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TAXATION

SALE-AND-LEASEBACK: SHELTER OR SHAM?

A. INTRODUCTION

Estate of Franklin v. Commissioner[1] provided the Ninth Circuit with the opportunity to review the deductibility of losses resulting from a real estate sale-and-leaseback transaction. The court held that if the purchase price does not approximate the fair market value of the property, a limited partner is not entitled to an interest or depreciation deduction. When the purchase price substantially exceeds the fair market value, a bona fide sale has not taken place.[2] Although the court attempted to restrict real estate tax shelters,[3] its emphasis on fair market value may allow taxpayers latitude to maneuver to avoid this result.

B. THE UNDERLYING TRANSACTION

The transaction which gave rise to the proceeding was the purchase by a limited partnership and subsequent lease-back to the sellers in 1968 of a motel and related property. Taxpayer Franklin was one of eight limited partners[4] who purchased the property under a sales agreement for $1,224,000, a price which he failed to demonstrate approximated the fair market value.[5] The limited partners invested $75,000 for the immediate prepayment of interest on the mortgage and paid another $75,000 to the general partner as compensation for services rendered to the limited partnership. Franklin's total investment was $20,000.[6] The purchase agreement required the limited partnership to make monthly principal and interest payments of $9,045.36 for ten

1. 544 F.2d 1045 (9th Cir. Nov., 1976) (per Sneed, J.; the other panel members were Trask and Barnes, JJ.).

2. *Id.* at 1048.

3. The court noted that *Franklin* was "another effort on the part of the Commisioner to curb the use of real estate tax shelters." *Id.* at 1046 (footnotes omitted). *See* Weiler, *Taxation of Partnerships & Subchapter S: Effect of at-risk rules on nonrecourse financing and other risk-limiting devices,* 46 J. TAX. 326, 327 n.6 (1977); *Taxation of Partnerships & Subchapter S: CA-9 articulates judicial "at-risk" rule in its* Estate of Franklin *decision,* 46 J. TAX. 124 (Hewitt & Pennell eds. 1977).

4. 544 F.2d at 1046. The taxpayer, Charles T. Franklin, died on August 28, 1971. The appeal from the Commissioner's deficiency determination and the Tax Court's adverse judgment was therefore taken by the decedent's estate.

5. *Id.* at 1048.

6. Estate of Charles T. Franklin, 64 T.C. 752, 753 (1975).

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years and a balloon payment of about $975,000 in 1979.[7] Under a nonrecourse financing agreement, none of the partners was personally liable to the sellers for any portion of the sale price; the sellers' sole remedy in case of default was limited to recovery of the property.[8]

The sale transaction was coupled with a lease of the property by the buyer to the sellers for a term of ten years. The monthly rent approximated the buyer's monthly mortgage payments.[9] There was no actual monthly payment of either the rent or the mortgage obligation subsequent to the original $75,000 payment; the parties simply made accounting entries to reflect money due them.[10] Although the partnership ostensibly purchased the property, it did not take possession, and the incidents of ownership remained with the seller-lessees during the lease period.[11]

C. Tax Consequences of the Transaction

The terms of the transaction created a tax shelter for Franklin.[12] He computed the adjusted basis in his limited partnership

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7. 554 F.2d at 1046.

8. For a short discussion of nonrecourse financing see Daily & Gaffney, *Anatomy of a Real Estate Tax Shelter,* 55 Taxes 127, 139 (1977).

9. The first ten months' rental payments were calculated to include the $75,000 prepaid interest. For the balance of the term, rent was set a $9,045 per month. 64 T.C. at 757.

10. 544 F.2d at 1047.

11. The lease required the seller-lessees to maintain the upkeep of the motel, including making all necessary repairs and capital improvements; to pay all taxes, assessments, charges, and utilities; to maintain fire, extended coverage, and other casualty and liability insurance on the property; to hold the partnership harmless from any liabilities; and to make payments on the encumbrances which they were able to place upon the property without the partnership's consent. The cost of these obligations was to be borne by the seller-lessees until 1979 when the final balloon payment was made. At that time, clear title, as well as the financial burden of ownership, would be transferred to the buyers. 64 T.C. at 757.

In addition, about five years after the initial transaction, the parties entered into an addendum to the lease which provided for the construction of capital improvements, including the purchase of real property for expansion. *Id.* at 758.

In March 1971, the seller-leesees, as mortgagors, secured a loan for $500,000 with a real estate mortgage, encumbering the leased property. The proceeds of the loan were not used solely to improve the leased property. *Id.*

Between 1967 and 1971, the sellers and the buyer's general partner were involved in approximately 49 transactions involving motels and apartment buildings. In addition to the transaction involved herein, the parties entered into two other motel property arrangements during November 1968. *Id.* at 759.

12. Like most real estate tax shelters, the *Franklin* transaction is based on the rule in Crane v. Commissioner, 331 U.S. 1 (1947), in which the Supreme Court held that the taxpayer's basis in real property includes the amount of an unassumed mortgage. *Id.*

interest by increasing his original actual investment of $20,000 by his share of the $1.224 million nonrecourse mortgage.[13] The sale-

at 14. The *Crane* rule is premised on the assumption that as long as the value of the property is greater than the mortgage, the buyer will pay the mortgage in order to retain the property, regardless of the buyer's personal liability on the debt.

The issue that was presented in *Franklin* was one that was reversed by the *Crane* Court: "Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage." *Id.* at 14 n. 37. The *Crane* doctrine has generated considerable comment. *See, e.g.*, Adams, *Exploring the Outer Boundaries of the* Crane *Doctrine; An Imaginary Supreme Court Opinion*, 21 TAX L. REV. 159 (1966) (questions the broad interpretation generally given *Crane*); Del Cotto, *Basis and Amount Realized Under* Crane: *A Current View of Some Tax Effects in Mortgage Financing*, 118 U. PA. L. REV. 69 (1969) (analyzes *Crane* and the cases following it); Epstein, *The Application of the* Crane *Doctrine to Limited Partnerships*, 45 SO. CALIF. L. REV. 100 (1972) (examines the problems of applying *Crane* to limited partnerships); Gallagher, *Fiscal Alchemy and the* Crane *Rule: Alternative Solutions to the Tax Shelter*, 8 CONN. L. REV. 607 (1976) (criticizes the *Crane* doctrine and offers alternatives). Under the provisions for federal taxation of partnership income, the individual partners, rather than the partnership as an entity, are separately liable for tax on income earned by the partnership. I.R.C. § 701. A partner's share of an item of partnership income, gain, loss, deduction or credit is determined with reference to his or her proportionate share of the total assets of the partnership, according to the partnership agreement. *Id.* § 702(c). The character of the items comprising a partner's distributive share is determined as if the partner, not the partnership, had received the item directly from the source. *Id.* § 702(b).

Id. § 704, as amended by the Tax Reform Act of 1976, P.L. No. 94-455 §§ 213(c)(2), 213(d), provides in pertinent part:

> (a) Effect of partnership agreement.—A partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this chapter, be determined by the partnership agreement.
>
> (b) Determination of Distributive Share.—A partner's distributive share of income, loss, deduction, or credit (or item thereof) shall be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances), if
>
> (1) the partnership agreement does not provide as to the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof), or
>
> (2) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect.

For an explanation of the effect of the Tax Reform Act of 1976 on real estate tax shelters see Dailey & Gaffney, *supra* note 8.

The basis of a partner's interest in the partnership is the amount of money and the adjusted basis in property which he or she contributed to the partnership, increased by any gain recognized by the partner at the time of the contributions. I.R.C. § 722.

The partner's basis is adjusted upward by his or her distributive share of the taxable and nontaxable income earned by the partnership and downward by actual distributions to him or her of partnership earnings, partnership losses, and nondeductible, noncapital partnership expenditures. *Id.* § 704(a).

13. An increase in a partner's share of the partnership liabilities is considered a contribution of money to the partnership liabilities is considered a contribution of money to the partnership, I.R.C. § 752(a), and therefore an increase to the basis in the partner-

leaseback transaction was structured by the general partner so that each limited partner's rental income would be offset and exceeded by the interest and depreciation deductions which each was to take in connection with the partnership's purchase and ownership of the property.[14] Franklin reported $22,244 and $16,583 in 1968 and 1969, respectively, as his distributive share of the losses.[15]

D. Disposition by the Tax Court

The Commissioner disallowed the loss deductions.[16] In the Tax Court, the Commissioner offered two alternative theories to support the denial: (1) the transaction was a sham "without any legal or economic purpose or motive other than tax avoidance;"[17] and (2) Franklin obtained only an option to purchase the property and was therefore not entitled to any loss deductions.[18] The Tax Court affirmed the Commissioner's ruling,[19] finding that Franklin

ship interest. The partner's share of partnership liabilities is determined in accordance with the ratio for sharing losses under partnership agreement. Treas. Reg. § 1.7502-1(e) (1956). A limited partner's share of partnership liabilities is limited to the difference between his or her actual contribution and the total contribution which he or she is obligated to make to the partnership. *Id.* In the case of an obligation for which none of the individual partners has assumed liability, such as nonrecourse financing, all of the partners share the liability to the extent of the fair market value of the property in the same proportion as they would partnership profits. I.R.C. § 752(c). Thus, the partnership's assumption of a mortgage, for which neither partnership nor any member thereof is liable, results in an increase in the adjusted basis of each partner's interest to the extent of his or her proportionate share of the total amount of the mortgage.

14. I.R.C. § 163(a) provides:

> General rule—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.
>
> I.R.C. § 167 provides in pertinent part:
>
> (a) General Rule. There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—
> . . . . (2) of property held for the production of income.
> (g) Basis for depreciation. The basis on which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 1011 for the purpose of determining the gain on the sale or other disposition of such property.

15. 64 T.C. at 760.

16. *Id.*

17. *Id.* at 761. For a discussion of the sham transaction doctrine see Gregory v. Helvering, 293 U.S. 465, 469-70 (1935); Blum, *Knetch v. United States: A Pronouncement on Tax Avoidance,* 1961 Sup. Ct. Rev., 135, 142-43; Rice, *Judicial Techniques in Combating Tax Avoidance,* 51 Mich. L. Rev. 1021 (1953).

18. 64 T.C. at 761.

19. *Id.* at 762.

had obtained only an option to purchase the property.[20] The Court accepted the argument that Franklin's obligation to pay the sales price was "not legally enforceable or [was] too indefinite and tentative to create 'indebtedness' within the meaning of section 163(a) or give the partnership a cost basis under section 167(g) and related provisions."[21]

On the basis of four factors, the Tax Court characterized the transaction as an option. First, the actual sales price was not $1.224 million, but rather that amount which was created by use of the sellers' equity formula in January 1979.[22] Second, the partnership was not obligated by the sales agreement to purchase the motel or to pay damages for failure to do so, nor did the taxpayer prove that he would lose anything of value if he forfeited the property.[23] Third, no evidence of title was to be delivered until January 1979.[24] Fourth, the sales agreement and lease did not transfer the burdens and benefits of ownership of the property to the purchasers.[25]

E. THE NINTH CIRCUIT DECISION

The Ninth Circuit affirmed the Tax Court's disallowance of

20. The Tax Court rejected the Commissioner's finding of a sham transaction and cited City Investing Co., 38 T.C. 1 (1962), to support its conclusion that the Commissioner erroneously emphasized the tax results the limited partners sought to achieve. Tax consequences favorable to the taxpayer do not necessarily imply that the sale was a sham. 64 T.C. at 761 n.3.

Although *City Investing* and *Franklin* involved sales and leasebacks of real property, the facts are clearly distinguishable. In *City Investing,* the transaction resulted from the taxpayer's announced policy of liquidating its real estate holdings in a certain area of New York. The purchase price was determined after arm's length negotiations and was at least equal to the fair market value of the property. 38 T.C. at 9. The advantageous tax consequence did not "detract from the reality of the sale." *Id.*

21. 64 T.C. at 762.

22. *Id.* at 763-64.

23. *Id.* at 767-68.

24. *Id.* at 767. The parties recorded the sale agreement. A warranty deed from the sellers to the buyer and a quitclaim deed from the buyer to the sellers were placed in escrow in November 1968. The documents were to be delivered to the buyer upon full payment of the purchase price or to the sellers upon the buyer's default. *See id.* at 756 for pertinent provisions of the sale agreement.

25. *Id.* at 768. *See* note 11 *supra.* In the Tax Court, Franklin argued that *Crane v. Commissioner*, 331 U.S. 1 (1947), and its progeny in the Tax Court, David F. Bolger, 59 T.C. 760 (1973), and Manuel D. Maverson, 47 T.C. 340 (1966), were controlling. 64 T.C. at 770. The Tax Court dismissed this argument because those cases dealt with the effect of the taxpayer's lack of personal liability for mortgages after the property had been transferred. In contrast, the issue in *Franklin* was the validity of the transaction as a sale. *Id.*

deductions but reached its result on a different theory. Rejecting the Tax Court's analysis that the taxpayer purchased only an option, the Ninth Circuit reasoned that the transaction was not a "sale *ab initio*."[26] The court stressed that a sale-and-leaseback transaction can involve a bona fide sale, even under some of the circumstances that existed in the Franklin transaction.[27] However, the distinguishing factor in the instant case was the failure of the taxpayer to demonstrate the approximate equivalence of the fair market value of the property and the sale price.[28]

26. 544 F.2d at 1048.

27. *Id.* at 1047. Courts have found that sale and leaseback transactions similar to that in *Franklin* were bona fide sales. *See, e.g.*, Hudspeth v. Commissioner, 509 F.2d 1224 (9th Cir. 1975); American Realty Trust v. United States, 498 F.2d 1194 (4th Cir. 1974); Manuel D. Mayerson, 47 T.C. 340 (1966).

In *Hudspeth*, parents sold land to their children who leased the property back to the parents. The sale-leaseback transaction was arranged because the parents owned more federally irrigated property than the legally permissible maximum of 160 acres per person. 509 F.2d at 1225. The Ninth Circuit held that the children purchased the property and were entitled to take interest deductions. *Id.* at 1227.

In *American Realty Trust*, the taxpayer purchased a resort hotel for $7,000,000, paying $2,500,000 down and taking title subject to an outstanding mortgage of $4,500,000. The taxpayer then leased the property back to the seller's wholly-owned corporation for a 21-year term. 498 F.2d at 1195. The taxpayer gave the seller an option to repurchase which was exercised by the seller's corporation after assignment of the option six and one half years later. *Id.* at 1196. The Commissioner argued that a sale had not taken place; the parties had cloaked a financing arrangement in the form of a sale, leaseback, and repurchase of real property. *Id.* The Commissioner disallowed the depreciation deductions taken by the purchaser-lessor and contended that the rental payments constituted interest on the loan. *Id.* The case was tried before a jury in the district court and resulted in a special verdict in the taxpayer's favor. *Id.* at 1196-97. The jury was instructed to consider the following issues in reaching its verdict: who had control of the property; what were the economic results which the parties intended; did the sales price approximate the property's fair market value; who bore the benefits and burdens of maintenance and/or ownership of the property; what was the relationship of the length of the lease to the useful life of the property; what effect did the option to repuchase have on the transaction; which party would receive the benefit of appreciation of the property; and did the payments by the lessee resemble rent or loan interest? *Id.* at 1197 n.11. The Fourth Circuit found sufficient evidence to support the jury's verdict. *Id.* at 1198. It further held, on the basis of considerable evidence, that the transaction was a bona fide sale and leaseback. *Id.* at 1199.

Manuel D. Mayerson involved the taxpayer's purchase of a run-down commercial building in an arm's length transaction. The sale was affected with a down payment and a purchase money mortgage for a term or 99 years. 47 T.C. at 342. The parties understood that the taxpayer-purchaser would obtain conventional financing and liquidate the mortgage as soon as possible after making improvements on the building to cure building code violations. *Id.* at 345. He did so after five years. *Id.* at 346. The Commissioner argued that the transaction was a lease, not a purchase, and the taxpayer therefore lacked a depreciable interest in the property. *Id.* at 347. The Tax Court found that the sale was transacted in conformity with common business practices and held that the transaction was a valid sale. *Id.* at 353.

28. 544 F.2d at 1048. It is interesting to compare the Ninth Circuit's treatment of the evidence of the property's value with that of the Tax Court. The appellate court found

The court explained that the amount of the purchase price in relation to the fair market value is significant in two instances: (1) in respect to a purchaser-lessor's depreciation deductions calculated on the cost basis of the property; and (2) when deductions are claimed for interest paid on a loan, the amount of which constitutes the major part of the inflated purchase price.[29] In order to be entitled to depreciation deductions, a taxpayer must have an investment in the property.[30] Where the balance of the purchase price greatly exceeds the fair market value of the property, the purported owner has no equity in the property and therefore has not made an investment which would result in an economic loss if he or she defaults on the loan obligation.[31]

The court relied upon a similar analysis in disallowing Franklin's interest deduction on his distributive share of the interest paid by the partnership to the seller-mortgagees.[32] The obligation had no economic significance as a valid indebtedness unless the property increased in value to the extent that Franklin had an equity investment.[33] In order for a taxpayer to be entitled to interest deductions, he or she "must actually secure the use or forbearance of money."[34] Although the financial dealings in *Franklin* created debt obligations on paper, they did not change the parties' positions sufficiently to give substance to the transac-

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the sellers' price and the insurance coverage to be "cogent evidence indicating that the fair market value was substantially less than the purchase price." *Id.* at 1048 n.4. The Tax Court was critical of the taxpayer's evidence but concluded that it could not estimate the property's value based on the sellers' purchase price and the amount of insurance coverage maintained on the property. 64 T.C. at 767-68.

29. 544 F.2d at 1049.

30. *Id.* at 1048-49.

31. *Id.*

32. *Id.* For a general discussion of the interest deduction see Asimow, *The Interest Deduction,* 24 U.C.L.A. L. REV. 749 (1977).

33. 544 F.2d at 1048-49.

34. *Id.* at 1049, *quoting* Norton v. Commissioner, 474 F.2d 608 (9th Cir. 1973); Bornstein v. Commissioner, 334 F.2d 779 (1st Cir. 1964); Lynch v. C.I.R., 273 F.2d 867 (2nd Cir. 1959). These cases involve factual variations on a tax shelter scheme devised by a lawyer-stockbroker who arranged for a loan to the taxpayer by a financial institution. The proceeds of the loan were used by the broker to purchase government bonds and securities, which were delivered to the lender to be held as collateral for the loan. Interest on the loan was usually partly prepaid, to be covered as the term of the loan progressed by the interest payments on the bond. The terms of the loans prohibited prepayment of the principal. The due date of the notes was the same as the maturity date of the bonds. In most cases, no bonds were held by the lender, and except for the taxpayer's initial investment, no money ever changed hands.

tion.[35] No money except the original $75,000 ever changed hands.[36]

F. *Franklin's* Impact on Real Estate Tax Shelters

While the court seems to be restricting the use of tax shelters,[37] the Ninth Circuit's holding in *Franklin* creates a rule which may defeat this purpose. By stating that the crucial factor to consider is the relationship between the fair market value and the purchase price of the property, the court may be opening the door to judicially sanctioned real estate tax shelters. In the future, taxpayers may be able to avoid the result in *Franklin* by carefully documenting that the sale price approximates the fair market value of the property. They need only demand more complete appraisals than did Franklin, or perhaps over insure the property in order to meet the burden of proof suggested by the appellate court.[38]

The Ninth Circuit's unfortunate choice of analysis, in place of the better reasoned approach of the Tax Court, is curious. The court may have felt constrained to reject the option analysis in light of its prior ruling in *Hudspeth v. Commissioner,*[39] in which a transaction similar to that in *Franklin* was found to be a legitimate sale-and-leaseback.[40] The *Hudspeth* decision, however, should not have bound the court to a validity-of-the-sale analysis. The two cases are distinguishable. The issue in *Hudspeth* was whether the exchange was a sale or a gift,[41] whereas that in *Franklin* was whether the transaction resulted in the purchase of real property or an option.

The Ninth Circuit found, in essence but without appellation, that the *Franklin* transaction was a sham.[42] The sham transaction

35. 544 F.2d at 1049.

36. *Id.* at 1047.

37. The court limited its decision to sale and leaseback transactions "substantially similar to" that in *Franklin.* 544 F.2d at 1049. Given the production at trial of the required quantum of proof, "[b]ad bargains from the buyer's point of view—as well as sensible bargains from the buyer's, but exceptionally good from the seller's point of view" will still be held to be sales. *Id.* For a brief general discussion of judicial disapproval of tax avoidance schemes see Blum, *supra* note 17, at 141.

38. *Id.* at 1048 n.4. *See* note 28 *supra.*

39. 509 F.2d 1224 (9th Cir. 1975). *See* note 27 *supra.*

40. *Id.* at 1227.

41. *Id.* at 1226-27.

42. For a discussion of the sham transaction doctrine see Gregory v. Helvering, 293 U.S. 465, 469-70 (1935); Blum, *supra* note 17, at 142-43; Rice, *supra* note 17.

doctrine is easily invoked; if the transaction appears in substance to be other than what the taxpayer's structural form suggests it is, the court will find it to be a sham. However, continued invocation of this doctrine only serves to create a series of judicially described sham transactions, rather than a set of guidelines by which taxpayers may structure their financial arrangements so that they may effect permissible tax savings without falling into judicial traps.

The Tax Court's characterization of the transaction as the acquisition of an option to purchase rather than an outright purchase represents a more reasoned analysis. Taking into consideration all of the circumstances of the transaction,[43] it isolates for future taxpayers a set of rules by which they may measure the probable validity of their transaction. Had the Ninth Circuit adopted the Tax Court's opinion, it would have achieved the result it sought.

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43. *See* text accompanying notes 22-25 *supra.*