corporations --

a. Transfers to corporations are excepted from gain or loss recognition under Sec. 453B, I.R.C. if the contribution is tax-free under the Code, such as Secs. 351 and

361, I.R.C. Reg. §1.453-9(c). This exception will not apply if the corporation receiving the installment obligation is the obligor. In such cases, the transfer will be deemed to be a disposition. See Rev. Rul. 73-423, 1973-1 C.B. 161.

b. Transfers from corporations are generally recognition events to shareholders except where (1) a corporate shareholder received installment obligations in a complete liquidation, (2) the shareholder received (in exchange for the shareholder's stock) an installment obligation acquired in a sale or exchange by the corporation during the 12-month period beginning on the date the plan of complete liquidation is adopted, and (3) the liquidation is completed during such 12-month period. Sec. 453(h)(1)(A), I.R.C.

(1) Notable limitations exist for this rule.

(2) The exception does not apply to sales of inventory or other property held primarily for sale to customers in the ordinary course of the corporation's trade or business, unless the sale is made in bulk. Sec. 453(h)(1)(B), I.R.C. The exception does not apply to the extent the obligation is attributable to the disposition of depreciable property, if the obligor and the shareholder are married to each other or are related persons. Sec. 453(h)(1)(B), I.R.C.

3. <u>Transfers to and from Partnerships</u> --

a. Contributions of property to a partnership in exchange for interests in the partnership do not trigger recognition of gain or loss. Sec. 721(a), I.R.C.

b. No gain or loss is generally recognized when distributions of installment obligations are made to partners. Sec. 731(a), I.R.C.

(1) When unrealized receivables or inventory are distributed to a partner, the Code construes a sale or exchange to the extent the distribution exceeds the partner's share in such property. A partner may be taxed as having sold or exchanged an installment obligation if the installment obligation constitutes "unrealized receivables". Sec. 751(b), I.R.C.

(2) When a partnership liquidates a retiring or deceased partner's interest, the partner must recognize gain or loss to the extent that the payment is deemed received in exchange for a share of the partnership's unrealized receivables. Therefore, liquidating distributions to retiring or deceased partners may also constitute sales or exchanges of installment obligations, where the obligations are unrealized receivables to the partnership. Sec. 736(a), I.R.C.

4. Transfers Incident to Death or Divorce --

a. Transmission at death is not a disposition. Therefore, no gain or loss is triggered merely on account of the decedent's death. Sec. 453B(c), I.R.C. This means the decedent's estate and heirs will not benefit from the tax-free step-up in basis to fair market value that normally accompanies death. The unreported gain is "income in respect of the decedent" and remains taxable to whomever is entitled to receive it. Sec. 691(a)(1), I.R.C.; Reg. §1.691(a)-5(a).

b. A transfer of an installment obligation to which Sec. 1041 applies, and other than a transfer in trust, is not a disposition, and the same tax treatment applies to the transferee as would have applied to the transferor. Sec. 453B(g), I.R.C.

L. Dispositions to Related Persons -- Taxpayers making installment sales to related persons may generally defer gain recognition under the installment method. However, there are certain anti-abuse provisions.

1. Sales of Depreciable Property -- When a taxpayer sells depreciable property to a related person, the taxpayer may not use the installment method to report gain. Sec. 453(g)(1)(a), I.R.C.

a. "Related person" in this case means: (1) a person and all entities which are "controlled entities" with respect to that person; (2) a taxpayer and any trust in which the taxpayer (or his spouse) is a beneficiary [unless such beneficiary's interest in the trust is a remote contingent interest (see Sec. 318(a)(3)(B)(i), I.R.C.)]; and (3) two or more partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profits interests. Sec. 453(g)(3), I.R.C.

b. This provision does not apply if the taxpayer establishes that the disposition did not have the avoidance of Federal income tax as one of its principal purposes. Sec. 453(g)(2), I.R.C.

2. Second Dispositions by Related Persons -- If the installment method is used for a sale of property to a related person, and if the related person disposes of the property before making all payments and within 2 years of its purchase, the original seller will be treated as if it received all remaining payments at the time of the second disposition. Sec. 453(e)(1), I.R.C.

a. For this purpose, the term "related person" means: (1) a person whose stock would be attributed to the

original seller under Sec. 318(a) ("Constructive Ownership of Stock, General Rule") [(other than paragraph (4) thereof, which addresses stock options)], or (2) a person who bears a relationship to the original seller described in Sec. 267(b) ("Losses, Expenses, and Interest with Respect to Transactions Between Related Taxpayers, Relationships"). Sec. 453(f)(1), I.R.C.

b. The running of the two-year period after the disposition to the related person is suspended for any period during which the related person's risk of loss with respect to the property is substantially diminished. Sec. 453(e)(2)(B).

c. Certain dispositions are excepted from this provision., as follows:

(1) Reacquisitions of stock by issuing corporations are not treated as first dispositions. Sec. 453(e)(6)(A), I.R.C.

(2) An involuntary conversion (within the meaning of Sec. 1033) and any transfer thereafter will not be treated as a second disposition if the first disposition occurred before the "threat or imminence" of the conversion. Sec. 453(e)(6)(B), I.R.C.

(3) Any transfer after the earlier of the death of the original seller or the related buyer, and any transfer thereafter, will not be treated as a second dispositions. Sec. 453(e)(6)(C), I.R.C.

M. Interest Charges on Deferred Taxes for Certain Dealers and Nondealers -- The installment sale rules require dealers in timeshares and residential lots and nondealers with installment obligations with aggregate face amounts in excess of $5 million to pay interest to the Service.

1. Dealers in Timeshares and Residential Lots -- Dealers in timeshares and residential lots are permitted to utilize the benefits of Sec. 453, I.R.C., provided they pay interest on tax attributable to payments received during each taxable year. Sec. 453(l)(2), I.R.C.

2. Nondealers with Sec. 453A Obligations with an Aggregate Face Amount Over $5 Million -- If the conditions are satisfied, the taxpayer is required to pay interest on the "applicable percentage of the deferred tax liability" for each obligation. Sec. 453A(b)(3), I.R.C.

(a) The applicable percentage is determined by dividing (1) the amount by which the aggregate face amount of the obligations outstanding as of the close of the taxable year

exceeds $5 million, by (2) the aggregate face amount of these obligations. Sec. 453A(c)(4), I.R.C.

(b) This percentage will not change as payments are made (or deemed made under the pledge rule) in subsequent taxable years. H.R. Conf. Rep. 495, 100th Cong., 1st Sess. 929 (1987).

(c) The "deferred tax liability" for the obligation is the amount of gain which has not been recognized as of the close of the taxable year multiplied by the maximum tax rate in effect under sections 1 or 11, whichever is appropriate. Sec. 453A(c)(3), I.R.C.

II. CREATIVE FINANCING

A. Introduction.

1. During the late 1980s and early 1990s, the fixed rate mortgage could not be found to any significant extent on a long-term basis.

2. Today, depending on whether one defines a 15-year fixed rate loan with a five- or ten-year call option as a long-term loan, one can once again find fixed rate long-term loans. In all events there is one certainty -- with continually-changing tax laws and continuous real estate acquisition, development, construction, sales and exchanges, there will always be a need for financing techniques which enable both the borrowers and lenders to attain sufficient rewards for the risks they take, and that need will continually challenge the tax counselor.

B. Issues Relating to Creative Financing.

1. There are many varieties of creative financing. See Feder, "Either a Partner or a Lender Be": Emerging Tax Issues in Real Estate Finance, 36 Tax Lawyer 191 (1983).

2. In each variation, from the perspective of the borrower, the following issues must be considered:

a. Will the lender be considered to be only a lender, or also an owner?

b. What is "contingent" interest? Is it interest, or is it a share of profits? If not interest, is deductibility lost? Can a share of profits be considered, in the case of a partnership, as a guaranteed payment, thereby permitting deductibility?

c. What is the impact on depreciation? In turn, this issue returns one to the question of basis for depreciation? Coming full circle, if there is no loan, but an equity infusion, there is no basis, no depreciation attributable thereto and no interest deduction. See Pollack, Sale-Leaseback Transactions Adversely Affected by a Variety of Recent Developments, 64 J. Tax. 151 (1986). In connection with the issue of whether the lender should receive the depreciation, see Tufts v. Comm'r, 461 U.S. 300 (1983), where, at footnote 5, the Court stated:

> The Commissioner might have adopted the theory, implicit in Crane's contentions, that a nonrecourse mortgage is not true debt, but, instead, is a form of joint investment by the mortgagor and the mortgagee. On this approach, nonrecourse debt would be considered a contingent liability, under which the mortgagor's payments on the debt gradually increase his interest in the property while decreasing that of the mortgagee.*** Because the taxpayer's investment in the property would not include the nonrecourse debt, the taxpayer would not be permitted to include that debt in basis.***
>
> We express no view as to whether such an approach would be consistent with the statutory structure and, if so, and Crane were not on the books, whether that approach would be preferred over Crane's analysis. We note only that the Crane Court's resolution of the basis issue presumed that where property is purchased with proceeds from a nonrecourse mortgage the purchaser becomes the sole owner of the property. 331 U.S., at 6. Under the Crane approach, the mortgagee is entitled to no portion of the basis. Id., at 10, n. 28. The nonrecourse mortgage is part of the mortgagor's investment in the property, and does not constitute a coinvestment by the mortgagee. But see Note, 82 Colum. L. Rev. [1982], at 1513 (treating nonrecourse mortgage as coinvestment by mortgagee and critically concluding that Crane departed from traditional analysis that basis is taxpayer's investment in property).

3. Among the variations are the following:

a. Loan with an interest "kicker" -- The lender charges a fixed interest rate, but there is additional interest payable if certain pre-determined standards are met. Examples are (i) increase in gross rent roll over a "floor" amount, (ii) increase in "net cash flow" of the owning entity, and (iii) increase in "net income", with certain checkpoints on the ability of the borrower to exercise its imagination in reducing net income.

b. Loan with an "equity kicker" -- This variation is really a modification of that immediately above. The annual interest kicker is generally the same. In addition, on sale or refinancing, or at a date certain if earlier, the lender receives an amount over and above the unpaid principal amount of the loan. If there is a sale or refinancing, the amount is generally a percentage of the proceeds in excess of (i) the original principal amount of the loan, (ii) the unpaid principal amount of the loan (which is even more detrimental to the borrower), or (iii) the value of the property on which the original loan was based.

c. "Appraisal kicker" loan -- This variation builds on the two preceding types. Here, the lender makes a longer term loan, but at pre-determined dates (such as each five years) appraisals are made of the property, and the borrower pays a percentage of the increase in value over the prior appraisal date (or initial loan date) to the lender.

d. Convertible loan -- The lender has the right, under this technique, to convert a loan into an equity in the project. A foreign person, wishing the security of a loan, with guaranteed (or, at the least, priority) interest and a lien on the property, may make such a loan; the ability to convert into an equity interest in the property at a later point is required so that a sharing in the growth in value can be assured, while the risk of a downside turn is, through the loan feature, averted.

e. Loan with a put and call -- Here, the lender has the right to purchase the property ("put" the loan) at a multiple of net cash flow, which is most likely to be exercised if net cash flow is low. The borrower, in turn, has the ability to cause the lender to purchase the property ("call" the loan) at such multiple of net cash flow, which is most likely to be exercised if net cash flow is high.

f. Combination loan and investment -- The lender both participates as an equity investor (usually through the joint venture route) and makes a loan to the owning entity. If possible, the two roles would ideally be taken by two different entities.

g. Variable rate mortgage -- The interest rate is more the focus here, with annual or triennial adjustments. At each adjustment date, the borrower has the right to accept the new (but only new if higher, under most loan documents) rate, or pay off the loan and seek financing elsewhere.

C. Debt or Equity.

1. The Traditional Tests.

a. In the analysis of the tax impact of the financing format, there is, in the context of the corporation/shareholder relationship, substantial authority which may be considered. While this authority might well, upon careful focus, appropriately be applicable only to the corporation/shareholder situation, it is clear that both the factors considered and the analysis utilized are broader in scope.

b. The tests of debt or equity may generally be gathered into three baskets, which are (i) the formal rights and remedies of the parties, (ii) thin capitalization and (iii) the intent of the parties. For a full discussion of the tests, see Plumb, The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and Proposal, 26 Tax L. Rev. 369 (1971). See, generally, O.H. Kruse Grain & Milling v. Comm'r, 279 F.2d 123 (CA9 1960); and Rowan v. United States, 219 F.2d 51 (CA5 1955).

c. The first test: The formal rights and remedies of the parties --

(1) While there is no absolute requirement that a promissory note or other evidence of indebtedness be issued (see Ortmayer v. Comm'r, 265 F.2d 848 (CA7 1959)), certainly the first factor to be considered is the presence of a note or other evidence of indebtedness. See, e.g., Nelson v. Comm'r, 19 T.C. 575 (1952); and Dodd v. Comm'r, 298 F.2d 570 (CA4 1962).

(2) The obligation to repay should have a fixed (or outside) maturity date. See, e.g., Utility Trailer Manufacturing Company v. United States, 212 F. Supp. 773 (S.D. Calif. 1962).

(3) Interest payments should be fixed or determinable based upon objective indices. Periodic payments which are contingent on earnings, or paid at the discretion of corporate directors, suggest that the contributions are equity rather than debt. See Fellinger v. United States, 363 F.2d 826 (CA6 1966). But see Monon R.R. v. Comm'r, 55 T.C. 345 (1970).

(4) Ordinarily, the obligation should not be subordinated in priority to those of general creditors. However, subordination will not necessarily be fatal where subordination is superimposed on the transaction by state law. See Jones v. United States, 659 F.2d 618 (CA5 1981).

d. The second test: Thin capitalization --

(1) As debt climbs in proportion to corporate equity, courts have concluded that the equity was too "thin" to support the debt structure. See, e.g., Dobkin v.

Comm'r, 15 T.C. 31 (1950), aff'd per curiam 192 F.2d 392 (CA2 1951).

(2) Values have traditionally been computed using the market value of assets. See Kraft Foods Co. v. Comm'r, 232 F.2d 118 (CA2 1956).

(3) A debt-equity ratio of 3 to 1 has generally been considered to be safe. As one of many factors considered, much higher ratios have been sustained where the company's financial strength and cash flow would support full debt service. see Bradshaw v. United States, 683 F.2d 365 (Ct. Cl. 1982) (50 to 1 ratio held to be debt); and Baker Commodities, Inc. v. Comm'r, 48 T.C. 374 (1967) (700 to 1 was not fatal).

e. The third test: The intent of the parties --

(1) An earlier view expressed by the Tax Court held that a debtor-creditor relationship was not created where a dominant shareholder owned all of the notes issued by a corporation. It was the Court's conclusion that a stockholder so situated would not enforce the corporate debt. See Gooding Amusement Co., Inc. v. Comm'r, 23 T.C. 408 (1954), aff'd 236 F.2d 159 (CA6 1956), cert. denied 352 U.S. 1031 (1957).

(2) The courts have since looked to more objective criteria to determine whether the creation of a true creditor-debtor relationship was intended by the parties. In Gooding Amusement Co. v. Comm'r, 236 F.2d 159 (CA6 1956), cert. denied 352 U.S. 1031 (1957), the Court looked to:

(a) whether the shareholder-creditor conducted himself in a fashion consistent with that of a creditor;

(b) whether outside investors would have made such a loan on similar terms;

(c) use of the borrowed funds;

(d) the debt-equity ratio; and

(e) whether the debt was held pro rata.

(3) The establishment of a sinking fund to repay the corporate "debt" should indicate that the corporation intended to repay. In Portage Plastics Co., Inc. v. United States, 486 F.2d 632 (CA7 1973), the Court noted the absence of a sinking fund in holding for the government.

(4) Despite the fact that bona fide debt is created, it may later be transformed to equity if circumstances

evolve which warrant the change. For example, in Tampa Gulf Coast R.R. Co. v. Comm'r, 56 T.C. 1393 (1971), aff'd per curiam 469 F.2d 263 (CA5 1972), the failure of the creditor to act as such transformed the debt to equity.

f. In Rev. Rul. 83-98, 1983-2 C.B. 40, the Service considered whether adjustable rate convertible notes (ARCNs) should be treated as debt or equity; such consideration, interestingly enough, was made without reference to Sec. 385, I.R.C. Under the facts of the ruling, X corporation was a publicly-traded corporation, with one class of common stock traded at about $20 per share and a current dividend rate of 78¢ per share, or 3.9 percent, annually. X proposed to issue $10 million of ARCNs, each at a price of $1,000 cash or 50 shares of X common stock (worth $1,000). The ARCNs would mature in 20 years; on maturity, the holder would receive, at its election, $600 cash or 50 shares of X common stock; and until maturity each would be convertible into 50 shares of X common stock. Although there would be no call provision during the first two years, thereafter X could call any ARCN at a price of $600 cash, with the holder then having the right to convert. While interest on a bond could not be less than $60 nor more than $175 per annum, the interest was tied to the dividends paid on the X common stock. Finally, the ARCNs were subordinated to all existing and future senior and general creditors of X.

(1) The Service found that, based on all the above factors, the ARCNs constituted an equity interest in X, treated as stock. The Service noted that the fixed interest and fixed minimum principal were insufficient factors to support their classification as debt.

(2) The Service distinguished the subordinated debentures held to be debt in Rev. Rul. 68-54, 1968-1 C.B. 69, because (i) the instruments there were intended to and did create a fixed obligation to pay money on a given date; (ii) the interest rate, although to an extent dependent on earnings, was determinable according to a formula and did not float in tandem with discretionary common stock dividends; and (iii) the notes were not convertible into stock.

(3) In addition, the Service distinguished the subordinated debt instruments in Rev. Rul. 73-122, 1973-1 C.B. 66, because (i) those instruments gave a right to be repaid a sum certain at some time within ten years; (ii) interest was to be paid at a fixed rate; and (iii) there was no conversion feature.

(4) One noticeable distinction between the 1983 ruling and the two earlier rulings is the absence of convertibility in the earlier rulings. Furthermore, it appears quite clear that the corporation in the 1983 ruling was looking

from the beginning to compel conversion into its stock, so that the ARCNs could be said to have been essentially equivalent to the stock, from a tax point of view, from the very beginning.

2. The Impact of Section 385.

a. In the 1969 Tax Reform Act, Congress added Sec. 385, I.R.C. to the Code in order to permit the Treasury Department to issue "legislative regulations" for purposes of distinguishing between debt and equity in the corporate context for all purposes under the Code. Such regulations were to set forth factors to be taken into account in determining the debt/equity issue with respect to particular factual situations. Such factors could include, inter alia, the following (which will be recognized as some of the key factors in the traditional testing of debt versus equity):

(1) A written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest (Sec. 385(b)(1), I.R.C.);

(2) Subordination to or preference over any corporate debt (Sec. 385(b)(2), I.R.C.);

(3) The debt-equity ratio of the corporation (Sec. 385(b)(3), I.R.C.);

(4) Convertibility into corporate stock (Sec. 385(b)(4), I.R.C.); and

(5) The relationship between stockholdings and holdings of the interest in question (Sec. 385(b)(5), I.R.C.).

b. On March 20, 1980, Proposed Regulations were issued under Sec. 385, I.R.C. These Proposed Regulations were revised extensively when the Proposed Regulations were supposedly finalized on December 29, 1980, to be effective as to interests created after April 30, 1981. The effective date for the finalization of the Proposed Regulations was postponed on April 27, 1981, so as to apply only to interests created after April 15, 1981, and again on December 30, 1981, so as to be effective only to interests created after June 30, 1982. Once again, the effective date was postponed, on June 29, 1982, to interests created after January 1, 1983. Finally, on July 1, 1982, the Internal Revenue Service announced that the Proposed Regulations would be withdrawn.

c. It is anyone's guess as to whether and when new Proposed Regulations will be promulgated, or whether the Treasury will in fact seek to have Congress remove Sec. 385 from

the Code, so that the Service must again place its focus on the traditional tests of debt versus equity. Notwithstanding the withdrawal of the proposed Regulations, a few key provisions of the proposed Regulations should be examined, with a view toward assessing their potential impact on the area of real estate financing.

d. In Prop. Reg. §1.385-0(b), it was noted that the initial inquiries of the Proposed Regulations were (i) whether there is an "instrument," as contrasted to an unwritten loan or one evidenced by a writing, for example, in the corporate books or a board of directors resolution, (ii) whether the instrument is straight debt or hybrid, with instruments convertible into stock or providing for contingent payment being considered hybrid instruments, and (iii) whether the instruments are held substantially in proportion to the corporate stock. Of these initial inquiries, neither the first nor the third should generally be a consideration so long as either the corporation is not a borrower or, even if the corporation is a borrower, the loan is made solely on the security of the real estate.

e. In Prop. Reg. §1.385-0(c)(2), it was pointed out that hybrid instruments "not issued proportionately are generally treated as indebtedness if the present value of straight debt payments with respect to the instrument is at least half of the fair market value of the instrument". Prop. Reg. §1.385-5 distinguished fixed payments from contingent payments in determining the present value of the straight debt payment.

(1) In Prop. Reg. §1.385-5(c)(1), "contingent payment" was defined to mean "any payment other than a fixed payment of principal or interest."

(2) In Prop. Reg. §1.385-5(c)(2), it was stated that an instrument provides for "fixed payments of interest" only if both of two conditions are met. First, interest at a definitely ascertainable rate is due on definitely ascertainable dates; and, second, with certain exceptions, the holder's right to receive interest when due (or within 90 days thereafter) cannot be impaired without the holder's consent.

(3) In Prop. Reg. §1.385-5(c)(3), it was stated that an instrument provides for "fixed payments of principal" only if both of two conditions are met: First, a definitely ascertainable principal sum is payable on demand or due on definitely ascertainable dates; and, second, with certain exceptions, the holder's right to receive principal when due cannot be impaired without the holder's consent, in this situation, one such exception is that the clarification of a payment as fixed is not affected by the fact that the obligation is nonrecourse, but only if the face amount would, if the obligation were issued in exchange for property, be included in the pur-

chaser's adjusted basis for the property. Prop. Reg. §1.385-5(c)(5)(iv). See also Prop. Reg. §1.385-5(f), Example (13).

(4) Under Prop. Reg. §1.385-5(c)(4), a rate of interest was "definitely ascertainable" if applied to a definitely ascertainable principal sum and either (i) invariable or (ii) variable, determined according to an external standard not subject to the borrower's control and not related to the success or failure of the borrower's business or activities.

(a) A principal sum is not variable simply because it is in the borrower's control to prepay all or a portion of the principal sum. Prop. Reg. §1.385-5(c)(4).

(b) An interest rate tied to the prime rate is considered to be a definitely ascertainable rate of interest. Prop. Reg. §1.385-5(f), Example (10).

(c) Where a fixed interest rate of 7 percent is combined with additional interest of 1 percent, contingent on the net profits of the borrower, and the obligations, which are subordinated, have a 10-year fixed maturity date, Prop. Reg. §1.385-5(f), Example (7), treats the obligation as indebtedness.

(d) In Prop. Reg. §1.385-5(f), Example (6), corporation W owns a tract of land and is building 350 houses thereon. W borrows $300,000 from P on August 15, 1985, which is payable on demand at any time after December 31, 1990. In addition, W is to pay $175,000 to P "in lieu of interest", with $500 payable on the sale of each house. Based on an assumption as to the present value of the $300,000 payment on August 15, 1985, the obligation to P is treated as debt.

(e) Where the maturity value of the obligation is determined according to the Consumers Price index, and the interest rate is paid on the fluctuating maturity value as a protection against inflation, then, under Prop. Reg. §1.385-5(f), Example (5), this is considered as straight debt, without any contingency.

D. The Sale-Leaseback.

1. Generally --

a. A sale-leaseback may take many forms. However, in real estate, generally the basic focus is on a two-step, two-party transaction, where one party ("X") sells the property to a second party ("Y") and then X leases the property back from Y.

b. The sale from X to Y may be financed by purchase money debt or may be financed by third party debt.

2. Reasons for use --

a. Historically, the use of the sale-leaseback technique started as a means of avoiding restrictive state usury laws.

b. The reason for use was then broadened to include the ability of borrowers to obtain higher loan-to-value ratios, because "purchasers" could pay full fair market value, whereas "lenders" could only lend some percentage of value. See, generally, Marcus, Real Estate Purchase-Leasebacks as Secured Loans, 2 R.E.L.J. 664 (1973), and Kaster, Purchase-Leaseback: Own or Loan?, 11 REIT Rev. 7 (1974).

c. Other reasons were offered, as follows:

(1) The "lender" would have better security in ownership and a leaseback, than under a mortgage, deed of trust or similar security instrument.

(2) The "borrower" would obtain working capital advantages through leasing, rather than borrowing. This was sometimes combined with the argument that, cosmetically, the "borrower's" balance sheet and profit and loss statement looked better with leases than with loans. However, FASB 13 has eliminated this supposed advantage in many circumstances. See Tucker, The Sale and Leaseback as a Financing Tool, 24 Trusts & Estates 27 (1985).

3. Caveat --

a. In analyzing the sale-leaseback transaction, and the alternative Federal income tax treatments thereof, one should always exercise caution. Most cases focus on the seller/lessee, as will be seen below. However, one must likewise focus on the purchaser/lessor. Does it have true ownership, or is it merely a financier? See, generally, Rosenberg and Weinstein, Applying the Tax Court's Nontax Benefit Test for Multiple-Party Sale-Leasebacks, 54 J. Tax. 366 (1981). See also Faber, Determining the Owner of an Asset for Tax Purposes, 61 Taxes 795 (1983).

b. In Frank Lyon Co. v. United States, 435 U.S. 561 (1978), the Supreme Court, finding the presence of a third-party lender to be the key factor, held that the taxpayer was the owner of the property (the headquarters building of a bank) that it had purchased and leased back to the bank.

(1) This was the case even though (i) the bank's lease payments essentially covered the mortgage payments, (ii) the lease was otherwise triple net, and (iii) the bank had the option to repurchase the building at a predetermined price, which would cover the unpaid balance of the mortgage, the taxpayer's out-of-pocket cash for the purchase of the building and a 6% return on the out-of-pocket cash.

(2) The Court noted, at pages 583-584, 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."

(3) See also Pacific Gamble Robinson & Affiliated Cos. v. Comm'r, 54 TCM 915 (1987); Sanderson v. Comm'r, 50 TCM 1033 (1985); West v. Comm'r, 48 TCM 796 (1984); and Dunlap v. Comm'r, 74 T.C. 1377 (1980), rev'd and rem'd on another issue 670 F.2d 285 (CA8 1982), in which the Court relied on Frank Lyon Co. in upholding a multi-party sale-leaseback of a supermarket.

c. In Hilton v. Comm'r, 74 T.C. 305 (1980), aff'd per curiam 671 F.2d 316 (CA9 1982), the Court found that the taxpayer was not a true property owner, because there was no real reason for the taxpayer s participation in the sale-leaseback transaction. Due to the nominal cash flow the purchaser/lessor would receive, the Court found that, from the point of view of economics, there was no detriment to abandonment of the property. [See also Rice's Toyota World, Inc. v. Comm'r, 81 T.C. 184 (1983), aff'd in relevant part 752 F.2d 89 (CA4 1985); and Narver v. Comm'r, 670 F.2d 855 (CA8 1982), aff'g 75 T.C. 53 (1980).] In addition, there were other factors that, in the view of the Court, served to distinguish Hilton from Frank Lyon Co., including the following:

(1) None of the funds of the investors in the purchaser/lessor partnership were paid to the seller/lessee.

(2) The rents were not based on a comparative fair rental value; moreover, after the initial lease

term, the rents were minor, providing minimal economic return, even though several years in the future.

4. Alternatives: The Perspective of the Seller/ Lessee --

a. The forms which a sale and leaseback may take, from the point of view of the seller/lessee, are as follows:

(1) A financing transaction --

(a) The determinative factors are as follows:

(i) An option to repurchase the property subject to the lease is the sine qua non. See Helvering v. F.& R. Lazarus Co., 308 U.S. 252 (1939). See also Illinois Power Co. v. Comm'r, 87 TCM 1417 (1986).

(a) While the existence of an option to repurchase does not assure a financing transaction (Desert Lawn Memorial Park, Inc. v. Comm'r, 19 TCM 32 (1960)), the absence of such an option negates a financing transaction.

(b) See Sun Oil Co. v. Comm'r, 35 TCM 173 (1976), rev'd 562 F.2d 258 (CA3 1977), where the Tax Court held that an option to repurchase did not make a sale-leaseback into a financing transaction where its purpose was to assure the taxpayer of a way to cancel a lease which had proven uneconomical to operate as a service station. The Tax Court did not make anything out of the rental being a 45/8% return overall after a return of the money invested. But see Belz Investment Co., Inc. v. Comm'r, 72 T.C. 1029 (1979), aff'd 661 F.2d 76 (CA6 1981), holding that a sale-leaseback with an option to repurchase was a true sale and leaseback, rather than a financing transaction; the Service has acquiesced in this decision.

(i) The payment by the tenant of real estate taxes, insurance and all maintenance expenses. For a good discussion of this and the other factors listed, see Frenzel v. Comm'r, 22 TCM 1391 (1963).

(ii) The indemnification of the purchaser/landlord by the seller/tenant against claims for injury and damage and the maintenance by the seller/tenant of public liability insurance.

(iii) The lack of any duties or risks of ownership of the purchaser in connection with its ownership of the property. See, e.g., Schaefer v. Comm'r, 41 TCM

100, 105 (1980), where the Court noted that the "sale/leaseback left Schaefer in the same position vis a vis the hotel properties as he occupied prior to the agreement. The simultaneous leaseback of the hotel and the unbridled discretion vested in Schaefer to sublet the property permitted him to continue to operate the property in the same manner as before, namely, through lessees or managers."

(iv) The only advantage to the seller/tenant in entering into the transaction being its immediate use of the cash paid to it as the purchase price.

(v) Any unsuccessful effort made by the seller/tenant to get financing prior to the sale.

(vi) The payment by the seller of all settlement costs (including the payment of the purchaser's legal fees).

(vii) Evidence indicating that the seller/tenant intended to exercise its option to repurchase when it sold the property.

(viii) The provision in the lease for no abatement in rent for any damage to the property on account of casualty or act of God.

(ix) The continuation in possession of the property by the seller/tenant.

(x) A low or inadequate repurchase option price as measured by the present fair market value of the property; on the other hand, an option to repurchase at even fair market value will not necessarily negate a financing transaction. See, e.g., Shillito Corp. v. United States, 42-2 USTC ¶9712 (S.D. Ohio 1942); and Comtel Corp. v. Comm'r, 45 T.C. 294 (1965), aff'd 376 F.2d 791 (CA2 1967).

(b) The income tax consequences, generally speaking, of the financing transaction are:

(i) The seller/tenant has no gain or loss on sale, inasmuch as the sale is disregarded. In addition, the seller/tenant takes the usual income tax deductions and credits attributable to ownership of the property (such as ACRS under Sec. 168, I.R.C., depreciation under Sec. 167, I.R.C. and any investment tax credit); in turn, the seller/tenant obtains no rental payment deduction, but, instead, is deemed to pay interest and/or principal on the loan.

(ii) The purchaser/landlord has no ownership of the property, and so receives no depreciation or

ACRS deductions and no investment tax credit. Rather, the purchaser/landlord receives interest income and/or principal repayments.

(iii) See, generally, Rev. Rul. 68-590, 1968-2 C.B. 66, and Rev. Rul. 72-543, 1972-2 C.B. 87, dealing with the sale-leasebacks of container ships, which set forth guidelines. On the characterization of equipment leases, see Rev. Rul. 55-540, 1955-2 C.B. 39; Rev. Proc. 75-21, 1975-1 C.B. 715; and Rev. Proc. 75-28, 1975-1 C.B. 758.

(2) A like kind exchange --

(a) Sec. 1031, I.R.C., provides for non-recognition of gain or loss if property held for productive use in a trade or business or for investment is exchanged for property of a "like kind."

(i) Reg. §1.1031(a)-1(c) treats a transfer of a fee in exchange for a leasehold of 30 or more years by a non-dealer as a like kind exchange. See Rev. Rul. 60-43, 1960-1 C.B. 687, and Rev. Rul. 76-301, 1976-2 C.B. 41. See also Priv. Ltr. Rul. 8304022 (Oct. 22, 1982).

(ii) A lease for less than 30 years with an option to renew might, if the circumstances so warranted, be treated as equivalent to a fee under Sec. 1031, I.R.C.

(b) If there is a like kind exchange, and if there is boot [for example, fee with adjusted basis of $1 million is exchanged for lease with a term of 40 years and $1.5 million cash], a gain will be recognized, but loss will not be recognized. See, generally, Massey, Sale-Leaseback Transactions: Loss Realization--The Neglected Issue, 6 J.R.E. Tax. 308 (1979).

(c) Compare:

(i) City Investing Co. v. Comm'r, 38 T.C. 1 (1962), where a 21-year lease with a renewal option was considered a true sale/leaseback, so that the loss was recognized.

(ii) Century Electric Co. v. Comm'r, 192 F.2d 155 (CA8 1951), which held a lease of more than 30 years was a like kind exchange, so that loss was not recognized; but see Jordan Marsh Co. v. Comm'r, 269 F.2d 453 (CA2 1959) (non-acq., Rev. Rul. 60-43, 1960-1 C.B. 687), where loss was recognized (on the ground that both the sale and rental were at fair market value).

(iii) Leslie Co. v. Comm'r, 64 T.C. 247 (1975), aff'd 539 F.2d 943 (CA3 1976), in which the Court found a bona fide sale-leaseback, so that the taxpayer could recognize a loss on the sale. See also Crowley, Milner and Co. v. Comm'r, 76 T.C. 1030 (1981), aff'd 689 F.2d 635 (CA6 1982), finding that a sale-leaseback for 30 years was a bona fide sale, rather than a financing transaction. See, generally, Weinstein, Realizing a Loss through a Sale-Leaseback, 10 R.E.L.J. 247 (1982).

(d) If the transaction is considered a like kind exchange, then no gain or loss will be recognized (Sec. 1031(a), I.R.C.), except to the extent that boot (that is, cash or other property which is not within the tax-free category) is received. Sec. 1031(b), I.R.C. See, generally, Tucker, Don't Sell Your Real Estate -- Exchange It, 5 R.E. Rev. 94 (1976).

(e) The basis of the property received is the same as the adjusted basis of the property transferred, subject to adjustments. Sec. 1031(d), I.R.C. See Reg. §1.1031(d)-2; and Rev. Rul. 59-229, 1959-2 C.B. 180. See also Rev. Rul. 79-44, 1979-1 C.B. 265, and Priv. Ltr. Ruls. 8003004 (Sept. 19, 1979) and 8248039 (Aug. 27, 1982).

(3) A true sale and true leaseback --

(a) The seller/tenant recognizes gain or loss on the sale. See, e.g., Leslie Co. v. Comm'r, 64 T.C. 247 (1975), aff'd 539 F.2d 943 (CA3 1976). As a concomitant, the seller/tenant no longer takes deductions attributable to ownership of the property, such as depreciation or ACRS. The rent payments are generally recognized as such. See, generally, Kronovet, Characterization of Real Estate Leases: An Analysis and Proposal, 32 Tax Lawyer 757 (1979).

(b) The purchaser/landlord utilizes the purchase price as basis, subject to the limitations thereon hereinabove referred to. Likewise, the purchaser/landlord obtains the deductions attributable to ownership, subject to the multitude of limitations thereon, including particularly the investment interest deduction limitation under Sec. 163(d), I.R.C. for "net leases."

(c) Caveat: Where a "tax-exempt entity" is involved in the sale and leaseback, then, under Sec. 168(j), I.R.C., there are potentially significant adverse tax consequences.

E. The Purchase with a Wrinkle.

1. Purchase subject to a lease --

a. As a general rule, the purchaser of real property may claim depreciation from the date it takes title or possession, whichever is earlier. See Rev. Rul. 69-89, 1969-1 C.B. 59. See also Rev. Rul. 68-431, 1968-2 C.B. 99.

b. Where the property purchased is subject to a lease, and the purchase price is, at least in part, based on the lease, the courts are split (although the Tax Court itself is consistent) as to whether the purchaser can claim depreciation on the improvements prior to the time that the lease expires.

(1) In Wagner v. Comm'r, 518 F.2d 655 (CA10 1975), rev'g 33 TCM 201 (1974), the Circuit Court held that, where a buyer acquires property subject to an existing lease, the buyer need not have possession of the property in order to take depreciation. The Court relied on Wisconsin Electric Power Co. v. Comm'r, 18 T.C. 400 (1952), and Fribourg Navigation Co., Inc. v. Comm'r, 383 U.S. 272 (1966).

(2) However, in Geneva Drive-In Theatre, Inc. v. Comm'r, 67 T.C. 764 (1977), aff'd 622 F.2d 945 (CA9 1980), the Courts held that, where the taxpayer purchased property subject to a lease, paying $200,000 more for the property than the raw land was worth, but the purchase price was partially based on the lease, the taxpayer could not take depreciation until the lease expired five years later.

(3) The lines of authority are reconcilable if one places focus on whether the lessor or the lessee constructed the improvements. On the one hand, in Wagner, the lessor that was the predecessor in interest of the purchaser erected the improvements; on the other hand, in Geneva Drive-In, the lessee of the land constructed the improvements. Thus, the holdings in the two cases leave only one party (that which either constructed the improvements or was the successor in interest thereto) depreciating the improvements at a time.

2. Purchase with a retained use --

a. As a general rule, rental payments, so long as they do not constitute a purchase of the equity in the property, will be deductible by the tenant (Sec. 162(a)(3), I.R.C.) and will constitute ordinary income to the landlord (Sec. 61(a)(5), I.R.C.).

b. If the rental to be paid by the seller/tenant is either very low in relation to the fair rental value of the property or is waived for a period of time, then, strange as it

may seem, the purchaser may be deemed to have received prepaid rental income.

(1) See Alstores Realty Corp. v. Comm'r, 46 T.C. 363 (1966), and Steinway & Sons v. Comm'r, 46 T.C. 375 (1966), in which the Court decided cases involving both the seller and the purchaser in a sale-leaseback transaction.

(a) Steinway sold a warehouse to Alstores for $750,000 in cash, taking back a lease of the premises for 2-1/2 years at no rental. This package was in lieu of Alstores' having paid the original offering price of $1 million to Steinway for the property.

(b) The Court held that Steinway had in fact sold the property for $1 million, receiving $750,000 cash and a lease with a value of $250,000. The Court found that, accordingly, Steinway had a selling price of $1 million and a prepaid rental (amortizable over the 2-1/2 years) of approximately $250,000. In contrast, Alstores was held to have paid $1 million for the property, with a taxable rental income of approximately $250,000.

(c) Alstores had argued that it paid only $750,000, and that it hid no rental income, because Steinway retained a right to occupy the warehouse (which was a reserved term of years) so that Alstores bought only a future interest, taking possession after the 2-1/2 year term.

(d) The argument of Alstores was rejected by the Court because, in its view, Steinway did not, either in form or in substance, reserve an estate for years. The Court cited, but distinguished, Ashlock v. Comm'r, 18 T.C. 405 (1952), in which it had found that the purchaser had obtained only a future interest on its purchase, because the "seller had reserved an ownership interest in the property (an estate for years)". In this connection, in Ashlock, the seller in fact retained full control of the property for the term reserved, whereas in Steinway and Alstores the purchaser assumed both control and the risks of ownership.

(2) In Alstores, it was pointed out, at page 373, that "Possibly the result in the instant case would be different if the parties had in fact intended to carve out a reserved term for years in Steinway and had structured their transaction in that form. . . . The so-called space occupancy agreement placed the two parties' rights, obligations and risks as they would be allocated in a typical lease arrangement. Hence, the arrangement was a lease in substance as well as in form."

3. Sale with reserved estate for years --

a. As a general rule, the cost of acquiring an estate for years is amortizable over the number of years of the Estate. See Reg. §1.162-11(a). See also Cooper Foundation v. O'Malley, 221 F.2d 279 (CA8 1955); and Bell v. Harrison, 212 F.2d 253 (CA7 1954). Where the tenant has an option to renew the lease, however, then, under Reg. §1.167(a)-4, the rules of Sec. 178, I.R.C. (dealing with lease renewals or the "reasonable certainty" thereof) must be considered.

b. Assume that a party owns land, which is a non-depreciable, non-amortizable asset under almost all circumstances. Assume further that the fee simple interest in the land is sold, with the seller retaining an estate for years. See, generally, Blum, Amortization of a Retained Terminable Interest after Transfer of a Remainder, 62 Taxes 211 (1984).

(1) In Lomas Santa Fe, Inc. v. Comm'r, 74 T.C. 662 (1980), aff'd 693 F.2d 71 (CA9 1982), the taxpayer built a golf course and a country club as the first step in the development of a luxury residential community. In order to solve title problems and insulate the taxpayer and its operations from the country club membership, the taxpayer formed a wholly-owned subsidiary and transferred the golf course and country club to that subsidiary, subject to a retained estate for 40 years in taxpayer.

(2) The Court found the subsidiary to a bona fide entity, separate from taxpayer, and refused to disregard the transfer of assets and existence of the estate for 40 years.

(3) However, the Court refused to allow the portion of the cost basis of the land attributable to the 40-year retained estate to be amortized by the taxpayer. Following the decision in United States v. Georgia Railroad & Banking Co., 348 F.2d 278 (CA5 1965), the Court found that:

> "The land and landscaping of the golf course did not have limited useful lives when held by Lomas and, therefore, were nondepreciable assets. The separation of that property into two interests, namely, a retained estate for 40 years and a transferred remainder, does not transform either part of the whole into a depreciable asset. [The taxpayer] is not entitled to amortize its basis in the estate for 40 years because the estate for 40 years is not an asset which is subject to an allowance for depreciation under section 167(a)."