A Decision Model for Lease Parties in Sale-Leasebacks of Real Estate

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Although the Economic Recovery Tax Act of 19811 made substantial changes in the tax treatment of sale-leasebacks of equipment, it left virtually unaffected sale-leasebacks of real estate. In an inflationary economy, when interest rates and construction costs are rising, the sale-leaseback is an important device for both financial and income tax reasons.2 But even though a particular sale-leaseback arrangement may achieve one or more financial goals, it does not necessarily follow that the Internal Revenue Service will recognize it for income tax purposes. Courts, in determining whether a sale and lease of real estate is valid for tax purposes, have held uniformly that substance controls over form.3 Therefore,

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1. Pub. L. No. 97-34, 95 Stat. 172. The new Act creates a “safe harbor” rule that guarantees a transaction will be characterized as a lease for purposes of allocating investment credits and the cost recovery allowances to the nominal lessor. To come within this rule (1) the property being leased must be new § 38 property (or certain qualified mass commuting vehicles); (2) the leased property must be leased within three months after its acquisition or, in the case of a sale-leaseback transaction, it must be purchased by the lessor within three months of the lessee’s acquisition for a purchase price that does not exceed the adjusted basis of the property in the hands of the lessee at the time of the lessor’s purchase; (3) both the lessor and lessee must affirmatively elect to treat the lessor as the owner of the property; (4) the lessor must be a corporation, a partnership of corporations, or a grantor trust, the grantor and beneficiaries of which are all corporations; (5) at all times during the term of the lease and at the time the property is placed in service, the lessee must have a minimum “at-risk” investment of not less than 10% of the adjusted basis of the property; and (6) the term of the lease, including all extensions, cannot exceed the greater of 90% of the useful life of the property under § 167, or 150% of the present class life (ADR midpoint as of January 1, 1981).

If these requirements are met, the economic substance of the transaction is disregarded. Thus, whether there is a bargain purchase price, whether the lessee may use the property after the lease term, and who has the incidents of ownership are unimportant. See H.R. Rep. No. 215, 97th Cong., 1st Sess. 217-18 (1981).


3. The substance over form principle was first set forth in Gregory v. Helvering, 293 U.S. 465 (1935), in which the Court held that “[t]he legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the
rather than holding that an arrangement is a sale-leaseback, courts may find the arrangements to be in substance a financing device, or even a mere sham.4

Unfortunately the cases, in examining the substance of the transaction, have focused on different factors. Early cases examined the parties' intent as determined from the facts and circumstances. Later cases scrutinized the economic realities of the transaction. Lately, courts merely have listed the numerous factors that indicate a valid sale-leaseback. No single test or combination of tests seems to be absolutely determinative.

Analysis of the seminal cases, however, reveals a useful framework for predicting whether the courts will find a transaction to be a sham, a financing device, or a valid sale and lease. This framework is valuable even though different code sections may be at issue in a given case.

The goal of this article is to present a decision model to assist tax planners and ultimately the courts in the difficult problem of

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determining whether a sale-leaseback of real estate is valid for income tax purposes. Part I briefly describes the business and tax

5. This framework is valuable even though different code sections may be at issue in a given case. Among the issues which arise in sale-leaseback transactions are: should a rent deduction be allowed to the lessee under I.R.C. § 162(a)(3); should the depreciation deduction be allowed to the lessor under § 167; should an interest deduction be allowed the lessor on the purchase indebtedness under § 163; and, if a partnership is the buyer, should the partners be entitled to deduct their distributive share of losses under § 703? In all of these instances, the main issue is who “owns” (in a tax sense) the property. The owner is entitled to the depreciation deduction, the interest deduction, and in the case of partners, the partnership losses, but is not entitled to the rent deduction.

The following is a summary of how the model in the present article was constructed.

(1) All litigated sale-leaseback, trust-leaseback, gift-leaseback, and option to purchase/conditional sale cases were read to determine which cases had meaningful tax similarities that could be used to develop a model. The model covered all litigated sale-leaseback cases involving real estate. Nonrecourse financing as well as recourse financing cases were included. I eliminated trust-leaseback and gift-leaseback cases because donative intent was a primary consideration for entering into the transaction; economic substance of the transaction was unimportant. Similarly, sale-leaseback cases involving related parties were eliminated. The business purpose for the transaction appeared to be the determining factor for the validity of those transactions. I excluded sale-leaseback cases that were considered like-kind exchanges because the tax issues discussed in the cases were different from those in taxable exchanges. Sale-leases of equipment were also eliminated because the “safe harbor” rules of the Economic Recovery Tax Act of 1981 control these transactions. These rules specifically disregard the economic substance of the transaction. Finally, option to purchase/conditional sale cases were eliminated. These cases had many similarities with the sale-leases of real estate, but they primarily involved equipment.

(2) After narrowing the model to the sale-leaseback of real estate, 68 different factors mentioned in the cases were identified and grouped into nine categories, each representing a general principle or postulate: (a) financial institutions as parties to the transaction, (b) conduit where no financial institution is involved, (c) likelihood the lease property will revert automatically to the seller-lessee, (d) bargain purchase price or economic compulsion to exercise the option, (e) comparison of lease term with useful life of property, (f) rate of return similarities, (g) value disparities, (h) benefits and burdens, and (i) purpose of entering into the transaction.

(3) The postulates were then subdivided into questions that when answered would determine the validity or invalidity of a sale-leaseback transaction: (a) is the buyer-lessee a financial institution? (b) is a financial institution an indirect party to the sale-leaseback transaction—that is, neither lessor nor lessee? (c) is there a conduit arrangement even though no financial institution is involved? (d) will the property revert automatically to the seller-lessee by the end of the lease term? (e) is there a bargain purchase price or economic compulsion to exercise the option? (f) is the term of the lease plus renewals greater than or equal to the useful life of the property? (g) are there no rate of return similarities? (h) are there clear rate of return similarities? (i) is the sales price too high or too low in relation to the
reasons for entering these transactions. Part II considers relevant case law to the present. Part III outlines a nine-step decision model developed from the cases.

**PART I**

**A. The Nature of a Sale-Leaseback Transaction**

In a typical sale-leaseback, an owner of property sells the property to an investor who immediately leases it back to the seller. The investor usually makes a cash down payment and finances the remaining purchase price with a recourse or nonrecourse loan. Although some sale-leasebacks involve equipment, most litigated cases concern buildings, or buildings and land. Typically, the lease term plus renewals extends over a substantial number of years, and the lease includes an option to purchase the property at the end of the lease term.

1. **Non-tax Reasons for Entering into a Sale-Leaseback Arrangement—Seller-Lessee**

The primary non-tax advantage of a sale-leaseback is that it provides

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6. In some early sale-leaseback cases the property was sold to financial institutions.

7. The investor, of course, could pay all cash or make no down payment. Increasingly, sale-leaseback arrangements involve nonrecourse financing in which the investor is not liable personally for the purchase of the property, i.e., liability goes only to the property itself.


vides more cash to the seller-lessee than would a mortgage on the property. The cash generated from the sale is generally equal to the fair market value of the property, whereas a conventional mortgagee by law can lend funds to a commercial borrower only up to a percentage (usually seventy to eighty percent) of the property's fair market value. Therefore, the sale-leaseback enables the seller-lessee to retain possession and use of the property while obtaining needed working capital.

Second, if a lease meets Financial Accounting Standards Board standards for operating leases, it does not appear on the balance sheet. By replacing fixed assets with current assets and possibly eliminating a liability that the seller may have had before the sale, the seller-lessee's current ratio increases. This, in turn, may increase the credit standing and borrowing capacity of the seller-lessee.

Third, a seller-lessee may want to construct an office or other building during a period of inflation when surging construction costs, accompanied by uncertain "take out" commitments, raise the cost of capital and limit its overall availability. During this time the sale-leaseback device makes construction possible without restricting available operating lines of credit.

Fourth, the sale-leaseback allows a seller-lessee to circumvent state and federal loan restrictions because sale-leaseback provisions, unlike loan agreements, do not contain prohibitions on the debtor's financial undertakings. In addition, a sale-leaseback can be structured so as not to breach provisions of a prior loan agreement that place barriers on additional obligations of the debtor.

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10. Statement of Financial Accounting Standards No. 13, "Account for Leases," FASB, Stamford, Conn., Nov. 1976, sets forth four criteria which require the lessee to capitalize the lease:

1. the lease must not transfer ownership of the property to the lessee by the end of the lease term;
2. the lease must not contain a bargain purchase option;
3. the lease term must not equal 75% or more of the estimated economic life of the leased property; and
4. the present value at the beginning of the lease term of the minimum lease payments must not equal or exceed 90% of the value of the leased property.

Criteria (3) and (4) do not apply when the beginning of the lease term falls within the last 25% of the total estimated economic life of the lease property.

11. The current ratio is the ratio of current assets to current liabilities.
Fifth, many companies find the sale-leaseback device a better way to raise capital than selling bonds in the market. With rising interest rates and volatile capital markets, businesses can save large sums of money when financing a building through a sale-leaseback. Again, a lease, unlike a bond obligation, is not included on the balance sheet.

2. Non-tax Reasons for Entering into a Sale-Leaseback Arrangement—Buyer-Lessor

First, the rent the lessor receives usually represents a higher return than a mortgage. Second, unlike mortgages, rents are more easily increased. In the absence of rent control, investors can tie rents to sales or to the inflation rate. Third, state usury laws frequently may be circumvented by a sale-leaseback. Fourth, because most sale-leasebacks involve "net" leases, the buyer-lesser does not bear the expense of maintenance, taxes, and other expenses of operating the property. Fifth, ownership of the property may be a good hedge against inflation.

3. Tax Reasons—Seller-Lessee

First, the seller-lessee is entitled to a rent deduction. Typically, the seller's rent deduction is significantly greater than the combined interest and depreciation the seller could have deducted had he retained the property, particularly if the property is land or if the property is fully or almost fully depreciated. Even if rental payments are lower than payments under the ownership alternative, the seller-lessee may gain a significant advantage if the short-term earnings of the business are improved because of the lower rent payments.

Second, usually no gain is recognized from a sale-leaseback transaction. Section 1031(a) of the Internal Revenue Code provides

13. One must recognize, however, that by obtaining this higher rate of return, the buyer forgoes any rights he would have had as a creditor under a mortgage loan.
14. In the case of land, the sale-leaseback in effect allows a depreciation deduction to the seller-lessee in the form of a rent deduction. In the case of nearly fully depreciated property, any recent purchases of improvements may offset the gain from the sale-leaseback because the improvements may be depreciable at accelerated rates.
that no gain is recognized when property, held for productive use in a trade or business or for investment purposes, is exchanged for property which is of a "like kind." According to the regulations, an exchange of a fee for a leasehold of thirty or more years is a like-kind exchange: it is viewed as an exchange of a fee interest for a leasehold interest in the property plus cash received in the amount of the sale price. If, however, the sale is not a like-kind exchange, gain is recognized under section 1002. The gain, if any, is capital gain (whether or not the property is section 1231 property or investment property), but when certain depreciable section 1245 or section 1250 property is sold part of the gain is recaptured at ordinary rates. A loss also may be recognized, assuming that the fair market value of the property is lower than the property's adjusted basis and there is no like-kind exchange. In this case, the seller is entitled to an ordinary loss deduction if the property is investment property. Such a loss may be advantageous to offset other capital or ordinary income of the seller.

4. Tax Reasons—Buyer-Lessor

First, the buyer-lessee is entitled to a depreciation deduction taken on the purchase price or cost basis of the property. Individual buyer-lessees, who generally are near the fifty percent federal tax ceiling, benefit more from a depreciation deduction than do corporations, whose maximum tax rate is forty-six percent. This deduction may fully offset rental income during the early years of the lease as well as provide a tax shelter for other income.

15. Hereinafter, unless otherwise denoted, all section references are to the Internal Revenue Code.


17. When "boot" (cash or other property) is received in addition to the like-kind property, gain is recognized up to the amount of the boot received, but not in excess of realized gain. Realized losses, however, are not recognized when boot is received.

18. A seller-lessee may want to recognize gain in order to take advantage of a net operating loss carryover that is about to expire. In addition, the investment credit carryover also may be about to expire.

19. Under § 1245 the amount of gain recaptured at ordinary rates is the full amount of the depreciation taken. This section applies to tangible personal property. Under § 1250 the amount of the gain recaptured is the excess of accelerated over straight line depreciation. This section applies to real estate.

20. Even though the use of accelerated depreciation (sum-of-the-year digits or declining balance) may reduce the depreciation deduction during the later years of the lease, the time
ond, if the buyer-lessee is a tax-exempt organization and if the rent is not "unrelated" business income, the rental income is not taxable.\textsuperscript{21} Third, if the purchase price of the property is high and the asset is financed by a loan or nonrecourse obligation, the buyer-lessee obtains an interest deduction on the loan. Fourth, if the subject of the lease is personal property, the investment credit under section 38 may also be available.

B. Consequences of a Holding that the Arrangement is a Financing Arrangement or a Sham

If the transaction is found to be a financing device, there is no sale by the purported seller-lessee, and therefore neither gain nor loss is recognized on the transfer.\textsuperscript{22} The purported seller-lessee consequently is not entitled to a rent deduction, but he may take a depreciation deduction, the investment tax credit, ordinary and necessary deductions, interest deductions, and property tax deductions.

The purported buyer-lessee is now a lender, and that portion of the payments which does not represent payment of principal is interest income. The lender has no ownership deductions such as depreciation. The exercise of the option to purchase by the purported seller-lessee would be considered a repayment of the loan and would not result in recognition of gain or loss.

If found to be a sham, the transaction is treated for tax purposes as though it never occurred.

\textbf{PART II}

This section discusses the major financing/sale-leaseback cases in chronological order, beginning with cases that found the transactions to be financing devices, followed by cases that found a valid sale-leaseback, and ending with cases that require special

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\begin{enumerate}
\item \textsuperscript{21} Section 511 provides that taxable income of tax-exempt organizations includes a percentage of the total rents received from "business leases" equal to the ratio of business lease indebtedness to the adjusted basis of the property. \textsuperscript{1} Treas. Reg. \S 1.514(a)-1(a)(1)(iv) (1953).
\item \textsuperscript{22} For an additional description of the effects of a financing arrangement, see Rev. Rul. 72-543, 72-2 C.B. 87.
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scrutiny because nonrecourse financing was involved.

A. Financing Cases

1. The Early Cases

Three early cases, Commissioner v. H.F Neighbors Realty, Co.,23 John Shillito Co. v. United States,24 and Helvering v. F & R Lazarus & Co.,25 contain very brief opinions and, except for Neighbors, provide little useful analysis. In all three cases, the taxpayer transferred legal title to land and buildings to a trust company for a price substantially less than the property's fair market value.26 The trust company contemporaneously leased, on a "net" lease basis, the property back to the taxpayer for ninety-nine years27 and issued trust certificates to investors to obtain the necessary proceeds for the purchase. The rent was passed on to the certificate holders as a percentage return on their investments.28 The certificates could be redeemed by the seller-lessee, and title to the property would then be returned to the seller.

In Shillito and Lazarus the issue was whether the lessor had made a capital investment in the property that warranted a depreciation deduction. In Neighbors the issue was whether there was a gain to the lessee on the sale and leaseback. In all three cases the test used was the intent of the parties as evidenced by all the surrounding circumstances.29

23. 81 F.2d 173 (6th Cir. 1936).
25. 308 U.S. 252 (1939), aff’d 101 F.2d 728 (6th Cir. 1939).
26. In Neighbors, the sale price was $936,104 and the appraised value was $2,000,000. 81 F.2d at 174. In Shillito, the selling price was $1,400,000 and the fair market value was $2,093,000. 42-2 U.S. Tax Cas. (CCH) at 10,684. In Lazarus, the sale price was $3,250,000 and the appraised value was $6,500,000. 308 U.S. at 253.
27. In Neighbors, 81 F.2d at 174, and Shillito, 42-2 U.S. Tax Cas. (CCH) at 10,684, the lease was “renewable forever.”
28. The certificate holders had a 5.5% return in Neighbors, 81 F.2d at 174, a 5% return in Lazarus, 308 U.S. at 253, and a 6% return in Shillito, 42-2 U.S. Tax Cas. (CCH) at 10,684.
29. The court in Neighbors looked at “the original intention of the parties” as evidenced by the documents and “extraneous evidence.” 81 F.2d at 175. Shillito states the “plaintiff did not intend to sell said property but to borrow money on the security of said real estate.” 42-2 U.S. Tax Cas. (CCH) at 10,685. The court in Lazarus found that “the ‘rent’ stipulated in the ‘lease’ back was intended as a promise to pay interest on the loan; and the ‘depreciation fund’ required by the ‘lease’ was intended as an amortization fund, designed to
In finding that the transactions were financing devices and not sale-leasebacks, only the Neighbors opinion provides useful analysis. Discounting the absence of any promise to repay the debt, any express personal obligation, or definite maturity date, the court in Neighbors pointed to five key factors: (1) inadequate consideration for the "sale"; (2) the provision for redemption or reconveyance was likely to be exercised because the fair market value of the property was $2,000,000 and the "debt" was half that amount; (3) the transferor's continued possession and management of the property; (4) the transferor's payment of taxes and assessments; and (5) the transferor's receipt and use of the rents and profits of the property.30 Also, existence of a debt was indicated because the taxpayer was obligated to maintain his financial position and not to sell his remaining property for less than a stipulated amount.31

2. Rent Deduction Cases

The intent test was followed in Frito-Lay, Inc. v. United States.32 Frito-Lay originally planned to construct a plant on a site that it owned, but ran into financial difficulties. Frito-Lay then transferred the site to a newly-formed subsidiary which in turn exchanged the title to the land for a $49,824 non-interest bearing note of Jones, who leased the land back to the subsidiary for twenty years. Jones agreed to construct a $1,579,910 plant on the land, with 7.5% of that amount to be paid per year as rent, which amounted to over 2.3 million dollars total rent over the lease term.

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30. 81 F.2d at 175.
31. Id. Three factors seemed important in Lazarus and Shillito: (1) the need for additional working capital was the motive behind the transaction; (2) the rent payments over the lease terms were equal to interest, and, in the case of Lazarus, the depreciation fund was an amortization fund for payment of principal; and (3) the fair market value of the land and buildings conveyed greatly exceeded the selling price of the property. In Lazarus, one of only two sale-leaseback cases to reach the United States Supreme Court, equitable ownership, not legal ownership, was important in determining the substance of the transaction. Although legal title was transferred to the buyer-lessee, the seller-lessee was the one who bore "the burden of exhaustion of capital investment." 308 U.S. at 254.

Lazarus also was important for its acknowledgement that substance, rather than form, would be controlling in characterizing a sale-leaseback transaction for federal income tax purposes and that the parties' intent is a key factor in this determination. The case, however, is not particularly helpful in analyzing more complicated sale-leaseback transactions.
At the end of the lease term, the subsidiary had the option to purchase the property for the original amount of the note. Looking at the intent of the parties as evidenced by the written agreements, read in the light of the facts and circumstances at the time the agreement was executed, the district court upheld the Commissioner's disallowance of the rent deductions taken.\textsuperscript{33} Although the court observed that the fact that "the amount payable to Jones would be a reasonable rental is coincidental to the financing arrangements,"\textsuperscript{34} the court noted that the option price was negligible in relation to the total rent paid and that mere cancellation of the note could cause title to be revested in Frito-Lay. In addition, the court found that the conduct of the parties indicated an intent to engage in a financing arrangement.

Paul W Frenzel\textsuperscript{35} followed and cited Frito-Lay Like the parties in Frito-Lay, the Frenzels ran into trouble trying to obtain financing for the construction of a building that they intended to rent to a third party. They nevertheless commenced construction and conveyed the land and building in progress to the First Trust Company for a sum equal to the total purchase price paid for the land plus the total cost of construction—$1,038,415. The trust company leased back the property to the Frenzels for a primary term of ten years at a rental comprising: (1) an amount sufficient to amortize the purchase price over a ten year period, plus (2) five percent of the amortized balance outstanding. The Frenzels paid all operating expenses, as in a typical net lease arrangement, made substantial improvements, and retained the option to purchase the property at the end of the primary term or of any of the three five-year renewal periods (when a much lower rent was due) for ten percent of the purchase price. The lessor had an unqualified right to receive the rent because the lessee agreed to maintain liability insurance, to hold the lessor harmless from all claims for injury or damage, and to pay rent in all events with no abatement or reduction in case of damage from a casualty or an act of God.

The Tax Court upheld the Commissioner's finding that the taxpayers had established an equity in the property under section

\textsuperscript{33} Id. at 889 (citing Haggard v. Commissioner, 241 F.2d 288 (9th Cir. 1956)).

\textsuperscript{34} Id. at 892.

\textsuperscript{35} 32 T.C.M. (P-H) ¶ 63,276 (1963).
162(a)(3) and that there was merely a financing arrangement. In so doing, the court adopted the "intention of the parties" test of Frito-Lay.\textsuperscript{36} Important facts and circumstances were that the taxpayers retained all the essential rights and risks of ownership "but gave up bare legal title with a strong string firmly attached in the form of an option by which they could reinvest themselves with that title when the property was paid for,"\textsuperscript{37} had paid all the expenses on the property, had indemnified the trust company for liability, and would pay the rent even in the case of casualty or destruction.\textsuperscript{38} A financing arrangement also was indicated because: (1) the parties tried to obtain financing;\textsuperscript{39} (2) First Trust was not concerned with permanent possession;\textsuperscript{40} (3) First Trust treated the transaction as a mortgage on its books;\textsuperscript{41} (4) all of First Trust's expenses, including attorney's fees, were paid by the lessees, as in a typical financing transaction;\textsuperscript{42} and (5) the sales price did not reflect the fair market value of the property.\textsuperscript{43}

3. \textit{Recent Cases}

In \textit{Miller v. Commissioner},\textsuperscript{44} a depreciation deduction case, the Tax Court did not mention the intent of the parties but rather concentrated on who bore the burden of the capital investment. The facts were unusual. Wesleyan College wanted to construct two buildings in accordance with its own plans and specifications. Erie County Savings Bank was to be the ultimate financer. The intermediary was CDC Corporation (CDC). The college leased land at a nominal one dollar per year for thirty-five years to CDC, and CDC immediately leased back the land to the college. CDC borrowed $870,000 from the bank, and the twenty-five year leaseback agreement provided a rental of $7,000 per month for the first year of the

\textsuperscript{36} Id. at 1584-85 (quoting Haggard v. Commissioner, 241 F.2d 288 (9th Cir. 1956)).
\textsuperscript{37} Id. at 1585. The court found that the expert's estimation of the fair market value of the property at the time of the exercise of the option was not clearly erroneous despite the fact the value of one lease was not taken into account.
\textsuperscript{38} Id. at 1586.
\textsuperscript{39} Id.
\textsuperscript{40} Id.
\textsuperscript{41} Id.
\textsuperscript{42} Id.
\textsuperscript{43} Id.
\textsuperscript{44} 68 T.C. 767 (1977).
lease and $9,000 per month for the remaining twenty-four years of the lease. At the end of twenty-five years both leases would terminate and title to the improvements on the land automatically would vest in the college. The lease was assigned and deposited with the lending bank as security for the loan. The bank also required the college to secure CDC’s note with the college’s land and its interest in the prospective buildings, and required financial statements from the college. The college’s monthly payments under the leaseback equaled the sum of CDC’s monthly mortgage payments to the bank plus $543 per month, which amounted to .75% of the amount borrowed. The bank required that, in case CDC defaulted, the bank could obtain the mortgage payments directly from the college. The college could, if it desired, make a cash settlement with the bank and reobtain the property using the same prepayment schedule as CDC’s prepayment schedule under the mortgage note. The college was to pay all maintenance, repairs, insurance, utilities, and taxes. In the event of casualty or condemnation, the proceeds were to be used to restore the building, or repay the note, with any remaining proceeds going to the college.

CDC later incurred financial setbacks, became inactive, and sold its rights to Dr. O.B. Miller, who was interested in the cash flow of $543 per month for the remaining twenty-three years of the lease, for which he paid $49,000. On Miller’s insistence that he not be personally liable on the mortgage note, the bank allowed CDC to assign to Miller its rights without its obligations because the bank relied on the value of the real estate and the creditworthiness of the college. Nevertheless, Miller deducted interest payments on the mortgage loan and took depreciation on the college buildings.

In looking at the substance of the transaction, the Tax Court concluded that the college, not CDC or Miller, had borrowed money and made capital investments. Miller purchased CDC’s right to receive the monthly $543 fee, not the ownership of two college buildings subject to a mortgage. The Tax Court pointed out that CDC, which supposedly borrowed $870,000 from the bank, had a capitalization of only $18,000 in shareholders’ equity and $39,000 in loans and, before the loan from the bank was granted, had a net operating deficit of $20,721.45 The Tax Court found that

45. Id. at 777.
the burden of the capital investment was on the college: it secured CDC's note; the thirty-five year ground lease ended when the leaseback agreement ended; the college's repayment privileges were identical to those of CDC; at the termination of the leaseback the college automatically acquired title without any additional payment; all taxes, assessments, insurance, etc., were paid by the college; and insurance or condemnation proceeds were to be used to reconstruct the buildings. The college, not CDC, had the capital investment, and "CDC, and hence Dr. Miller, acted merely as a conduit between [the] college and [the] bank." Thus, Miller was not entitled to the depreciation deduction.

In Sun Oil Co. v. Commissioner and Cynthia Schaefer, the two most recent financing cases, the issue was the rent deduction, although Schaefer also involved the depreciation deduction. In both cases the primary test used was that of burdens and benefits, not the intent of the parties.

Sun Oil concentrated on whether the burdens and benefits on the buyer-lessee and the seller-lessee reflected the traditional bargained-for business relationship between owner and lessee. In that case, Sun Oil sold 320 parcels of unimproved service station sites at cost to General Electric Pension Trust, a tax-exempt trust. Sun Oil simultaneously leased each location from the trust for twenty-five years with lease renewal option rights for an additional sixty-five years.

The court concluded that the following burdens on and benefits to the lessee indicated a financing arrangement rather than a valid sale-leaseback:

1. The rent was geared to amortize the moneys advanced by the Trust at an agreed annual rate of 4½% over the primary twenty-five year term. The court concluded that this rate was not equivalent to fair rental value, but was consistent with the going market interest rate for quality

46. Id. at 778.
48. 49 T.C.M. (P-H) 80,440 (1980).
49. 562 F.2d at 263.
50. Id. at 266.
firms such as Sun Oil.\textsuperscript{51}

(2) Sun Oil bore the tax, maintenance, and annual operating expenses. There was to be no abatement of rent even in case of condemnation or casualty. The lessor had no obligation for expenditures in connection with the leased premises. Sun Oil agreed to indemnify the lessor and hold it harmless from any liability arising from use and occupancy. The court concluded that "[t]hrusting all of such burdens and risks on the lessee under every condition and circumstance... is hardly consistent with customary substantive bargains in the market place between lessors and lessees."\textsuperscript{52}

(3) The lessee could make a rejectable offer to the lessor to repurchase if the property were condemned, seized by eminent domain, or in the lessee's sole judgment the leased site were no longer profitable or necessary to its business.\textsuperscript{53} The lessee had the option to substitute other real property of equal value, measured by lessee's book value, in the event of condemnation or decline in profitability of the leased land.\textsuperscript{54} The court concluded that these rejectable offer and substitution rights of the lessee were "benefits characteristic of the ownership of property rather than [those] of a leasehold."\textsuperscript{55}

(4) The repurchase price in the lease was geared to the unamortized principal advanced by the buyer-lessee and therefore was not related to fair market value.\textsuperscript{56} The court concluded that the option to acquire the property at the end of the primary term at the value to the lessor was a form of "equity" because the value to the lessor was really the present value of future payments for sixty-five years at a specified rate.\textsuperscript{57}

\textsuperscript{51} Id. at 269.
\textsuperscript{52} Id. at 263.
\textsuperscript{53} Id. at 263-64.
\textsuperscript{54} Id. at 263-65.
\textsuperscript{55} Id. at 265.
\textsuperscript{56} Id. at 267.
\textsuperscript{57} Id. at 268.
In the most recent financing case, *Cynthia Schaefer*, the court examined the lessee's dominion and control over the property, the investment of the lessor, and a broad range of burdens and benefits of the parties to deny both rent and depreciation deductions. In this case, a doctor purchased a hotel for $200,000, paid nothing down, and issued a note for the full amount. The note required annual principal payments of $10,000. The doctor in turn leased the property back to the original owner, a good friend of the doctor, who originally had purchased the property for $200,000 four years prior to this lease arrangement. The lease to the original owner was on a year-to-year basis with rents guaranteed at $10,000 and the potential of higher rents if the profits from the hotel were greater. The lessee had the option to repurchase the property for $200,000 and had a right to $40,000 "profit" if the lessor sold the property to anyone else for $240,000.

The court considered the totality of the following burdens and benefits as indications that the seller-lessee really remained the owner of the property:

(1) The lessee had "unbridled discretion" to sublet the property, thus permitting him to continue to operate the property in the same manner as before the sale-leaseback;

(2) the lessee continued to be liable on the note given when the property was first purchased;

(3) the lessee agreed to pay real estate taxes and fire insurance premiums, and to hold the lessor harmless from liability arising out of the operation of the premises;

(4) the lessee bore all the risks of current operating losses;

(5) the lessor could not reasonably expect to receive more

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58. 49 T.C.M. (P-H) ¶ 80,440 (1980).
59. This is an unusual case because both rent and depreciation deductions were at issue.
60. *Id.* at 1912.
61. *Id.* at 1916.
62. *Id.*
63. *Id.*
64. *Id.*
than the $10,000 guaranteed annual lease payment;\(^6^5\)

(6) the lessor was shielded from any long-run downside risks due to the “put option” to resell to the lessee;\(^6^6\)

(7) the lessor was unlikely to benefit from any long-range appreciation of the property because (a) the lessor did not contemplate retaining the property for appreciation purposes if the lessee found a buyer, (b) the lessee retained the right to all profits on the sale of the property up to $240,000,\(^6^7\) (c) the lessee held the recorded title to the property and therefore held veto power over the lessor as to any possible sale,\(^6^8\) and (d) the lessee could virtually force the lessor to reconvey the property simply by terminating his role as lessee under the leaseback agreement.\(^6^9\)

Control of the premises constituted a very important benefit to the lessee. The control was evidenced by the lessee’s initiative in granting an option to the sublessees to purchase the hotel without the approval of the lessor. Furthermore, the lessee, in the sublease agreement, reduced the lessor’s interest in the hotel’s operating income without the lessor’s approval.\(^7^0\)

The court also examined whether the lessor had any investment in the property. The court observed that the lessor made no initial payment to purchase the property, that the $10,000 lease payments received were offset by the $10,000 principal installment required of the lessor under the agreement, and that the lessor had “put” an option to sell the property to the lessee for the original purchase price with the lessee receiving cash for the amount of the equity.\(^7^1\)

The court concluded that the lessor had made no real economic investment in the hotel property: “it is not coincidental that the net inflow due [the lessee] under the agreement . approximates the amount required to be paid by” the lessee to the former owner of the property.\(^7^2\)

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\(^6^5\) *Id.*  
\(^6^6\) *Id.*  
\(^6^7\) *Id.*  
\(^6^8\) *Id.*  
\(^6^9\) *Id.* at 1917.  
\(^7^0\) *Id.* at 1915.  
\(^7^1\) *Id.*  
\(^7^2\) *Id.* at 1917.
From these financing cases, one can conclude that the courts have no systematic approach to the sale-leaseback problem. Although the rent deduction cases concentrate on the equity interest of the lessee and the depreciation deduction cases concentrate on the capital investment of the lessor, the cases evince a varying emphasis on the intent of the parties, the burdens and benefits created by the lease arrangement, and the fair market value of the payments under the sale-leaseback arrangement. Although the facts of each case differ and the general tests of each case vary, many of the same factors are repeated in the courts' analyses. Yet, no relative weights or ranking of importance are given to these numerous factors.

B. Sale-Leaseback Cases

Most of the valid sale-leaseback cases are recent. Like the recent financing cases, they involve complicated fact patterns and varying tests. Both Keeling v. Commissioner\textsuperscript{73} and American Realty Trust v. United States\textsuperscript{74} use an intent test, concentrating on economic compulsion to exercise the option. The United States Supreme Court in Frank Lyon Co. v. United States,\textsuperscript{75} on the other hand, uses a multiple factor approach, citing more than thirty factors in reaching its decision. Finally, in Belz Investment Co. v. Commissioner,\textsuperscript{76} the court adopts a test using the parties’ intent, the economic substance of the transaction, and the status of the parties.

1. Keeling v Commissioner

In Keeling v. Commissioner, real and personal property belonging to a company owned in part by the taxpayer and in part by the taxpayer’s associate, Mosher, was sold for $141,000.47 and leased back for $2,200 rent per year. The lease was for a term of five years with an option to purchase the property for $71,701 at the end of the term. Approximately half of the annual rent was to be placed in an escrow account bearing four percent interest and applied to the option purchase price. The lessee was liable for fire, casualty

\textsuperscript{73} 30 T.C.M. (CCH) 954 (1971).
\textsuperscript{74} 498 F.2d 1194 (4th Cir. 1974).
\textsuperscript{75} 435 U.S. 561 (1978), rev’g 536 F.2d 746 (8th Cir. 1976).
\textsuperscript{76} 72 T.C. 1209 (1979).
and life insurance, and taxes. In addition, the lessee could sublease the property.

The Commissioner contended that the transaction was a financing arrangement. He argued that the taxpayer-lessee had an equity interest in the property because a portion of the rent was applied to the option price, and the option price was below the fair market value of the property, determined by an expert to be $101,000. In addition, the Commissioner argued that the lease agreement imposed many of the rights, risks, and responsibilities on the lessee that normally attach to a purchaser of property. The court disagreed with each of the Commissioner's arguments. The court stated that mere application of the rent to the option price did not create an equitable interest in the taxpayer and that no equitable interest arose from the payment of the $71,000 option price because the taxpayer's financial condition was so meager that there would be no "compulsion to exercise" the option. In addition, the court decided that the existence of these risks and responsibilities was "mere surplusage" in determining if in fact a sale or a lease existed. Overall, the court found significant the fact that the negotiation to sell the property was intended to solve Mosher's immediate cash needs, not the taxpayer's needs, and that the option to purchase was added as an afterthought. Thus, the court concluded, the parties did not intend a financing arrangement.

2. American Realty Trust v United States

Another case in which both the intent of the parties and economic compulsion were considered in determining a valid sale-leaseback was American Realty Trust v. United States. In this case, American Realty Trust (ART) entered into an agreement with Helmsley, a real estate entrepreneur, whereby Helmsley transferred to ART for $7,000,000 a resort property in Palm Beach. The selling price consisted of a cash down payment of $2,500,000.

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77. 30 T.C.M. (CCH) at 959.
78. Id.
79. Id.
80. Id.
81. Id.
82. 498 F.2d 1195 (4th Cir. 1974).
and the balance of $4,500,000 due through a mortgage loan arrangement. ART agreed to lease the property on a “net” lease basis to Palm Beach Towers, Helmsley’s wholly-owned corporation, with certain provisions under the lease to be undertaken or guaranteed by Helmsley personally. The provisions of the lease arrangement included the following: (1) a rental term of twenty-one years with two successive twenty-five year renewal options; (2) a net rental to average $645,000 per year; (3) a rental rate to be reduced by fifty percent of any diminution in the annual mortgage payments; (4) the seller-lessee was to bear the burden of capital improvements; (5) the seller was granted options to repurchase in the fourth, fifth, sixth, and seventh years of the lease for prices declining to $6,190,000 in the last year; and (6) any condemnation award for the property was to be applied to the mortgage to the extent of the outstanding principal balance, to the landlord up to $2,525,000, and to the tenant up to the value of its leasehold estate, with the remainder to be shared by the landlord (sixty percent) and the tenant (forty percent).

Helmsley exercised the option in the seventh year because of the sudden availability of “wrap-around” financing that allowed him, through his corporation, to acquire title to the property with little cash outlay of his own. Until the option was exercised, ART took depreciation on the property. The Commissioner denied those deductions claiming the arrangement was a mere financing arrangement. The government argued that the “burdens and benefits” were with Helmsley, the rents were equal to interest, and there was economic compulsion for the lessee to exercise the option. The Court of Appeals for the Fourth Circuit, affirming the district court, held the transaction to be a valid sale-leaseback and not merely a tax avoidance device. The court found that Helmsley was not under any economic compulsion to exercise the repurchase option but that he decided to exercise his option merely because of the sudden availability of wrap-around financing. Also of importance was testimony that the agreed-upon purchase price of $7,000,000 was “fair” and not unduly low. The court stated:

83. Id. at 1199.
84. Id.
85. Id.
“merely because tax planning may have preceded a transaction, or because tax savings have flowed from it, we are not constrained to characterize the entire event as primarily, or even substantially, a tax avoidance device.” The court distinguished *Lazarus* on the basis that Helmsley’s lease was for an initial term of only twenty-one years, whereas the lease in *Lazarus* ran for ninety-nine years.

3. Frank Lyon Co. v. United States

*Frank Lyon Co. v. United States* was the only sale-leaseback case other than *Lazarus* to reach the Supreme Court. In *Lyon*, Worthen, a bank, was unable because of banking restrictions to obtain financing for the construction of a bank building. Worthen then contracted with Lyon, a closely held corporation in the business of distributing home furnishings, to lease its land, sell its building, and lease the building back for twenty-five years plus eight additional five-year terms. Lyon was to be paid rent in an amount equal to the principal and interest payments that would amortize the $7,140,000 mortgage loan it had received from New York Life, a third party mortgagee, over the twenty-five year primary period. Worthen also had the option to repurchase the building at four different times at a price equal to the sum of the unpaid balance of the mortgage plus Lyon’s $500,000 investment ($7,640,000 selling price less the $7,140,000 mortgage) and six percent interest compounded on Lyon’s investment.

The Commissioner determined that for tax purposes Lyon was not the owner of the building and therefore was not entitled to the depreciation deduction or the interest deduction. The district court held in favor of Lyon, but the Court of Appeals for the Eighth Circuit and the United States Supreme Court reversed. In applying a multiple factor approach to determine the economic substance of the transaction, the Court held the following factors significant:

(1) the presence of a third party, an independent mortgagee;

86. Id.
87. Id.
89. Id. at 575.
(2) the fact that the lessor was exclusively liable on the note held by this independent mortgagee;\(^{90}\)

(3) the nonfamily, nonprivate, arms-length nature of the entire transaction;\(^{91}\)

(4) the fact that the transaction was shaped by features other than tax avoidance—diversification in the case of Lyon and the legal requirements of the lessee to sell and lease back the property;\(^{92}\)

(5) the fact that the option prices and rents were reasonable;\(^{93}\)

(6) the fact that Lyon’s investment of $500,000 was substantial;\(^{94}\)

(7) the fact that Lyon could sell the property at a profit at any time and obtain the benefit of future appreciation;\(^{95}\)

(8) the fact that Lyon bore certain risks from the transaction;\(^{96}\) and

(9) the fact that the government would receive the same amount of revenue no matter how the transaction was viewed.\(^{97}\)

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90. Id. at 576-77.

91. Id. at 583. Related factors included: (a) “Lyon’s substantiability and its independence from Worthen”; (b) “the competitiveness of the bidding”; (c) “the bona fide character of the negotiations”; (d) “the presence of several finance organizations seriously interested in participating in the transaction” and “the submission of formal proposals by several of those organizations”; and (e) “the absence of any understanding between Lyon and Worthen that Worthen would exercise any of its options to extend.” Id. at 582-83.

92. Related factors included: (a) the “competitive situation” between Worthen and another bank; (b) the “undercapitalization” of Worthen; and (c) the fact Lyon was not “engaged generally in the business of financing.” Id. at 582-83.

93. Id. at 582. The court also mentioned “the substantiability of the purchase price.” Id.

94. Id. at 579.

95. Id. at 583.

96. Id. Related factors included: (a) “the presence of all building depreciation risks on Lyon”; (b) the risk “that Worthen might default or fail, as other banks have failed”; (c) “the fact that Worthen could ‘walk away’ from the relationship at the end of the 25-year primary term, and probably would do so if the option price were more than the then-current worth of the building to Worthen”; and (d) “Lyon’s liability for the substantial ground rent if Worthen decides not to exercise any of its options to extend.” Id.

97. Id. at 580. Factors (1), (2), (3), (4), and (8) are considered important by the IRS Audit Manual, “Equipment Leasing Tax Shelter” (CCH) ch. 800, ¶ 844.
4. Belz Investment Co. v Commissioner

The most recent valid sale-leaseback case, Belz Investment Co. v. Commissioner,98 adopted a test that examines the parties’ intent, the economic substance of the transaction, and the status of the parties. In this case, Belz Investment Company filed consolidated corporation income tax returns with five subsidiaries—among them Expressway Motel Corporation. Expressway contracted with Holiday Inn to construct a motel for Expressway. Prior to completion of the motel, Expressway became dissatisfied with time delays and with the quality of the workmanship, so Expressway agreed to sell the motel to and simultaneously lease it back from Holiday Inn. The agreement conveyed the right, title, and interest in the property99 to Holiday Inn for $1,502,000, of which approximately $35,000 represented a profit for Expressway. The lease agreement required Expressway to pay Holiday Inn annual rent in the amount of twenty-five percent of gross room rentals and five percent of gross annual restaurant and bar beverage revenue. The lease term ran for twenty years, and Expressway had the right to renew the agreement on the same terms and conditions for three additional ten-year terms. Expressway had to maintain the premises and pay all charges for utilities, taxes, and assessments. In addition, Expressway had to provide and keep in force insurance on the property Expressway had certain rights to insurance and condemnation proceeds in excess of the payments on the outstanding mortgage. Expressway possessed an option to purchase the property after ten years for $1,502,000 reduced by the excess, if any, of the gross rental payments made over the sum of $1,438,000. Also, the obligations under the first mortgage were to be assumed by Expressway with a corresponding credit against the adjusted purchase price.

The issue was whether Expressway’s payments were in substance “rent” or “equity.” Petitioner asserted that the amounts were clearly deductible rent because: (1) Expressway did not take title and had no equity in the property; (2) Expressway had to pay the amounts in order to continue its use of the property; (3) the rent-

98. 72 T.C. 1209 (1979).
99. The property included the motel itself, Expressway’s rights under the ground lease, and the land adjacent to the ground lease which Expressway owned.
als and option prices were reasonable; and (4) Expressway and Holiday Inn negotiated at arms-length with no understanding that Expressway would exercise the option. The Commissioner argued that the sale-leaseback was in substance a "secured lending arrangement" whereby Holiday Inn "loaned" $1,502,000 to Expressway when Holiday Inn purchased the motel and that Expressway's exercise of the option was a foregone conclusion.

The Tax Court concluded that the parties entered into a bona fide sale-leaseback arrangement. The court considered the following factors in reaching its decision: (1) evidence existed that the transaction was arms-length, entered into for a valid business purpose, and was not for tax considerations; (2) the exercise of the option to purchase was not a "foregone" conclusion given the uncertainty of the rent revenues which were to be applied to the option price and the arguably fair market value of the option price; (3) the lessor alone was obligated to pay both the ground rent and the first mortgage on the property; (4) the sales price was reasonable; and (5) the rent was determined by a percentage formula without any minimum rental.

C. Nonrecourse Financing Cases

Nonrecourse financing is common in real estate ventures. An investor in a real estate venture can leverage his investment through a nonrecourse loan and claim depreciation and other deductions in excess of his equity investment. In Crane v. Commissioner, the Supreme Court ruled that the absence of personal liability with respect to a mortgage did not prevent its inclusion in the depreciation basis of the property. Real estate tax shelters, unlike other tax shelters, are not subject to any statutory provisions limiting the amount of the deductions to the amount of the "at risk"
investment.\textsuperscript{108}

The first sale-leaseback case involving nonrecourse financing was \textit{David E. Bolger},\textsuperscript{109} in which the taxpayer purchased through straw corporations several pieces of property which the taxpayer then leased back on a net lease basis to the seller. The purchase price was fully financed through an institutional lender on a nonrecourse basis. The lender received rent directly from the seller-lessee. The rent at least equaled the debt service obligation, but was never significantly greater than the debt service. The issue in the case was whether the taxpayer-investor was entitled to a depreciation deduction on the property under section 167.

The Internal Revenue Service stipulated that the fair market value of each piece of property, taking into account the existing lease, was at least equal to the mortgage on the property.\textsuperscript{110} Therefore, the IRS could argue only that it was unreasonable to assume that a capital investment would eventually occur despite the absence of any personal liability. The IRS asserted that the taxpayer might abandon the property because the cash flow was minimal and the property was mortgaged to the full extent of its value. The Tax Court rejected this argument, concluding that the taxpayer was building equity in the property and could expect the property to appreciate. Thus, the lessor would suffer a substantial forfeiture upon abandonment.\textsuperscript{111}

It seems rather clear that if the facts of \textit{Bolger} were repeated today the result would be different. The court in \textit{Hilton v. Commissioner}\textsuperscript{112} criticized the Commissioner in \textit{Bolger} for "blithely abandon[ing] ship" and not examining the "efficaciousness of the lease."\textsuperscript{113} The \textit{Bolger} case is important, however, for developing the test followed in all subsequent nonrecourse sale-leaseback cases: whether the lessor stands to lose anything by abandoning the transaction. If the lessor would lose nothing from abandoning the transaction, the lessor is not the owner of the property entitled to

\textsuperscript{108} I.R.C. § 465.
\textsuperscript{109} 59 T.C. 760 (1973).
\textsuperscript{110} \textit{Id.} at 765.
\textsuperscript{111} \textit{Id.} at 770-71.
\textsuperscript{112} 74 T.C. 305 (1980).
\textsuperscript{113} \textit{Id.} at 349.
the depreciation deduction.\textsuperscript{114}

This "abandonment" test was used in \textit{Estate of Franklin v. Commissioneer},\textsuperscript{115} in which a tax shelter was set up for several doctors, one of whom was Franklin. In that case the Romneys agreed to sell the Thunderbird Inn to the Associates, a California limited partnership of which Franklin and several other doctors were limited partners. Although the property's worth was about $800,000, the selling price was $1,224,000, payable over a ten year period, with interest on any unpaid balance of 7.5\% per annum. The purchase obligation was nonrecourse. The only money paid down was a $75,000 prepaid interest charge. At the end of the tenth year, the Associates could make a balloon payment of the difference between the remaining purchase price, forecast at $975,000, and any mortgage then outstanding against the property. The monthly payments approximately equaled the rent from the seller who leased the property back from the Associates. The United States Court of Appeals for the Ninth Circuit found that the taxpayer-investor did not acquire an equity interest in the property entitling him to the depreciation deduction because he failed to demonstrate that the purchase price was at least approximately equivalent to the fair market value of the property\textsuperscript{116} Such a demonstration would "rather quickly yield an equity in the property which the purchaser could not prudently abandon."\textsuperscript{117} Because the unpaid balance of the purchase price exceeded the fair market value of the property, the buyer-lessee had only a "mere chance" to benefit from appreciation in the property and could abandon the arrangement at any time.\textsuperscript{118}

The "abandonment" test also was applied in \textit{Hilton v. Commissioneer}.\textsuperscript{119} There, a newly constructed department store was sold by Broadway to a single purpose financing corporation and leased back under a long-term net lease. The financing company then conveyed its interest in the property to a general partnership which in turn conveyed portions of its interest to a number of tiers

\textsuperscript{114} \textit{Id.} at 364.
\textsuperscript{115} 544 F.2d 1045 (9th Cir. 1976), \textit{aff'd} 64 T.C. 752 (1975).
\textsuperscript{116} \textit{Id.} at 1048.
\textsuperscript{117} \textit{Id.}
\textsuperscript{118} \textit{Id.}
\textsuperscript{119} 74 T.C. at 350.
of limited partners. The selling price of the property was $3,137,500, even though Broadway incurred direct and indirect costs in the acquisition and construction of the store totaling $3,332,834. The lease term was thirty years with an option to extend for another sixty-eight years. The rentals were $198,603.75 or 6.33% of the purchase price for the initial term, $47,062.50 or 1.5% of the purchase price for the first renewal term of twenty-three years, and $31,375 or one percent of the purchase price for the second and third renewal periods. A ten percent balloon payment was due at the end of the initial thirty-year term. Broadway had the right to purchase the property if the lessor decided to sell for $50,000, subject to the Indenture and Assignment of Lease and Agreement. The limited partners of one partnership put up $180,000, all of which went to the general partner and lawyer for services rendered. The limited partners of the other partnership put up $155,000 cash. This amount also went to pay commissions.

The court concluded that the limited partners as buyer-lessees "would not at any time find it imprudent from an economic point of view to abandon the property" because "[t]he low rents and almost nominal cash flow leave little room for doubt that, apart from tax benefits, the value of the interest acquired by the petitioners is substantially less than the amount they paid for it." In reaching this conclusion the court relied substantially on expert testimony. One expert tried to show that the lessor-investors were the owners of the property by calculating the residual value of the property at three lease renewal dates in the future. The expert assumed the residual value of the property would equal the purchase price of $3,150,000 at the end of thirty years, fifty-three years, and seventy-six years, but made no serious investigation to ascertain the market value of the property. The expert justified his statement re-

120. Because the financing corporation’s capitalization was only $1,000, it planned to sell its corporate notes to certain insurance company lenders. The corporate notes were secured by an indenture of mortgage and deed of trust, which conveyed the financing corporation’s interest in the property to the trustees for the insurance companies, and by assignment of the lease and the rentals to the trustee. The rentals flowed directly to the insurance companies from Broadway. The interest rate of 5.125% shared by the insurance companies on the mortgage notes was tied to the credit rating of Broadway—commonly known as a bond type lease. Id. at 324-25.
121. Id. at 360.
122. Id. at 351.
garding residual value by pointing out that the assessed value of the land, $812,690, if it appreciated at 4.7% per year, would result in a land value alone of $3,150,000 in thirty years.\footnote{123} The court disregarded the expert's opinion, however, because the appraised value of the property did not reflect fair market value.

The court found the testimony of the IRS's real estate expert more persuasive. His testimony, unlike that of the other expert, was based on a thorough investigation of the property and the details of the actual transaction. The IRS expert familiarized himself with the physical aspects of the property, the neighborhood, and the city, and examined the construction and the potential obsolescence of the property. His testimony focused on the economic gain to the buyer-lessors in the absence of any tax advantages. He examined two types of economic gain: (1) net income or loss, \textit{i.e.}, cash flow; and (2) net proceeds resulting from sale, condemnation, and mortgage financing. He assumed that the lessee probably would exercise its right to extend the lease through the first option period because the lessee was expected to occupy the premises "through the normal life expectancy of the viability of the market area the store was designed to serve."\footnote{124} For various cogent and well-supported reasons, the expert did not consider possible returns beyond the first option period.\footnote{125}

As to cash flows, the IRS expert noted that the lease rental payments amortized ninety percent of the principal amount of the mortgage notes, leaving a balloon payment of $313,750 remaining due at the end of the loan period. He assumed refinancing at the end of the initial term of the lease at the original mortgage rate and concluded that the lessors would receive only $23,000 per year of pre-tax flow.\footnote{126} He concluded that the present value of this income thirty years in the future would not justify the $334,000 orig-

\footnote{123} Id.\footnote{124} Id. at 354.\footnote{125} This was "due to the highly speculative nature of any predictions concerning the future of the property, and the fact that the value of the economic returns produced by an extension of the lease past 2021 would be relatively small on a discounted basis." Id. at 355.\footnote{126} Id. at 356. The expert pointed out that at the end of the initial lease, the taxpayers had the option of making capital contributions to cover the balloon payment or refinancing the balloon. Refinancing was assumed in light of the rent provision in the lease for subsequent option periods and the probability that the lessee would continue its occupancy for the first renewal period.
inal investment by the lessors and that therefore no economic gain would result during that period.

As to possible economic gain on sale, the IRS expert determined that the lessors would suffer a loss because the lessee could purchase the lessor's interest for $50,000. Disregarding the option, the expert stated that the lessor's "opportunity for gain on any sale will be limited to any then-present value of the rental income flow and the residual, the combined total of which . . . is minimal and in any event less than [the lessor's] investment." The court concluded that, because the lease gave the lessee authority to sublet the property or to assign its leasehold interest after the original term of the lease, the lessee had virtually total control of the property even if the property were sold.

The IRS expert also suggested that economic gain might result from condemnation, but that because the "act of condemnation lies wholly beyond the control of the owner or the lessee of property, and since the amounts of awards cannot even be speculated in advance," the gain is not a factor which a prospective investor would look to in investing in the property.

Finally, the IRS expert concluded that there was no economic gain from repayment of the mortgage notes because gain would result only if there was a substantial decrease in the original interest rate of 5.125%—an unlikely event given the fact that the original rate was below the prevailing commercial lending rate and interest rates were escalating.

A case with facts very similar to those of Estate of Franklin was David L. Narver, Jr., in which the court decided that the lessors had no investment in the leased property because they "would have nothing to lose by abandoning the transaction." In Narver,
A corporation sold a building to two limited partnerships which immediately leased the property back to the corporation's wholly owned subsidiary. The purchase price was fixed at $1,800,000 with an initial payment to the seller of $180,000 as prepaid interest. Seven percent interest was to be paid on the unpaid balance of the purchase price, which was to be amortized over a twenty-year period. The indebtedness was nonrecourse. Under the purchase agreement, the buyers were to pay taxes and insurance, with the corporate seller entitled to sell upon the buyers' default on these payments. The term of the lease was ten years with an option in the lessee to renew the lease for eight five-year periods. Rent was $1,000 per month during the initial term and $1,000 per month plus a cost of living adjustment for the renewal periods. The lessees had the right to purchase the building site at the end of the ten year lease at a price set by appraisers, but in no case less than $200,000. The sublease from the lessees to the wholly owned subsidiary contained the same terms as the lease except that the partnerships did not assign their options to purchase the building or extend the lease beyond the ten years.

A key factor in the court's analysis in Narver was the fair market value of the property, established by experts to be $412,000. In addition, "the absence of multiparty arm's-length dealing, and the circumstances surrounding payments under the net lease on the partnerships' nonrecourse indebtedness," led the court to conclude that "the transaction in issue lacked from the outset the substance necessary to justify treating it as a sale." The court also did not consider the transaction to be a financing device. Because the "partnerships were not personally liable for the purchase price, there was only a mere chance that a genuine debt obligation would arise at some future time when the partnerships' obligation under the agreement of purchase would be reduced to a figure more in line with the building's fair market value." Thus, the seller in fact advanced no money to the limited partners, nor had the partnerships secured the use of forbearance of money under the

133. Id. at 65.
134. There was extensive discussion of expert opinion on valuing the property. Id. at 99-98.
135. Id. at 99-100.
136. Id. at 101.
circumstances.\footnote{Id.}

In contrast to \textit{Estate of Franklin, Hilton, and Narver} is \textit{Dunlap v. Commissioner},\footnote{74 T.C. 1377 (1980).} in which the court found a valid sale-leaseback. There, Safeway Stores, Inc. sold for $8,800,000 a warehouse distribution center to El Paso Properties, a single purpose financing corporation. El Paso in turn transferred title to the property to certain investors, one of whom was Dunlap. Simultaneously with the sale, the property was leased back to Safeway for twenty-five years under the terms of a net lease. Safeway had the option to extend the term of the lease for six additional five-year terms at an annual rent of $264,000. There was no purchase option upon the expiration of the sixth renewal term. Safeway retained, however, the right to purchase the property after the tenth year of the original term for an amount equal to the discounted present value of the rent payable during the lease term. El Paso financed $8,413,000 of the purchase price by placing its secured notes with institutional investors. These notes were secured by an indenture of mortgage and deed of trust, and by an assignment of the Safeway lease and the rentals therefrom. The investors were not liable personally on these notes. The remainder of the purchase price was financed by the individual investors.\footnote{Id. at 1405. Dunlap made a $116,000 cash payment which was transferred totally to Safeway. None of the money went to the promotors of the tax shelter.} The rent payable under the net lease, $761,507 annually, was sufficient to repay the mortgage with interest during the original twenty-five year term.

The Commissioner first contended that the sale-leaseback transaction was a two-party financing arrangement between the seller and the institutional investor similar to the arrangement in \textit{Lazarus}. The taxpayers, on the other hand, argued that the transaction was a bona fide three-party transaction similar to the arrangement in \textit{Lyon}. The Commissioner argued that to have a bona fide three-party transaction, the taxpayer-lessee must assume personal liability on the loan. Furthermore, he contended that a two-party transaction was evidenced by the fact that: (1) the institutional investors would not carry the secured notes in the event Safeway terminated the lease agreement by purchase of the distribution
center; (2) Safeway had to furnish the institutional investors with financial statements; and (3) the rent paid under the initial lease term approximated the principal and interest due under the secured loan. The court disagreed with the Commissioner's contentions. The court stated, as it had in *Hilton*,<sup>140</sup> that personal liability was a "neutral factor" in determining the substance of the transaction.<sup>141</sup> Also neutral was the fact that the rent was geared to the cost of interest and mortgage amortization. The court determined that if Safeway terminated the lease agreement, the investors would pay off the mortgage because the purchase price was set at an amount approximating the remaining balance on the mortgage and the property was subject to a lien as long as the mortgage was not paid off.<sup>142</sup> Thus, the court found no merit in the Commissioner's assertion as to the investor's obligations. Finally, the court concluded that no evidence existed "as to the use or dependence placed upon [the financial] statements by the institutional investors."<sup>143</sup> The court pointed out that El Paso also furnished the institutional investors with its financial statements and balance sheets.

The Commissioner's second argument was that the transaction was a "sham" entered into for the purpose of creating tax losses. The court rejected this argument on a number of grounds. First, Dunlap had a legitimate business reason for investing in the property.<sup>144</sup> Second, Dunlap made a "bona fide investment in the property," evidenced by his $116,000 down payment to Safeway rather than to the tax shelter promoters.<sup>145</sup> Third, the possibility existed that Dunlap would own the property eventually because Safeway had no option to purchase the property after the sixth renewal term.<sup>146</sup>

141. 74 T.C. at 1435.
142. *Id.* at 1435-36.
143. *Id.* at 1436.
144. *Id.* Dunlap thought the warehouse location was in an expanding area where real estate values would appreciate.
145. *Id.* at 1437.
146. *Id.*
This section presents a decision model intended to assist parties involved in sale-leaseback transactions. A decision model is a framework consisting of a series of steps, each involving one or more considerations to be used in making a decision. This model uses only factors discussed in the court cases analyzed in Part II. At some places in the model no cases are available to illustrate specific points making it necessary to devise hypothetical situations. Following the decision model gives results consistent with the outcomes of the courts’ decisions.

Although the model relates to sale-leaseback transactions, it also is useful in cases without a leaseback of property, e.g., a lease with an option to purchase. It does not apply, however, to trust-leasebacks, gift-leasebacks, and leasebacks involving related parties.147

Step I: Financial Institutions as Parties to the Transaction

For purposes of this step, a financial institution is a bank, savings and loan association, trust company, sales finance company, insurance company, or any other institution engaged in financing arrangements on an on-going basis.148

1. Is the Buyer-Lessor a Financial Institution?

Generally, when a financial institution is the buyer-lessee in a

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147. See note 5 supra.

148. In many of the early sale-leaseback cases financial institutions were direct parties to the transaction, usually serving as the buyer-lessee. In later cases financial institutions, although not direct lessees or lessors, nonetheless were involved as third parties. They provided funds to the buyer-lessee to enable him to purchase the property. The sale-leaseback cases fail to articulate clearly the difference between two- and three-party transactions which involve financial institutions. The Supreme Court in Lyon recognized the important distinction between these two types of situations and distinguished the earlier Supreme Court case, Lazarus, on the ground that Lazarus involved only two parties—the lessee and a trust company—whereas Lyon involved three parties—the lessee, lessor, and the independent mortgagee. The Court noted that the presence of the independent mortgagee was what “significantly distinguish[ed] this case from Lazarus.” 435 U.S. at 576. The Court failed, however, to elaborate on this distinction. After reading the cases in this area, the key factor in the two-party cases apparently is whether the buyer-lessee is a financial institution and, in the three-party cases, whether the buyer-lessee is a mere conduit for the loan payments from the seller-lessee to the third party financial institution.
sale-leaseback transaction, in either a two- or three-party transaction, a financing arrangement exists. In all sale-leaseback cases cited in which a financial institution was the buyer-lessee, the courts found a financing device.\textsuperscript{149} The conduct of the seller-lessee was particularly pertinent in determining that there was a loan or mortgage agreement, although the conduct of the buyer-lessee also was important. The seller-lessee typically needed capital, initiated the transaction, and merely induced the financial institution to furnish the funds.\textsuperscript{150}

In one limited circumstance a financing arrangement would not exist even though the buyer-lessee is a financial institution. This is when the financial institution acquires the property for its own investment or business purpose. Because banks often are limited by state and federal law as to the types and amounts of their investments,\textsuperscript{151} a valid sale is unlikely when a bank is the buyer-lessee. Financing companies and trust companies, however, frequently are under no such restrictions. Thus, to determine whether these institutions are seeking the property for their own purposes, the courts should examine closely whether the institution initiates the trans-

\textsuperscript{149} See notes 23-43 & accompanying text supra.

\textsuperscript{150} For example, in Paul W Frenzel, 32 T.C.M. (P-H) \textsuperscript{1} 63,276 (1963), the seller-lessee tried to obtain 100\% financing for the construction of a warehouse but was unable to obtain even a 75\% mortgage loan. The Frenzels, therefore, entered into a sale-leaseback transaction with a trust company. The trust company ignored the essential features of a lease, such as the sublessee's easement rights. This indicated that the trustee was "not too concerned with permanent possession." Id. at 1586. In addition, the trust company treated the transaction as a mortgage on its books, and the expenses involved in the transaction were paid by the buyer-lessee, as was common in a financing deal. All of these actions were typical for financial institutions in loan situations and indicated a financing device.

In Helvering v. F & R Lazarus & Co., \textsuperscript{2} 308 U.S. 252 (1939), Commissioner v. H.F Neighbors Realty, 81 F.2d 173 (6th Cir. 1936), and Shillito v. United States, 42-2 U.S. Tax Cas. (CCH) \textsuperscript{3} \$ 9712 (S.D. Ohio 1942), the buyer-lessors were financial institutions. In all of these cases, trust certificate devices were used, a device enabling the seller-lessees to obtain capital for their purposes. In Lazarus, the seller-lessee sought to reduce its current indebtedness and obtain funds to purchase a stock interest in another department store. Because of the local taxation of mortgage bonds, the trust certificate device, according to the bank president, was the only feasible plan. 101 F.2d at 729. In Neighbors, the company-lessee approached a trust company for a loan to provide the needed funds for reduction of its indebtedness, but the interest rate of six percent was considered too high. 81 F.2d at 173-74. A trust certificate device was used instead. The Shillito Department Store likewise entered into a trust arrangement after negotiating with investment bankers "with the view to borrowing money on serial notes." 42-2 U.S. Tax Cas. (CCH) at 10,684.

\textsuperscript{151} In particular, banks are regulated as to their real estate acquisitions.
action, whether the board of directors of the institution approves the transaction as a purchase of property, how the institution treats the transaction on its books, and whether the institution makes an investigation of the property similar to that made by a potential owner.\textsuperscript{152}

To summarize the decision model thus far: when, in a two- or three-party transaction, the buyer-lessee is a financial institution not seeking the property for its own purposes, the conclusion mandated is that the transaction constitutes a financing arrangement;\textsuperscript{153} no further analysis is necessary.

2. \textit{Is a Financial Institution an Indirect Party to the Sale-Leaseback, and Is the Buyer-Lessee a Mere Conduit for the Loan Payments from the Seller-Lessee to the Third Party Financial Institution?}

In a sale-leaseback transaction in which a financial institution is a third party but not the buyer-lessee or the seller-lessee, the transaction is more difficult to analyze.\textsuperscript{154} The buyer-lessee may be

\textsuperscript{152} No sale-leaseback case cited dealt with a financial institution that sought property for its own purposes. However, in an option to purchase case, Northwest Acceptance Corp. v. Commissioner, 500 F.2d 1222 (9th Cir. 1974), aff'd 58 T.C. 836 (1972), a sales finance company, which usually financed the purchase of equipment by leasing the equipment, was found not to be engaged in financing when it purchased lease contracts from a company that was in the business of leasing equipment. The financing company was, in effect, taking over these leasing agreements and was considered to have stepped into the shoes of the company as owner of the property. Thus, the transactions at issue in that case were considered valid leases, not conditional sales, and the lessor was entitled to both the depreciation deduction and the investment credit.

\textsuperscript{153} If there is a three-party transaction and the buyer-lessee is a financing institution not seeking the property as an investment, there will be a financing arrangement. Although no existing cases deal with this situation, the same analysis as in a two-party transaction would apply.

When a two- or three-party transaction occurs in which a financial institution is the seller-lessee, there may or may not be a financing arrangement. For example, no financing device existed in Lyon when the lessee bank sought to finance the construction of a building through the sale-leaseback device. In part, this was due to federal and state restrictions placed upon bank indebtedness. Similarly, in Arkansas Bank & Trust Co. v United States, 224 F Supp. 171 (W.D. Ark. 1963), an option to purchase case, the court considered the bank restrictions on indebtedness a key factor in its determination that there was a true lease. Both of these cases also referred to other important factors supporting their decision, such as reasonableness of payments made under the lease. Therefore, if a financial institution is the seller-lessee, the courts should proceed with the analysis.

\textsuperscript{154} Most sale-leaseback cases fall within this category.
a mere "conduit" for providing loan proceeds from the financial institution to the seller-lessee and for providing loan payments in the form of rent from the seller-lessee to the financial institution. When the buyer is such a conduit a financing arrangement exists. No single factor, however, points conclusively to the existence of a mere conduit of mortgage payments from a seller-lessee through a buyer-lessee to a financial institution. Steps III through IX of this decision model give a rank order to the factors mentioned in the various cases to assist parties in understanding which factors are more controlling.

To summarize part 2 of Step I of the decision model: the courts

155. Miller v. Commissioner, 68 T.C. 767 (1977); see note 44 & accompanying text supra. Miller best exemplifies the application of this theory. The court found that the transaction was a financing arrangement because, inter alia, the lease term coincided with the term of the loan, the rent payments roughly coincided with the term of the loan, the property was certain to return to the original owner, the financial institution looked to the seller-lessee and not the buyer-lessee for assurance that the loan payments would be made, and the lessor's payment indicated no investment in the property. Because all the factors in Miller are unlikely to appear together in a single sale-leaseback case, the analysis will be more difficult in most cases. In addition, it is not clear from Miller which factors are most important.

In Hilton v. Commissioner, 74 T.C. 305 (1980); see note 119 & accompanying text supra, a case involving nonrecourse financing, the court found a conduit arrangement. There, the initial lease term coincided with the term of the loan. The rental payments made by the lessee covered 90% of the principal note represented by the mortgage on the property. At the end of the initial term of the lease, the seller-lessee had the option of either making capital contributions to cover a sizeable balloon payment or of refinancing the balloon. The property could return to the lessee because of a repurchase option. The buyers made no investment in the property. They put up $110,000 of the $3,137,700 purchase price—all of which went to pay commission fees, and none of it passing to the seller-lessee. The "deal" was packaged by a law firm as a financing transaction and was not negotiated at arm's length. In fact, it became effective only after the original seller-lessee negotiated and financed the lease arrangement. Unlike Miller, in which it was obvious from all the circumstances that CDC was a mere conduit for the loan payments, in Hilton the testimony of two experts had to be examined to determine the true nature of the transaction. In a case like Hilton, the court should proceed with the analysis because most of the factors considered important in that case are referred to in subsequent steps of the decision model.

156. For example, in Frank Lyon Co. v. United States, 435 U.S. 561 (1978); see notes 88-97 & accompanying text supra, in which the conduit theory was argued, the sale-leaseback and financing arrangements were effected simultaneously, and the buyer's rent payment equaled the mortgage payments. The arrangement was found to be a valid sale-leaseback, however, because the buyer put up a substantial sum of its own funds for the investment and was personally liable on the loan, the property would not return to the lessee automatically, and the option price was reasonable.
are likely to find that a financing arrangement exists if the buyer-lessee appears to be a mere conduit for the loan and loan payments. If it is not clear that the buyer-lessee is the mere conduit for the payment of the loan, the analysis should continue. The analysis also should continue if there is a three-party transaction in which a financial institution is not involved as the third party.

Step II: Conduit Where No Financial Institution Is Involved

The conduit theory also may apply when a third party lender is not a financial institution. The factors are the same as those which apply when a financial institution is involved: (1) the sale-leaseback and financing are arranged simultaneously; (2) the lease term coincides with the term of the loan; (3) the rent payments coincide with the interest and principal payments; and (4) the lender is assured of obtaining the interest payment from the seller-lessee because the buyer-lessee is undercapitalized or otherwise unlikely to make the payments.

Unger v. Campbell,157 a sale-leaseback case between related parties, illustrates the conduit principle in a three-party transaction with no financial institution. In Unger, a son sold equipment to his mother and then leased it back. To finance the purchase the mother signed an unsecured note to the son’s company. The mother, an immigrant who barely spoke English, had a net worth of approximately $8,000 at the time she signed the note. The rental payments of $2,000 per month were satisfied by the son depositing a check in his mother’s bank account. The payments on the unsecured note were satisfied by the son drawing a check in the amount of $1,500. The court concluded that the mother was a mere conduit for the son’s payments of rent and interest. The court correctly characterized the transaction as a sham and not a true financing device. The sale-leaseback was entered into not for any business purpose, but solely for tax purposes.

Here, as in Step I, part 2, other factors may override the four indicators of a conduit. Those other factors include a significant investment by the lessor, the probability that the property will remain with the buyer, and the fact that a transaction is at arm’s-

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157. 61-1 U.S. Tax Cas. (CCH) ¶ 9163 (N.D. Tex. 1960).
Step III. The Likelihood That the Leased Property Will Revert Automatically to the Seller-Lessee

If the title to the leased property is retained by or will revert to the seller-lessee at the end of the lease term, the seller-lessee should be considered the owner because the lessee not only possesses the property during the lease term but also will own the property at the end of that term. The cases in the sale-leaseback area, and in particular the option to purchase cases, indicate the importance of this factor.\(^{159}\)

To summarize Step III of the decision model: if title is to revert to the seller-lessee by the end of the lease or if title is retained by the seller-lessee, the courts should find a financing device. The absence of the transfer of title has no probative value. Thus, the analysis must continue.

Step IV Bargain Purchase Price or Economic Compulsion to Exercise the Option

When courts in sale-leaseback cases determine that there is "economic compulsion" for the lessee to exercise the option, they unanimously conclude that a financing device exists.\(^{160}\) This factor similarly is determinative in option to purchase cases.\(^{161}\)

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158. See Dunlap v. Commissioner, 74 T.C. 1377 (1980), in which the Commissioner in effect argued that there was a conduit relationship by asserting that the transaction between Safeway Stores, a financing corporation, and certain investors was like Lazarus and not Lyon. See note 138 & accompanying text supra.

159. In Miller v. Commissioner, 68 T.C. 767 (1977), the seller-lessee had a reversionary interest that guaranteed that the property would return to the college. See notes 44-46 & accompanying text supra. In Cynthia Schaefer, 49 T.C.M. (P-H) \# 80,440 (1980), title never was transferred to the buyer. See notes 58-72 & accompanying text supra. The court observed that "it is incredible that a purchaser would buy a piece of real property without obtaining good title." 49 T.C.M. (P-H) at 1916. A transfer of title is much more common in option to purchase cases in which, whenever title is transferred to the lessee by the end of the lease term, a financing arrangement results. See Hill v. Commissioner, 38 T.C.M. (CCH) 481 (1979); Rochester Dev. Corp. v. Commissioner, 36 T.C.M. (CCH) 1213 (1977); Mary A. Browning, 9 T.C.M. (CCH) 1061 (1950); Renner & Marcus, Inc., 9 T.C.M. (CCH) 451 (1950); Bowen v. Commissioner, 12 T.C.M. (CCH) 446 (1949); Helser Mach. & Marine Works, Inc., 39 B.T.A. 644 (1939).

160. See notes 23-43 & accompanying text supra.

161. When "economic compulsion" exists in option to purchase contexts, there is a sale,
rationale as in the prior step is important here. If the lessee, in addition to having a possessory interest in the property, is likely to own the property at the end of the lease term because the option price is so low as to be irresistible, then he should be considered the owner from the outset.

Unlike the prior step, however, one cannot merely examine the lease documents to determine "economic compulsion." In general, but not always, "economic compulsion" depends on value considerations. The main factor is the reasonableness of the repurchase option price. If the option price is unreasonably low, there will be compulsion to exercise the option. Reasonableness is determined at the time of execution of the original lease agreement. A hindsight approach generally is shunned because numerous circumstances could arise during the term of the lease to change the value of the property. The fact that the option may be exercisable at different times during the term and renewal terms of the lease adds to the complexity of the analysis and demands that a prospective approach be used. To complicate the matter further, the courts provide little guidance as to what is reasonable. 162

Another important factor in determining economic compulsion is the useful life of the property subject to the lease. An option is unlikely to be exercised if the property is not going to be useful at not a lease, and the lessee is treated as the owner. See M & W Gear Co. v. Commissioner, 446 F.2d 841 (7th Cir. 1971), aff'g in part & rev'g in part 54 T.C. 385 (1970); Haggard v. Commissioner, 241 F.2d 288 (9th Cir. 1956); Watson v. Commissioner, 62 F.2d 35 (9th Cir. 1932); Jefferson Gas Coal Co. v. Commissioner, 52 F.2d 120 (3d Cir. 1931); Burroughs Adding Mach. Co. v. Bogdon, 9 F.2d 54 (8th Cir. 1925); Cal-Mame Foods, Inc. v. Commissioner, 36 T.C.M. (CCH) 383 (1977); Smith v. Commissioner, 51 T.C. 429 (1968); Van Valkenburgh v. Commissioner, 26 T.C.M. (CCH) 753 (1967); Lensing v. Commissioner, 20 T.C.M. (CCH) 1399 (1961); Whitman v. Commissioner, 10 T.C.M. (CCH) 250 (1951); McWaters v. Commissioner, 9 T.C.M. (CCH) 507 (1950); Bowen v. Commissioner, 12 T.C. 446 (1949); Judson Mills, 11 T.C. 25 (1948); Helser Mach. & Marine Works, Inc. v. Commissioner, 39 B.T.A. 644 (1939); Smith v. Commissioner, 70 B.T.A. 27 (1930); Holeproof Hosiery Co. v. Commissioner, 11 B.T.A. 547 (1928).

162. In Frank Lyon Co. v. United States, 435 U.S. 561 (1978), the Supreme Court refused to speculate on whether the renewals or repurchase options would be exercised but did conclude, apparently without the use of appraisals or experts, that the option prices were reasonable. Similarly, in American Realty Trust v. United States, 495 F.2d 1195 (4th Cir. 1974), and Belz Inv. Co. v. Commissioner, 72 T.C. 1209 (1979), the option prices were considered by the courts to be reasonable but the bases for these determinations were unclear. See notes 98-106 & accompanying text supra. See also Keeling v. Commissioner, 30 T.C.M. (CCH) 954, 959 (1971); notes 78-81 & accompanying text supra.
the time the option is exercisable. This useful life factor is discussed in the next step of the decision model.

A determination of "economic compulsion" may not always depend purely on fair market value considerations, i.e., the anticipated value of the property at the end of the lease term and the amount that must be paid at that time. In fact, the option price may be nominal and yet no economic compulsion may result. Conversely, the option price may be reasonable yet economic compulsion may exist.

To summarize Step IV of the decision model: if the seller-lessee is compelled economically to exercise the repurchase option, the courts should consider the transaction a financing arrangement. They need make no further inquiries. Based on the above discussion, economic compulsion could exist when the repurchase option is nominal in value in relation to the expected value of the property or when a valid business reason existing at the time of the initial sale-lease transaction compels the exercise of the option, unless some other reason, such as the financial condition of the lessee, indicates that the option will not be exercised. Absent economic compulsion the court should proceed with the analysis.

**Step V: Comparison of Lease Terms with Useful Life of Property**

Another key consideration is whether the lease term plus renewals is greater than or equal to the useful life of the property. A rationale similar to that in the prior three steps exists here: a seller-lessee entitled to possess and use the property for its entire economic life should be considered the owner of the property. Under these circumstances the lessee surrenders nothing as a result of the sale-leaseback.

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163. See Keeling v. Commissioner, 30 T.C.M. (CCH) 954 (1971), in which despite a low option price the taxpayer's financial condition indicated that the option would not be exercised.

164. See Comtel Corp. v. Commissioner, 376 F.2d 791 (2d Cir. 1967) aff'g 45 T.C. 294 (1965), an option to purchase case, in which stock in a hotel was "sold" for $8,000,000 and was bought back several months later for $8,872,000. Although this option price was a substantial sum, the court found economic compulsion because of the taxpayer's overriding desire to have the underlying assets that the stock represented. This business purpose existed before the agreement was executed and was the sole purpose behind the transaction. Id. at 796.
This test varies depending on the subject of the lease. If land, which ostensibly lasts forever, is the subject of the lease, the lease term plus renewals essentially must be in perpetuity. When both land and buildings are the subject of the lease it is difficult to separate the life of the land from that of the buildings. The courts generally fail to articulate any clear rule here even though most sale-leaseback cases fall into this category.\textsuperscript{166} If the term lasts forever, as in several cases discussed earlier, a financing arrangement should be deemed to exist.\textsuperscript{166} When only buildings or equipment are the subject of the lease, the useful life is more easily determined.\textsuperscript{167} Although easily determinable for buildings and equipment, useful life does not appear to be a major court consideration.

In option to purchase cases, useful life is more likely to be examined.\textsuperscript{168} Unfortunately, even in these cases, many of which involve equipment only, application of the useful life criterion is inconsistent. This probably is due to the difficulty of determining economic life. Although courts are accustomed to calculating useful life for depreciation purposes, they are not well-equipped, in the absence of expert opinion, to discuss the various factors which enter into the determination of useful life.

To summarize Step V of the decision model: when the term of the lease plus renewals clearly is greater than or equal to the useful life of the property, the courts should find a financing device. When the economic life of the property is unclear or difficult to determine, the courts should proceed with the analysis.

\textit{Step VI: Rate of Return Similarities}

With the typical loan, the rate of return is a nonfluctuating fixed percentage over a stated period of time. Were a sale-leaseback con-
strued as a loan, the rent most likely would be fixed over the lease term and the option price would be exercisable at various times during the term at a flat percentage of the purchase price, declining each year. Certainly many sale-leaseback arrangements could be construed as a loan because the rent could be considered interest by converting the rent into a percentage of the sales price and the option price could be considered the remaining principal due. Apparently, therefore, the rate of return is not probative unless it is compared with the generally expected rate of return for financing of the kind in question and, more importantly, compared to the fair market rental value and option prices.¹⁶⁹

1. Are There No Rate of Return Similarities?

No financing arrangement exists when the rental payments and option price in a sale-leaseback transaction have no loan similarities. This usually occurs when the rentals are based on a percentage of profits or of gross revenue. When rents are so determined there generally is a risk normally not associated with a loan transaction.¹⁷⁰

2. Are There Clear Rate of Return Similarities?

In many cases the loan similarities of rentals and options to interest and principal are obvious; the parties often make no attempt to disguise these characteristics.¹⁷¹ Most financing arrangements,

¹⁶⁹. A rate of return test is part of the IRS Audit Manual, "Equipment Leasing Tax Shelters" (CCH) ch. 800, ¶ 873. There are, however, no such guidelines for real estate.

¹⁷⁰. Thus in Belz Inv. Co. v. Commissioner, 72 T.C. 1209 (1979), an important factor in the court's determination of no financing arrangement was the fact that the rents were based on a percentage of revenues from the motel, restaurant, and bar which were the subject of the lease. The court found that these revenues could not be calculated accurately in advance, given the newness of the business. Thus uncertainty existed as to whether these payments would be made. But Cynthia Schaefer, 49 T.C.M. (P-H) ¶ 80,440 (1980), illustrates that with an established ongoing business in which rents based on profits or gross revenues are not uncertain and the lender could be assured of a risk-free return, there still may be a financing arrangement. In a case such as Schaefer, further analysis is necessary before concluding there is or is not a financing arrangement.

¹⁷¹. Sun Oil Co. v. Commissioner, 562 F.2d 258 (3d Cir. 1977), is a clear example. See notes 49-57 & accompanying text supra. The rentals were "mathematically geared to amortize the moneys advanced by the trust at the agreed annual rate of 4.625% over the primary term of the lease." 562 F.2d at 268. Also there was a Schedule of Direct Reduction Loan attached to the leases which set forth the interest rate, the amount of the principal loan, the
however, attempt to disguise any loan characteristics. For example, a financing arrangement could arise when there is no option to purchase, and the rent payments thus would constitute both principal and interest. Although no sale-leaseback case has dealt with this situation, such a circumstance most likely would occur when the life of the property is coextensive with the term of the lease. In such a context no option is necessary to protect the interests of the lessee.\textsuperscript{172} A financing arrangement also may arise when there are no rental payments. Thus, the option price would constitute both interest and principal. Again, no cited sale-leaseback case has dealt with this situation.\textsuperscript{173} Such a case most likely would arise when the time between execution of the transaction and exercise of the option is so short that no substantial hardship could result to the lessor-lender from not receiving rent for a short period of time.

In the typical financing circumstance in which the loan characteristics are disguised, both rent payments and an option price are present. Under these circumstances, either: (1) the rents could represent not only interest but part of the principal; or (2) the rent could represent part interest and the option price could represent part interest and principal. The first situation is more likely to occur given the time-value of money. In \textit{Frito-Lay v. United


\textsuperscript{173} See note 164 \textit{supra}.
States, involving a two-party transaction and no financial institution, the rentals paid by Frito-Lay to Jones represented 7.5% of the total cost of the construction. The IRS succeeded in its assertion that the construction cost constituted the principal, 4.33% of the rentals constituted interest (which was allowed as a deduction), and the remaining 3.2% of the rentals represented return of principal. Transactions such as Frito-Lay in which loan characteristics are disguised are difficult to analyze. Therefore, in these circumstances, courts should not find a financing arrangement but should proceed with the analysis. If, however, a court finds that (1) the rentals represent interest on the “loan” or “sales” proceeds, (2) the option prices represent the unamortized principal payment, (3) the rentals and option prices represent going rates for investments of that type on the market, and (4) the rents and options do not reflect fair market value rents and options, the court should conclude that a financing arrangement exists; no further analysis is necessary.

Step VII. Value Disparities

Substantial disparity in the actual payments made under the lease and their fair market equivalents clearly can indicate a financing arrangement. The actual payments of consequence are the sales price, rental payments, and option price. As mentioned in Step IV, reasonable option prices are very important in determining the validity of a sale-leaseback. The rentals and sales prices also are relevant.

1. Is the Sales Price Too High or Too Low in Relation to the Fair Market Value of the Property or the Cash Flow from the Property?

The sales price in relation to the fair market value of the property and to the value of the interest purchased are key considera-

175. The going rate of return is the rate of return a similar investment would yield. Thus, a speculative investment would yield a high interest rate relative to a risk-free investment. An example of a risk-free investment is a bank account or treasury bill.
176. In effect, by determining that the rent is interest, the court determines that the rent does not reflect fair market rental values. See note 171 supra.
tions in determining whether a sale-leaseback is valid. The cases indicate that the sales price is extremely important when nonrecourse financing is involved. In a nonrecourse context in which the sales price of the property exceeds its fair market value, the leasing transaction is not recognized for tax purposes.\textsuperscript{177}

In a sale-leaseback in which recourse financing is involved, a low sales price rather than a high sales price is a key consideration. In several of the cases discussed earlier, in which a financial institution was the buyer-lessee, a low sales price indicated a financing arrangement.\textsuperscript{178} In those cases the lessor-lender was not willing to supply funds to the full extent of the property value.

The courts do not examine the sales price unless it is blatantly unreasonable. Apparently the courts believe that a small difference between the sales price and the value of the property is unimportant given the difficulty of making that determination.\textsuperscript{179} In only

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\textsuperscript{177}. Estate of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1976); David L. Narver, Jr., 75 T.C. 53 (1980); see notes 115-118 \& accompanying text supra.
\textsuperscript{178}. See notes 23-43 \& accompanying text supra.
\textsuperscript{179}. The difficulty of determining the fair market value of the property is evidenced by the sale-leaseback cases in which the issue is whether a sale or a like-kind exchange has taken place. In Standard Envelope Mfg. Co. v. Commissioner, 15 T.C. 41 (1950), the experts' estimates of the property value varied from $60,000 to $132,750. The discrepancy was in part due to the fact that, because some appraisers had no personal familiarity with comparable properties, they examined courthouse records. Yet, in Century Elec. Co. v. Commissioner, 192 F.2d 155 (8th Cir. 1951), aff'd 15 T.C. 581 (1950), cert. denied, 342 U.S. 954 (1952), the amounts on the real estate tax assessment records were considered to be the fair market value. In May Dep't Stores Co. v. Commissioner, 16 T.C. 547 (1951), the court determined the fair market value by looking at a recent purchase offer made by an independent third party. The court pointed out the importance of the timing factor, noting that the time of sale, not the time of trial or condemnation, was the proper time for examining fair market value. In Missouri Pac. R.R. v. United States, 497 F.2d 1386 (Ct. Cl. 1974), the seller and buyer had different bases for valuation. The buyer's appraiser based his estimate on capitalization of annual net income that the lessor might reasonably anticipate. The seller, on the other hand, obtained an appraisal excluding leasehold interests. The seller specifically asked the appraiser to appraise the land as if the buildings were owned by someone other than itself (thereby obviating the maintenance and service wage constrictions emanating from brotherhood involvement); were free and clear of any and all encumbrances (including leasehold interests); were salable and carried marketable title; and were to be exposed for sale in the open market without contingencies or restrictions. Id. at 1389.

As Missouri Pacific indicates, a multitude of factors affects fair market value. An example of one unusual factor occurred in Century Electric, in which the fact that the college was not subject to general state, city, and school taxes allegedly gave the property a "premium."
one case, *American Realty Trust*, did the court emphasize the reasonableness of the sales price. In that case, the sales price was a close gauge on the reasonableness of the option price because the options could be exercised shortly after the sale at values of eighty-eight to ninety-two percent of the sales price.\textsuperscript{180} In most instances, however, the courts do not even consider the reasonableness of the sales price.\textsuperscript{181}

With nonrecourse financing it is important not only to determine the reasonableness of the sales price but also to ensure that the value of the interest acquired by the buyer-lessee is not less than the amount paid for that interest. If the buyer can "abandon" the transaction because he has nothing to lose by doing so, the buyer's investment in the property is insufficient and he should not be considered the owner. In fact, when the value of the interest acquired is less than the amount paid for it, the motive behind the transaction should be examined. In such a case the buyer likely seeks tax losses.\textsuperscript{182}

Frequently, valuation depends upon the terms of the lease. For example, in *Standard Envelope*, the provision in the lease requiring the purchaser to invest up to $50,000 in improvements in the property was an important consideration in calculating the fair market value of the property transferred.

\textsuperscript{180} 498 F.2d at 1196.

\textsuperscript{181} In *Belz Inv. Co. v. Commissioner*, 72 T.C. 1209 (1979), the court was unclear as to whether the sales price reflected the fair market value. Arguably, it was reasonable because it included a $35,000 profit factor on a $1,502,000 price. In *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978), and *Frito-Lay, Inc. v. United States*, 209 F Supp. 886 (N.D. Ga. 1962), the selling prices arguably were unreasonably low, and certainly less than fair market value. In *Lyon*, the sales price of $7,640,000 was based on the parties' estimate of the cost of construction, and yet the actual cost was $10,000,000. In *Frito-Lay* the sales price similarly related to the cost of construction and not to the fair market value of the property constructed. There the court concentrated on the nominal option price in finding a financing device.

\textsuperscript{182} In *Hilton v. Commissioner*, 74 T.C. 305 (1980); see notes 119-130 & accompanying text supra, the amount the buyers paid for the property went to the lawyers for commission. On the basis of expert testimony, the court concluded that the buyer-lessee would obtain no economic gain from the rental payments, no gain on sale of the property, and no gain if the repurchase option were exercised. The court disregarded possible gain on condemnation because condemnation was not a likely event.

In *Cynthia Schaefer*, 49 T.C.M. (P-H) ¶ 80,440 (1980), the lessors made no initial payment for the property. The lessors could not gain from the sale of the property because any profit, up to $40,000, went to the lessee. In addition, the lessor could not gain from the rental payments because it was unlikely that more than $10,000 rent would be paid (even though the lease provided for a sharing of profits and all rent went to pay the purchase price of the property).
To summarize this part of Step VII: if nonrecourse financing is involved, the court should determine whether the sales price is greater than the fair market value of the property or whether the value of the interest purchased is less than the amount paid for that interest. If either of these circumstances exists the courts should find an invalid sale-leaseback arrangement. If recourse financing is involved and the sales price is significantly less than the fair market value of the property, there is a financing arrangement; otherwise the analysis should continue.

2. Do the Rental Payments Reflect Fair Market Value?

In all cited sale-leaseback cases in which the rent was reasonable a true lease was found. The reasonableness of the rent alone, however, is not determinative, for a financing arrangement may be found if other factors are overriding.

In all cited sale-leaseback cases in which the rentals are unreasonably low the court characterized the transaction as a financing device. High rents also may indicate a financing arrangement. Although no case in the sale-leaseback area illustrates this point, in the option to purchase cases high rentals frequently indicate financing devices. Application of rents to the option price is a significant factor as well in option to purchase cases, but in sale-leaseback cases this factor is not controlling.
To summarize: if the rents are unreasonably high or unreasonably low, this is indicative but not determinative of a financing arrangement. If the payments are not clearly unreasonable, the analysis should continue.

Step VIII. Benefits and Burdens: Does the Equity Interest Lie with the Seller-Lessee?

In a typical loan arrangement, the equity interest lies with the seller-lessee. The lender assumes little risk and also possesses little opportunity for gain. An equity interest comprises a number of factors, some of which already have been discussed. For example, high rents may indicate that the seller-lessee is building up an equity interest in the property. That the useful life of the property coincides or is less than the lease term plus renewals also indicates that the seller-lessee has an equity interest in the property. Similarly, the fact that title automatically reverts to the lessee or that the lessee is economically compelled to exercise the option indicates that the lessee holds an equity interest. Conversely, a sales price that exceeds the fair market value of the property or a gain from the property that is less than the investment indicates the absence of an equity interest.

Equity also includes all the "benefits and burdens" of ownership. The benefits that the courts have pointed to as indicating the existence of an equity interest are: (1) the benefits of appreciation; (2) the receipts of the condemnation award or other insurance proceeds; (3) the right to control the assignment of the lease; (4) the right to control the improvements on the leased property; and (5) the right to sublet the property.

The risks and responsibilities that courts use to indicate the ex-

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Stoker, Inc. v. Commissioner, 14 T.C. 441 (1950); Browning v. Commissioner, 9 T.C.M. (CCH) 1061 (1950); McWaters v. Commissioner, 9 T.C.M. (CCH) 507 (1950); Goldfields of America, Ltd. v. Commissioner, 44 B.T.A. 200 (1941); Helser Mach. & Marine Works, Inc., 39 B.T.A. 644 (1939).

In the option to purchase area some courts find a financing device when rents are applied to the option price. See, e.g., Smith v. Commissioner, 51 T.C. 429 (1968); Norman Van Valkenburgh, 36 T.C.M. (P-H) ¶ 67,162 (1967); Rev. Rul. 590, 1968-2 C.B. 66. But see Lester v. Commissioner, 32 T.C. 711 (1959); WBSR, Inc. v. Commissioner, 30 T.C. 747 (1958)

188. The IRS Audit Manual, "Equipment Leasing Tax Shelter" (CCH) ch. 800, ¶ 852 adopts a burdens and benefits test.
istence of an equity interest in the seller-lessee are: (1) the risks of
depreciation; (2) the responsibilities for making improvements; (3)
a provision that the lessee will insure the premises for the benefit
of the lessor; (4) an indemnity clause that holds the lessor-creditor
harmless against all liabilities; (5) personal liability on the loan; (6)
the existence of a net lease; (7) a provision that rent is to be paid
in all circumstances; (8) a provision that no diminution of the rent
will result from casualty or condemnation; and (9) the risk of cur-
rent operating losses.

Many of the provisions in lease forms are not and should not be
determinative of a valid sale-leaseback arrangement. Several courts
recognize that these provisions are "mere surplusage" in determin-
ing the validity of a lease transaction. Provisions which grant
one party the right to sublet or obtain condemnation proceeds, or
which allocate to one party the responsibility for carrying insur-
ance, paying taxes, maintaining the property, paying rent abso-
lutely, and indemnifying or holding the other party harmless
against liability, have been so considered.

Net lease arrangements are found in all the valid sale-lease-
back arrangements cited and thus are not indicative of ownership.
They should be given no special consideration by planners and
courts in the decision analysis. Similarly, the courts generally find
that receipt of condemnation awards is not controlling.

189. Hilton v. Commissioner, 74 T.C. 305 (1980); Cal-Maine Foods, Inc. v. Commissioner,
36 T.C.M. (CCH) 34,334 (1977); Keeling v. Commissioner, 30 T.C.M. (CCH) 30,969 (1971).

190. In a net lease, the lessee bears the burden of ordinary maintenance, repairs, taxes,
utility charges, and insurance, and he must keep the premises in good condition except for
reasonable wear.

191. In Belz Inv. Co. v. Commissioner, 72 T.C. 1209 (1979), and Frank Lyon Co. v. United
States, 435 U.S. 561 (1978), the condemnation award arguably benefited the lessee, but in
both cases the court found that the lessee was not the owner of the property. In Belz, the
lessee was entitled to insurance proceeds if the premises were destroyed and to all damages
awarded on condemnation. The court admitted that these provisions "might confer some
benefits on [the lessee] that a traditional lessee would not be expected to receive," and
noted "that the lease agreement in Frank Lyon contained insurance and condemnation
award provisions similar to those involved herein." 72 T.C. at 1229. In American Realty
Trust v. United States, 498 F.2d 1194 (4th Cir. 1974), the court also discussed the condem-
nation award. There, the phrasing of the award made it difficult to determine who had the
benefits or risk on condemnation. 498 F.2d at 1195. In Hilton, the judges heavily discounted
condemnation as a consideration in evaluating a potential source of economic gain because
"the act of condemnation lies wholly beyond the control of the owner or the lessee of prop-
erty, and since the amounts of awards cannot even be speculated in advance." 74 T.C. at
Like the receipts of the condemnation award, the burden of providing improvements is not a significant factor in the sale-leaseback cases. Most cases do not even mention this factor. In *American Realty Trust*, in which the lessee bore the cost of some capital improvements made on the property, the court never considered this factor and assigned ownership to the lessor. 192

A factor given considerable importance by the courts is the personal liability of the buyer-lessee on the loan, and this often is an indicator of a valid sale-leaseback transaction. 193 In contrast, some cases conclude that the absence of personal liability is a neutral factor. 194

Another important factor is control over the leased property. This factor is particularly significant when the lessee fails to consult the lessor as to major matters involving the leased property or contravenes an express lease agreement as to matters concerning the leased property. 195

To summarize Step VIII: if the court finds that the substantial burdens and benefits lie with the buyer-lessee they should find a valid sale-leaseback. If, however, the clear equity interest lies with the seller-lessee the transaction should be deemed a financing arrangement.

**Step IX. Purpose for Entering into the Transaction**

If, after analyzing all the above factors, the court still cannot

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358. There, the condemnation award went to the lessor unless the lessee made an offer to purchase the property at a price equal to the unpaid principal and interest of the notes outstanding.
192. 498 F.2d at 1198-99.
194. Dunlap v. Commissioner, 74 T.C. 1377 (1980); Hilton v. Commissioner, 74 T.C. 305 (1980). These cases did not disregard who bore the economic gain or loss from the appreciation or depreciation in the value of the property. Both courts examined cash flows in establishing this factor. See part 1 of Step VI of the decision model.
195. Cynthia Schaefer, 49 T.C.M. (P-H) ¶ 80,440 (1980), best illustrates this statement. In *Schaefer*, the lessee granted an option on the leased property and reduced the lessee's profits without the lessor's consent. Depreciation and rent deductions were denied. In David L. Narver, Jr., 75 T.C. 53 (1980), the seller-lessee executed a lease assignment to the original owner in partial payment of the lessee's purchase obligation to the original owner. No evidence existed, however, that the lessors were informed of this assignment of rents.
decide if the arrangement is a financing device, the court should examine the purpose behind the transaction.\textsuperscript{196} Usually, however, the presence of a valid business purpose for the transaction is not as important as the absence of a tax avoidance purpose.\textsuperscript{197}

To summarize this last step in the decision model: if the sale-leaseback transaction was entered into for a tax avoidance purpose, it should not be recognized as a valid sale-leaseback.

\textbf{Conclusion}

This Article has set out a basic framework for judges and planners in analyzing the complex area of sale-leaseback transactions. The decision model presented is based on sale-leaseback cases involving recourse and nonrecourse financing. The steps in the model can be summarized as follows:

\textit{Step I. Financial Institutions as Parties to the Transaction}

1. Is the buyer-lessee a financial institution?
   If no, the analysis should continue (Step I, part 2).
   If yes, but the financial institution is purchasing the property for its own investment purposes, go to Step II.
   If yes, and the financial institution is not purchasing the prop-

\textsuperscript{196} In Keeling v. Commissioner, 30 T.C.M. (CCH) 30,969 (1971), a major consideration in the court's determination that the agreement was not a financing arrangement was the fact that the petitioner did not initiate the sale-leaseback. The court stated that the sales "negotiations were apparently well along before petitioner even became aware of their existence." \textit{Id.} at 958.

\textsuperscript{197} In Hilton v. Commissioner, 74 T.C. 305 (1980), the court determined that the fact that the lessee had a financing purpose in entering into the transaction should not make any difference in determining the validity of the transaction. The court stated that the seller-lessee's financing requirement may be a valid business purpose to support a sale-leaseback transaction for tax purposes. \textit{Id.} at 346. The court recognized, however, that a tax avoidance purpose would result in an invalid sale-leaseback arrangement and concluded that there was "no justification for the petitioner's participation in this transaction apart from its tax consequences." \textit{Id.} at 361. In American Realty Trust v. United States, 498 F.2d 1194 (4th Cir. 1974), the court concluded that the deal was "not merely a tax avoidance device, that commercial considerations underlay it," specifically the availability of a wrap-around mortgage. 498 F.2d at 1198. In Frank Lyon Co. v. United States, 435 U.S. 561 (1978), the fact that the transaction was shaped by features other than tax avoidance—the diversification in the case of Lyon and the legal requirements in the case of the lessee-bank—was an important consideration. Similarly, the absence of evidence indicating that the transaction was tax motivated or a sham was pointed to in Belz Inv. Co. v. Commissioner, 72 T.C. 1209 (1979).
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Property for its own investment purposes, a financing arrangement exists. Whether the bank seeks the property as an investment is determined by the intent and conduct of the parties.

2. Is a financial institution an indirect party to the sale-leaseback transaction—i.e., neither lessor nor lessee?

If no, the courts should proceed to Step II.

If yes, does the buyer-lessee merely serve as a conduit for the payment of the loan from the seller-lessee to the financial institution? This is determined by examining the personal liability of the buyer-lessee on the loan, whether the loan was guaranteed by the seller-lessee, whether the buyer-lessee is undercapitalized, whether the loan payments coincide with the rent payments, whether the term of the loan coincides with the term of the lease, and whether the financial institution views the seller-lessee as the true debtor. If the court answers these questions affirmatively, the court should conclude that there is a financing arrangement. If it is not clear that the buyer-lessee is a mere conduit, the analysis should continue.

*Step II. Is There a Conduit Arrangement Even Though No Financial Institution Is Involved?*

The same factors discussed in part 2 of Step I should be considered. If a conduit relationship exists, there is a financing device. If no such relationship exists, the analysis should continue.

*Step III. Will the Property Revert Automatically to the Seller-Lessee by the End of the Lease Term?*

If yes, there is a financing arrangement.
If no, the analysis must continue.

*Step IV Is There a Bargain Purchase Price or Economic Compulsion to Exercise the Option?*

If economic compulsion to exercise the option exists, the court should find a financing transaction. Economic compulsion exists when the repurchase option is a bargain purchase option or when there is a valid business reason at the time of the initial sale-leaseback transaction which compels the exercise of the option. No compulsion exists if some other reason, such as the financial condi-
tion of the lessee, indicates that the option will not be exercised.
If there is no economic compulsion the analysis should continue.

Step V Is the Term of the Lease Plus Renewals Greater Than or Equal to the Useful Life of the Property

If yes, there is a financing device.
If no, the analysis should proceed.

Step VI. Rate of Return Similarities

1. Are there no rate of return similarities?
   If the buyer-lessee is not entitled to a definite risk-free return,
   no financing arrangement exists. There may be a valid sale-lease-
   back, partnership, or joint venture arrangement, so the analysis
   should continue.
2. Are there clear rate of return similarities?
   If no, the analysis should continue
   If yes, there is a financing arrangement.

Step VII. Value Disparities

1. Is the sales price too high or too low in relation to the fair
   market value of the property or the cash flow from the property?
   If nonrecourse financing is involved, courts should determine
   whether the sales price is greater than the fair market value of the
   property or whether the value of the interest purchased is less than
   the amount paid for that interest. If either of these circumstances
   exist, the court should find an invalid sale-leaseback arrangement.
   If recourse financing is involved, the analysis should continue.
2. Are the rental payments reflective of fair market value?
   If the rents are unreasonably low or unreasonably high, this is
   indicative but not determinative of a financing arrangement. If the
   payments are not clearly unreasonable, the analysis should continue.

Step VIII. Benefits and Burdens: Does the Equity Interest Lie
with the Seller-Lessee?

If yes, there is a financing device.
If no, a valid sale-leaseback arrangement probably exists but the
analysis should continue.
Step IX. Purpose for Entering into the Transaction

If the actual purpose, as determined by the intent and conduct of the parties, indicates that the transaction was entered into to avoid tax, the sale-leaseback should not be recognized.