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Taxation–Sale and Leaseback–Multiple Party Transaction with Economic Substance and Business Purpose is Valid

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TAXATION—SALE AND LEASEBACK—MULTIPLE PARTY TRANSACTION WITH ECONOMIC SUBSTANCE AND BUSINESS PURPOSE IS VALID. *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978).

The taxpayer, Frank Lyon Company, purchased from and simultaneously leased back to the Worthen Bank and Trust Company a building which Worthen used as its principal office building and banking facility. Lyon claimed, as owner of the building, depreciation and interest deductions on its 1969 federal income tax return. The Commissioner of Internal Revenue determined this transaction was not a sale-and-leaseback but only a financing transaction. Lyon, according to the Commissioner, did not possess an adequate ownership interest in the building to claim these deductions. The United States Supreme Court disagreed and held that the transaction was a sale-and-leaseback and therefore, the deductions were properly claimed. *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978).

A sale-and-leaseback transaction has become a recognized and conventional method for acquiring the use of both real and personal property.[1] The arrangement involves the sale of property by its owner-user, who simultaneously with the buyer's purchase, enters into a lease with that buyer for the seller's continued use of the property.[2] When properly entered into and executed, these transactions produce favorable business results and tax advantages to both the seller-lessee and the purchaser-lessor. The transaction benefits the seller-lessee by freeing working capital without the loss of the property's use.[3] A sale-and-leaseback will also improve the seller-lessee's balance sheet (subject to appropriate disclosures provided by generally accepted accounting standards), allow immediate realization of gain or loss, and provide subsequent rental deductions. Sale-and-leaseback provides the purchaser-lessor with rental income which can be off-set by a depreciation deduction[4] and an interest expense deduction.[5] By utilizing one of the methods of accelerated depreciation[6] in conjunction with the interest expense

1. Mandell, *Tax Aspects of Sales and Leasebacks as Practical Devices for Transfer and Operation of Real Property*, 18 N.Y.U. INST. ON FED. TAX. 17 (1960).

2. Marcus, *Real Estate Purchase-Leasebacks as Secured Loans*, 2 REAL ESTATE L.J. 664 (1974). For an article on the sale-and-leaseback of equipment, see Zeitlin, *Tax Planning in Equipment-Leasing Shelters*, 21 U.SO. CAL. 1969 TAX INST. 621.

3. Marcus, *supra* note 2, at 669.

4. I.R.C. §167.

5. I.R.C. §163.

6. I.R.jc. §167(b).

deduction, the purchaser-lessor should have more deductions than income from the leased property for several years following the transaction.

The most formidable problem in structuring a sale-and-leaseback is the difficulty in determining when the courts will hold that a sale-and-leaseback is merely a secured loan.[7] "For over twenty years, taxpayers, the IRS and the courts have been searching for guidelines indicating when a sale-leaseback should be recognized for tax purposes."[8] Guidelines in sale-and-leaseback cases are hard to delineate because they are based on factual determinations unsupported by *clearly* defined regulations or code provisions. Prior to the United States Supreme Court's decision in *Lyon,* the law consisted of a case by case determination of the facts attendant to each transaction. A significant factor was the determination of ownership. The Seventh Circuit Court of Appeals summed up the problem by stating that "the determination of whether the grantor of the conveyance to the corporation remains the owner for the purpose of taxation is a question of fact . . . and . . . such determination must depend upon the terms of the conveyance and upon all circumstances attendant on its creation and operation."[9]

Cases which are helpful in searching for sale-and-leaseback guidelines include *Helvering v. F. & R. Lazarus & Co.,*[10] upon which the Commissioner in *Lyon* relied; *Helvering v. Clifford,*[11] which adopted the doctrine of the bundle of ownership rights; *Sun Oil Co. v. Commissioner,*[12] which used the Eighth Circuit's holding in *Frank Lyon Co. v. United States*[13] as authority; and *American Realty Trust v. United States,*[14] a Fourth Circuit decision which conflicted with the Eighth Circuit's holding in *Lyon.*

In *Lazarus,*[15] the taxpayer transferred "ownership" of three

7. Marcus, *supra* note 2, at 669.

8. Rosenberg and Weinstein, *Sale-Leasebacks; An analysis of These Transactions after the Lyon Decision,* 45 J. OF TAX. 146, (Sept. 1976). This article considered the impact of the Circuit Court's decision on future sale-and-leaseback transactions.

9. Sheldon Bldg. Corp. v. Commissioner, 118 F.2d 835, 836 (7th Cir. 1941). Other cases which the court considered include: Halvering v. Clifford, 309 U.S. 331 (1940); Higgins v. Smith, 308 U.S. 473 (1940); Griffiths v. Halvering, 308 U.S. 355 (1939); Gregory v. Helvering, 293 U.S. 465 (1935); Corliss v. Bowers, 281 U.S. 376 (1930); and City National Bank & Trust Co. v. United States, 109 F.2d 191 (7th Cir. 1940).

10. 308 U.S. 252 (1939).

11. 309 U.S. 331 (1940).

12. 562 F.2d 258 (3d Cir. 1977).

13. 536 F.2d 746 (8th Cir. 1976).

14. 498 F.2d 1194 (4th Cir. 1974).

15. 308 U.S. 252 (1939).

buildings to a bank-trustee and continued to claim depreciation deductions for them. The Commissioner challenged these deductions contending Lazarus did not have "ownership" of the buildings. The United States Supreme Court examined the transaction and the company's ownership interest which included responsibility for capital loss from wear, tear, and exhaustion of the building. The Court concluded that Lazarus still owned the buildings; it had only received a loan from the bank-trustee secured by the buildings. In the Court's view, the form of the transaction was a sale-and-leaseback; but the substance was merely a financing transaction.

The doctrine of the bundle of ownership rights was adopted in *Clifford.*[16] The taxpayer, Clifford, had transferred property to a trust of five years duration for his wife and children. He maintained a substantial degree of control over the property. Clifford was the trustee and had all voting powers incident to the trusteed shares of stock; he had the power to invest any money in the trust estate and to compromise any claims held by him as trustee. The Court determined that the trust income was includable in Clifford's gross income because "[t]he bundle of rights which he retained was so substantial that . . . 'for the purpose of taxation he [was] treated as owner altogether.'"[17]

In *Sun Oil Co.,*[18] the taxpayer, Sunray, had transferred ownership of 320 service station sites to a tax exempt trust and simultaneously leased these sites back from the trust. Sunray (the predecessor of Sun Oil Co.) then deducted from its taxable income rental payments to the trust for the use of the sites. The Third Circuit Court of Appeals disallowed this deduction, stating that the transaction did not constitute a *sale* because Sunray continued to bear the risks, burdens, and benefits of ownership.

In another case, *American Realty Trust,*[19] the taxpayer had purchased property and simultaneously leased it back to the seller. The taxpayer contended that the transaction constituted a "good faith" purchase and leaseback, but the Commissioner maintained that it was a sham, a mere financial arrangement. The Fourth Circuit affirmed the trial court's decision that the transaction was a valid sale-and-leaseback. The court found that the purchase and leaseback was not a tax avoidance device. There were commercial

16. Helvering v. Clifford, 309 U.S. 331 (1940). Application of the doctrine of the bundle of ownership rights is not limited to sale-and-leaseback cases.

17. *Id.* at 337.

18. Sun Oil Co. v. Commissioner, 562 F.2d 258 (3d Cir. 1977).

19. American Realty Trust v. United States, 498 F.2d 1194 (4th Cir. 1974).

factors, (*e.g.* a fair purchase price, an arm's-length transaction and the availability of "wraparound" financing which encouraged the purchaser to act quickly),[20] which underlay the transaction. In addition, the parties intended that the ownership would pass to American Realty Company.

In summary, before the *Lyon* decision, case law had established several guidelines for a sale-and-leaseback transaction. These guidelines included the following: each case was dependent upon its own facts; courts considered the substance of the transaction over its form; a true sale conveyed the risks, burdens, and benefits of ownership to the purchaser; the intent of the parties was considered; and finally, the transaction's primary purpose should not be tax avoidance.

With these guidelines in mind, an examination of the facts in *Lyon* reveals that in 1965 Worthen began to plan a multi-story bank and office building—the Worthen Building—in Little Rock, Arkansas. When Worthen realized that its ownership of the building would not be feasible because of various state and federal restrictions,[21] the bank opened negotiations with several investors. Worthen wanted to sell the building and lease it back from the purchaser. The bank had already arranged construction financing with outside lenders and wanted the purchaser-lessor to assume all indebtedness.

Lyon, a closely held Arkansas corporation engaged in the distribution of home furnishings, was one of several parties interested in the investment.[22] Frank Lyon, the majority stockholder and Chairman of the Board of the Frank Lyon Company, was also serving on the Worthen Board of Directors at the time of this transaction. Lyon offered to purchase the building for $500,000 and assume total liability on the construction financing and the permanent loan. The total purchase price, to include the $500,000 and assumption of liability on the construction financing and permanent loan, was not to exceed $7,640,000. Worthen accepted this offer, and agreements were executed conveying the building to Lyon and leasing the build-

20. *Id.* at 1194.

21. Originally Worthen was to own the facility but could not because the debentures used to finance the purchase would not be marketable at the interest rates allowable under Arkansas law. Also, ownership by Worthen required the approval of the Arkansas State Bank Department and the Federal Reserve System. See ARK. STAT. ANN. 67-547.1 (Cum. Supp. 1977); 12 U.S.C. 371d; 12 C.F.R. 265.2 (f) (7) (1978).

22. Other investors who had indicated an interest included Goldman, Sachs and Co.; White, Weld and Co.; Eastman Dillon; Union Securities and Co.; and Stephens, Inc.

ing back to Worthen.[23] The building was completed and Worthen took possession in December 1969.

On its 1969 federal income tax return, Lyon claimed as deductions one month's interest on the permanent financing, one month's depreciation on the building, interest on the construction loan, and sums for legal and other expenses incurred in connection with the transaction. On audit, the Commissioner determined that Lyon was not the owner of the Worthen Building and that the sale-and-leaseback arrangement was merely a financing transaction in which Lyon loaned Worthen $500,000.[24] The Commissioner assessed a $280,387.20 tax deficiency against Lyon.

Lyon paid the assessment and then filed a claim for refund in the United States District Court for the Eastern District of Arkansas. The district court ruled in Lyon's favor, holding that the claimed deductions were allowable.[25] On appeal by the Commissioner, the Eighth Circuit reversed, stating that Lyon "toted an empty bundle" of ownership rights which were too insubstantial to establish a claim to the status of owner for tax purposes.[26] The

23. On May 1, 1968, Worthen leased the site to Lyon for 76 years and 7 months. The same day, Worthen signed an agreement to lease from Lyon the building for a primary term of 25 years with options in Worthen to extend the lease for eight additional five year terms—a total of 65 years. The rent Worthen was to pay would be exactly equal to the mortgage payments Lyon would make on the permanent loan. Therefore, at the end of the initial lease, the loan would be amortized, but Lyon would not have recovered its $500,000 cash investment.

24. In looking at the sale-and-leaseback transaction, the Commissioner determined that the ownership rights acquired by Lyon were too thin to substantiate the claim of ownership. Ownership for tax purposes was likened to a bundle of sticks with Lyon toting "an empty bundle."

25. The district court found for Lyon based on the following: parties intended a sale-and-leaseback; the substance as well as the form of the transaction was a sale-and-leaseback with the option to repurchase; Lyon held the legal title under Arkansas law and for federal income tax purposes; Lyon needed to diversify its holdings; Lyon needed to use its accumulated earnings; Lyon was the borrower and sole obligor; Worthen was under no obligaton to repay Lyon the $500,000; and the other terms of the agreement were consistent with a sale-and-leaseback agreement. Frank Lyon Co. v. United States, (1975) FED. TAXES (P-H) (36 A.F.T.R.2d) ¶ 75-5154 (E.D.Ark. June 11, 1975).

26. The court concluded with the Commission that Lyon toted an empty bundle of ownership sticks. The court considered the following factors in reaching this conclusion: Worthen retained the tax deduction for investment credit and sales taxes paid upon the materials used in construction; the lease agreement circumscribed the usual right of an owner to obtain a profit from his investment by transferring his interest to a third party; any appreciation realized as a result of condemnation accrued to Worthen; the parties geared the purchase-option price to the unpaid balance in the mortgage plus taxpayer's initial investment plus accrued interest at the limited rate of 6%; the final option price at the end of the initial 25 year term reflected the taxpayer's initial investment plus compound interest; finally, Worthen retained ultimate control over the disposition of the building for 65 years. Frank Lyon Co. v. United States, 536 F.2d 746 (8th Cir. 1976).

United States Supreme Court, finding a valid sale-and-leaseback transaction, concluded that it was Lyon's capital that was invested in the building according to the agreement of the parties. It was Lyon, therefore, who was entitled to the depreciation deductions under the Internal Revenue Code.[27] The Court cited twenty-six affirmative factors giving substance and economic reality to the sale-and-leaseback transaction, and in summary stated:

> In short, we hold that where, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.[28]

The Court's reasoning can best be clarified by examining separately each of these five indicia of a true sale-and-leaseback transaction.

A Genuine Multiple Party Transaction

The Commissioner had relied heavily on *Lazarus,*[29]concluding that Worthen, like Lazarus, still kept the "bundle of ownership rights" and should not be allowed to claim the deductions. However, the United States Supreme Court distinguished *Lyon* from *Lazarus* by noting that the Lazarus "transaction was one involving only two (and not multiple) parties, the taxpayer-department store and the trustee-bank."[30] In the present case, Lyon, Worthen, New York Life (permanent financing), and the First National City Bank (construction financing) were the principal parties.[31] "Thus, the presence of the third party, in our view, significantly distinguishes this case from *Lazarus* and removes the latter as controlling authority."[32] Where there is a genuine multiple party transaction (*i.e.*, more than two), the third-party creditor could reach the other assets of the purchaser-lessor in the event of default.

The Court also distinguished *Lyon* from *Sun Oil,*[33] "a two-party case with the added feature that the second party was a tax-exempt

27. 435 U.S. 561.
28. *Id.* at 583.
29. Helvering v. F. & R. Lazarus & Co., 308 U.S. 252 (1939).
30. 435 U.S. 561, 575.
31. *Id.* at 567.
32. *Id.* at 576.
33. Sun Oil Co. v. Commissioner, 562 F.2d 258 (3d Cir. 1977).

pension trust."[34] The absence of a third party does not automatically invalidate a sale-and-leaseback transaction. The presence of the third party, however, adds credence to a sale-and-leaseback transaction.[36]

With Economic Substance

The Commissioner and the court of appeals had determined there was insufficient economic substance to the sale-and-leaseback transaction, and, therefore, Lyon could not claim the depreciation and interest deductions. When the United States Supreme Court examined the economic substance of the Worthen-Lyon transaction, it found that Lyon alone was liable on the indebtedness.[37] The Court noted the district court's finding that the rentals and option prices detailed in the agreement[38] were reasonable; that Worthen could walk away from the relationship at the expiration of the lease and would probably do so if the option price were more than the current worth of the building to Worthen;[39] and that Lyon was a substantial company, totally independent of Worthen.[40] The Court also observed that there was no legal obligation for Worthen to ever repay Lyon the $500,000 which the Commissioner had contended was a loan.[41]

As the Court pointed out, the economic substance of some of these factors could be questionable. For example, the rent equalled the principal and interest payments, and in effect, would amortize the permanent financing over the term of the lease. In addition, the re-purchase option prices were the sum of the unpaid balance of the permanent financing and Lyon's $500,000 investment with 6 percent

34. 435 U.S. 561, 575.

35. American Realty Trust v. United States, 498 F.2d 1194 (4th Cir. 1974).

36. The Court listed among the twenty-six factors in *Lyon* the following indicators of a multiple party transaction: The presence of several finance organizations seriously interested in participating in the transaction and in the resolution of Worthen's problem; the submission of formal proposals by several of those organizations; the bargaining process and period that ensued; the competitive nature of the bidding; the bona fide character of the negotiations; and the three party aspect of the transaction. 435 U.S. 561, 582.

37. *Id.*

38. The stated quarterly rent for the first eleven years of the lease was $145,581.03. For the next 14 years, the quarterly rent was $153.289.32, and for the option periods the rent was $300,000 per year. Worthen had the option to repurchase the building at the following times and prices: 11/30/80 (after 11 years)—$6,325,169.85 11/30/84 (after 15 years)—$5,432,607.32 11/30/89 (after 20 years)—$4,187.328.04 11/30/94 (after 25 years)—$2,145,935.00

39. 435 U.S. 561, 583.

40. *Id.* at 582.

41. *Id.* at 579.

interest compounded on that investment.[42] The Court decided that despite these elements which weighed against a valid sale-and-leaseback, the transaction had economic substance.[43]

Compelled or Encouraged by Business or Regulatory Realities

The Court determined that the sale-and-leaseback transaction was compelled by "Worthen's undercapitalization"[44] and was encouraged by Worthen's inability to carry its building plans into effect by a conventional mortgage and other borrowing.[45] In addition to these business realities, federal restrictions required that an independent third party own the building[46] and state banking regulators suggested that Worthen obtain an option to repurchase the building.[47]

It is clear, however, that an artificial transaction constructed to avoid non-tax government restrictions would not be validated for tax purposes simply because of business realities. It must be remembered that a compelling business reality was but one of the indicia of a valid sale-and-leaseback.

Imbued with Tax-Independent Considerations

Lyon's need to diversify its holdings was one of eight factors listed by the district court as persuasive in its determination that the transaction was based on tax-independent considerations.[48] The United States Supreme Court considered this factor to be Lyon's principal motivation for entering the transaction.[49]

Not Shaped Solely by Tax Avoidance Features

The Court conceded that Lyon had considered the favorable tax consequences before entering into the transaction. The Court, how-

42. *Id.* at 567.

43. Other factors that established economic substance included the risk borne by Lyon that Worthen might default or fail; the fact that if the building lease were not extended, Lyon would be the full owner of the building, free to do with it as it chose (until its ground lease expired); Lyon's liability for the substantial ground rent if Worthen decided not to exercise any of its options to extend; and the absence of an understanding between Lyon and Worthen that Worthen would exercise any of the purchase options. 435 U.S. 561, 583.

44. *Id.* at 582.

45. *Id.*

46. *Id.*

47. *Id.*

48. (1975) FED. TAXES (P-H) (36 A.F.T.R.2d) ¶¶ 75-5154, 5158 (E.D. Ark. June 11, 1975).

49. 435 U.S. 561, 582.

ever, saw no reason for disallowing those consequences as it acknowledged "the reality that the tax laws effect the shape of nearly every business transaction."[50] At the same time, the Court emphasized that it was "not condoning manipulation by a taxpayer through arbitrary labels and dealings that have no economic significance."[51] The Court determined that "the nonfamily and nonprivate nature of the entire transaction . . . and the absence of any differential in tax rates and of special tax circumstances for one of the parties . . . convince us that Lyon has far the better of the case."[52]

The United States Supreme Court concluded that "so long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes. What those attributes are in any particular case will necessarily depend upon its facts."[53] It therefore appears certain that recognition of sale-and-leaseback transactions will remain a case by case determination.

It is not certain that *Lyon* significantly clarifies the existing guidelines in sale-and-leaseback transactions. Still, it spells out factors which the courts should consider in the analysis of each case. Lyon teaches that multiple party transactions are more favored than two-party transactions; the existence of an independent third-party creditor may validate a transaction otherwise inadequate to insure the anticipated tax benefits.

In addition to the number of parties, their identity and relationship will be considered. The fact that one of the parties to the transaction serves on the board of directors of two of the principal corporate parties will not diminish the validity of an otherwise sound nonfamily and nonprivate relationship.

To insure that the business reasons supporting the transaction have economic substance, the form of the transaction will be carefully evaluated. Thus, a showing that the rental, option, and purchase prices are reasonable, either in relation to each other or in relation to the marketplace, lends credence to the arrangement. As in *Lyon,* a compelling business reason or regulatory reality adds further validity to the proposed sale-and-leaseback.

Whatever the form of the transaction, tax avoidance cannot be the sole reason for the transaction. Although the importance of tax considerations in any major financial venture will be recognized, a

50. *Id.* at 580.
51. *Id.* at 583.
52. *Id.*
53. *Id.* at 584.

showing by the taxpayer that tax independent considerations, such as diversification of assets, underlie the transaction may prove essential to its validity. In this determination, courts will look closely at the intent of the parties. Thus, a *meaningless* label applied to a transaction shaped solely by tax avoidance features will normally prove *useless* as well.

It is clear that the genuine sale-and-leaseback will be recognized for tax purposes and will allow a taxpayer to claim deductions for depreciation and interest based on his ownership of the property. What is less clear is precisely how much the *Lyon* decision illuminates the semi-darkness surrounding the tax treatment of sale-and-leaseback transactions.[54]

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54. In a United States Tax Court decision, Hilton v. Commissioner, No. 2088-74, decided in the fall of 1978, special trial Judge Charles Johnston cited *Lyon* for the following: Lyon retained the property and remained liable on the mortgage; Lyon entered the transaction in order to diversify its business; there was economic reality in Lyon's assumption of the mortgage liability; Lyon was an established business with substantial assets; the transaction was the product of arms-length bargaining between the owner/financing corporation and the lessee; the rents were unchallenged and were reasonable throughout the period of the lease; the option prices represented fair estimates of market value on the applicable dates; and Lyon faced a real risk of loss.