CHAPTER 40

SALE (GIFT) – LEASEBACK

INTRODUCTION

A sale-leaseback involves one party selling property (or in the case of a gift-leaseback, giving property) to another party and then leasing back the same property. This type of transaction is usually intended to secure one or more of a number of income and/or estate tax advantages.

WHEN IS USE OF SUCH A DEVICE INDICATED?

1. When a client’s problem is cash flow; the client’s corporation is “rich” in assets, but is “poor” in cash. The sale of a selected corporate asset and the immediate leaseback of that asset can generate cash without a loss of the use of that asset.

2. When a client earns a large amount of income and is, therefore, in a high income tax bracket. He wants to divert highly taxed income to a member of his family in a lower tax bracket. The hoped-for result is the netting of more after-tax income within the family unit.

3. When a client owns property that is rapidly appreciating and would like to shift that future wealth to a family member in order to save estate taxes on that appreciation.

4. When a client would like to find an alternative to financing business property through a mortgage. Sale-leasebacks have been called “off balance sheet” financing because the lease obligation will often appear as a footnote on the balance sheet rather than as a liability. This should have the effect of increasing the client’s credit standing and ability to borrow money.

WHAT ARE THE REQUIREMENTS?

1. The transaction must have validity to avoid litigation and conflict with the Internal Revenue Service. There must actually be a completed and irrevocable sale (or gift) and a legally enforceable lease agreement. In the case where real estate is to be sold, the transaction may result in the imposition of a realty transfer tax. This type of tax is imposed by the state or local governments where the property is located. Typically, there are many exemptions, but it will still be necessary to check the applicable state rules before proceeding with the transaction.

2. In the case of a sale, the transaction must represent a necessary business operation and not one designed solely and merely to shift income tax responsibility to a lower bracket family member.

3. The terms of the transaction, and especially the amount of the lease payment, must be arrived at in an arm’s length, bona fide manner. Any rent or lease amount should be reasonable and preferably developed by an independent appropriately credentialed professional. The process by which that rent amount is computed should be documented.

4. If a trustee is involved, the trustee should, in fact, be independent from the grantor of the trust. When the term of the trust is over, trust corpus should not return to the grantor.

5. Under the kiddie tax rules (see Chapter 22), to successfully shift taxation to the bracket of a child, that child must generally be age 18 or over or in some cases, age 24 or over.

The following factors should be considered: (a) Are the lease provisions, especially payments, strictly observed? (b) Does the lessee pay the entire amount of the promised rent? (c) Is the rent reasonable? (d) Was the sale price equivalent to the fair market value of the property?[[1]](#endnote-1)

A positive answer to these questions is necessary for a successful shift of income tax burdens and the attainment of a rental deduction by the lessee. Essentially, it is important to follow the formalities of the transaction.

If a trust is used, these questions should be asked: (a) Is the trust temporary? (b) Will the property revert to the grantor at the end of a given period (reversionary interest trust)? (c) Is the trust or trustee controlled by the grantor?[[2]](#endnote-2)

A positive answer to any of these questions will result in taxation of income to the grantor.

The danger factors noted above are particularly important where the transactions are between related parties such as (1) a corporation and its stockholders; (2) husbands and wives; (3) parents and children; (4) grantors using relatives as trustees to create benefits for dependents; (5) affiliated corporations with common stockholders; (6) taxpayers and foundations created by them; and (7) partnerships and their partners.

HOW IT IS DONE – EXAMPLES

Your client, Dennis Raihall, is the president of the Son Ray Corporation. He explains to you that the business is in need of cash. It is on the verge of a break-through in its production process that could double corporate earnings, but it needs money immediately to pay for expensive retooling.

The corporation has a number of valuable assets. One of these assets is selected and sold to the LeClair Corporation. The LeClair Corporation pays Son Ray Corporation the fair market value of the asset and now owns it. Since Son Ray Corporation still needs the asset in its business, it arranges to lease it back from the LeClair Corporation for a reasonable rental price. (It is important that the shareholders of the two corporations are not the same individuals.)

There are a number of types of assets the Son Ray Corporation could have sold: trucks, cars, machinery, equipment, fixtures, office buildings, apartment houses, and other types of real property. Furthermore, professional equipment such as computers, X-ray machines, etc., are all possibilities.

(CAVEAT: Beware of depreciation recapture on the sale. Note that gain is both realized and recognized on the corporate level if an appreciated asset is sold.[[3]](#endnote-3)) It is important to make certain that the proposed sale-leaseback is not prohibited by a loan agreement with the firm’s bank.

The after-tax proceeds of the sale will give the Son Ray Corporation additional cash and increase its working capital. Assets continue in operation just as they did before the sale. The basic difference is that, instead of Son Ray carrying that particular item on its books as an asset, it now leases the property and pays fair market rent for its use. Son Ray will now have the use of a large sum of cash, the after tax proceeds of the sale, which can be used to generate additional profits.

Suppose that Son Ray Corporation owned a factory it built more than 10 years ago at a cost of $200,000. The market value of the property is currently $250,000 (land $50,000, building, $200,000). The Son Ray Corporation has decided not to mortgage the property because the rate of interest it would have to pay is very high, it would not be able to write off payments of principal, and it feels that it could obtain more cash through a sale. Another reason it chose not to mortgage the property was that such a debt would adversely affect its credit standing and ability to borrow additional funds.

The property could be sold for $250,000 and leased back for 10 years with additional options at an annual rental of $30,000. Only the profit on the sale (net proceeds less adjusted basis) would be subject to tax. If an accelerated method of depreciation had been used, deductions taken in prior years may have to be recaptured and reported as additional income received on the sale. Son Ray Corporation now has the balance of the after tax sale proceeds to develop the process that may double overall corporate earnings. Also, the rent paid to the buyer will be a tax deductible expense (with a greater deduction than prior depreciation amounts).

Another way the leaseback arrangement is often utilized is in intrafamily transfers. For example, a client, Mary Jo Kopeznsky, a highly compensated physician, complains about the high income tax burden she faces every year. She wants to know how she can maximize her family income by minimizing her overall tax burden.

She could transfer (as a gift) business property she owns (such as expensive medical equipment or a professional office building she owns and shares with a number of other professionals) to an irrevocable inter vivos trust established for her 18 year old daughter. The trustee could be a bank or other independent fiduciary. The trust, at a reasonable rental, leases the building back to Doctor Kopeznsky. This means the doctor does not have to move out of her building or lose the use of her equipment. Her daughter is immediately benefited. It is extremely important that there be no preconceived agreement with the trustee as to the amount of rental to be paid or the terms of the lease.

The trust could either distribute the rental income each year to the doctor’s daughter or accumulate it for later distribution to her. For example, when her daughter reaches age 21 (and in all states is no longer a minor), trust income or principal might be distributed each year and paid outright and unconditionally to the daughter. If the daughter chose to, she could use the money to pay for her own college education. If, under the applicable state law, a parent is not obligated to provide a college education for an adult child, none of the income will be taxable to the high tax bracket mother, even if it is paid directly to the daughter’s college. Moreover, the property would be owned outside the reach of the doctor’s creditors, an additional benefit.

TAX IMPLICATIONS

1. In the case of a sale and leaseback, the corporation that sells an asset must pay tax on any gain realized just as in the case of any other sale. Likewise, just as any partnership or corporation that rents property is allowed to take a tax deduction for the cost of the rental, when a sale-leaseback occurs, the fair rental paid by the seller for the use of its previously owned property is completely deductible as an ordinary and necessary business expense.[[4]](#endnote-4)

2. In the case of a gift-leaseback, proper care will enable the donor to receive a double benefit. First, the donor will obtain a business tax deduction for payments of rent. Then, when the rental income is paid to the trust (assuming it is a nongrantor trust), it will generally be taxed to the trust (as long as it is accumulated) or to the donor’s child or other trust beneficiary.[[5]](#endnote-5) Ideally, the tax bracket of the beneficiary or the trust will be lower than the donor’s. The tax savings can provide an excellent means of establishing a college education fund. Note, however, if the income is paid to a minor below age 18 (or full time students up to the age of 23), the child will be taxed, but generally at the parent’s top bracket, to the extent the payment exceeds $2,100 in 2015 as indexed for inflation. Therefore, a recipient child must generally be 18 or older (or in some cases 24 or older) for the income shift to work.

3. By making an irrevocable gift of an asset (except for life insurance transferred by the insured within three years of death), future growth is removed from the client’s estate at no additional estate tax cost.

4. There may be gift tax implications if there is an outright gift or if the sales price is less than the property’s fair market value.

5. If property is purchased using an installment note, cost recovery and interest deductions may offset a significant portion of the income from the lease. The lessee will be able to completely deduct the lease payments as an ordinary and necessary business expense. In the case of a sale-leaseback, the lessee would have to report interest income. If the lessee-user acquires the property and subsequently disposes of it, he will be subject to the recapture rules relating to cost recovery deductions, just as if he had been the owner of the property all along.

6. Where the property is sold to family members, and the installment payments are closely geared to the rental paid by the seller under the leaseback, the IRS will contend, and the courts will probably agree, that this is really a transfer with a retained life estate under IRC section 2036(a). This will certainly be the case where the lease is in effect for life. See *Est. of Maxwell*,[[6]](#endnote-6) where a mother sold the property to a son on an installment sale, then forgave the payments on the sales price except the interest on the installment note, which was almost exactly the same as the rent she paid. She was in her 80s and had cancer when she sold the property. Although the property here was a personal residence, the same rationale could extend to business assets.

7. If property is sold to a related party using an installment note, the resale of the property within two years will cause the original seller to have to recognize the deferred gain.

IMPLICATIONS AND ISSUES IN COMMUNITY PROPERTY STATES

With respect to the sale-leaseback, two aspects are present. Initially, if the sale price is later found to be less than what was the then fair market value, the amount of the gift (undervaluation) is spread between both spouses if the asset was community property. However, some states’ gift taxes have a much lower threshold than federal gift taxes, as to current cash tax payments, and consideration may be given to filing, in the year of the sale-leaseback, a gift tax return based on some other gift, thus possibly starting any statute of limitation periods to begin to run as to any subsequent imposition of a gift tax deficiency, including interest and penalties. The filing of a federal gift tax return should be considered to start the running of the statute of limitations if the risk of an audit is not significant.

The second concern is making sure that valid legal title has passed. The California statutory scheme, for example, grants the right to the management and control of community property to either spouse, with certain exceptions. However, in Texas, community property is either joint management property or the management property of one of the spouses. If property is classified as the "sole management" community property of a particular spouse, that spouse has the right to control or otherwise dispose of the property despite the other spouse’s interest in the property. If community property is joint management property, both spouses must participate. Sole management property is the property the spouse would have owned if single. If one spouse incurs a tax liability, the IRS may have different remedies against sole management community property as opposed to joint management community property.[[7]](#endnote-7)

 With respect to the lease, mortgage, or transfer of real property, both spouses must join in executing the conveying instrument, and practitioners should obtain both signatures for any transfer (including the gift) of any asset.

FREQUENTLY ASKED QUESTIONS

**Question** – In the case of a gift-leaseback, what are the basic prerequisites?

*Answer* – Where a donor transfers an office building or other income producing assets to a trust for a child and then leases it back:

(1) The donor cannot retain substantially the same control over the property as the donor did before the gift was made.

(2) The leaseback must be in writing and must provide for a reasonable rental (obtain an appraisal from an independent full time professional appraiser, preferably one who has expertise and specializes in the type of property to be valued).

(3) The leaseback, as distinguished from the gift in trust, must have a bona fide business purpose.[[8]](#endnote-8)

(4) The trust must have an independent trustee unrelated to the grantor.[[9]](#endnote-9)

(5) Title to the property should be in the trust or the child and should be recorded.

**Question** – What does the IRS look at and seek to attack in the case of sale-leaseback between related parties?

*Answer* – Basically, the IRS is trying to determine whether the transaction is genuine or merely structured as a sale. If the transaction is, in reality, a disguised loan, at best only part of the “rental” payments will be deductible because they will be considered payments of interest and principal. Only the interest portion can be taken as a tax deduction.[[10]](#endnote-10) Assuming the interest is considered “investment interest,” it will be deductible, but only to the extent the taxpayer has investment income. Interest will be deductible without limit if it is considered “business interest.” The characterization will be determined case by case, based on the facts and circumstances.

Alternatively, if the transaction is considered a sale, the seller-lessee has to pay a tax on any gain realized and recapture accelerated depreciation. If the property is leased for business purposes, he will be able to deduct his payment under the lease as rent.

The buyer-lessor also would be concerned with the distinction. In the case of a bona fide sale, the buyer-lessor may take depreciation or cost recovery deductions to the extent of the portion of the purchase price that is allocable to buildings or improvements and be entitled to a deduction for all expenses relating to the maintenance and operation of the property.[[11]](#endnote-11) However, if the Internal Revenue Service treats the transaction as a loan, the buyer will not be entitled to these deductions. This is because the buyer will be considered as a mere mortgagee rather than as owner of the property.

If the transaction is considered a sale, the next question is whether or not the sale price is equal to the fair market value of the property. If the sale price is less than the fair market value of the property transferred, the difference may be considered a gift. This may result in a gift tax being imposed on the seller-lessee.

An adjustment clause might be used to require an additional payment to the seller if the IRS revalues the property at a higher price. However, while the IRS has historically challenged the defined value clauses, there have been some recent taxpayer successes in this area.[[12]](#endnote-12)

**Question** – How can the transaction be structured to minimize an IRS challenge that the arrangement is in reality a loan?

*Answer* – If possible, the transaction should be structured so that it falls within the following safe harbor: (1) the lessor must be a corporation other than an S corporation, (2) the lessor must have a minimum “at risk” investment of 10% of the adjusted basis of the property at all times, (3) the term of the lease, including extensions, must not exceed certain limits, (4) the property must be leased within three months of its acquisition or, in the case of a sale-leaseback, it must be purchased by the lessor within three months of the lessee’s acquisition for a price not in excess of the adjusted basis of the property in the hands of the lessee.

If the safe harbor test cannot be utilized, then the transaction should have economic reality. In this regard, all the significant burdens and benefits of ownership should be transferred to the new owner. The parties should assume their obligations as lessee and lessor, respectively. The sale price of the property should be fair and reasonable in light of current market conditions and sales of comparable properties. Financial arrangements must be reasonable. The IRS has indicated it will litigate two party gift and leaseback cases (i.e., the lessee is the donor, or an S corporation or partnership).

The transaction should not force a “buy-back.” If there is a compulsory repurchase option, the seller is in virtually the same position he would have been in had he mortgaged the property rather than selling it and leasing it back. If a buy-back provision is included, the terms must be arranged and the amount of the purchase price computed as a result of arm’s length bargaining. (For related parties, consider IRC Section 2703.)

The buyer must receive the benefit of any appreciation in value. A final factor generally examined is the application of rent toward the repurchase price. The rental price paid by the lessee should be realistic, and it is advisable to obtain documentation to support how the rent was determined. It should closely approximate rentals for comparable property and comparable facilities. If part of the rent is to be applied to a repurchase price, the Internal Revenue Service might claim that such payments are in reality disguised payments of interest rather than payments for the use of the property.[[13]](#endnote-13)

**Question** – What is the primary economic disadvantage to funding through a sale-leaseback rather than a mortgage?

*Answer* – The primary drawback to funding through a sale-leaseback is the loss of the residual value of the property at the termination of the lease. This drawback can be minimized through an arms’ length repurchase option or option(s) to renew the lease over the expected life of the property.

**Question** – What terms should be specified in the lease that may help sustain an equal bargaining position between the donor and the trustee?

*Answer* – The following should be helpful:

A. Set rent at current market rates (obtain at least one independent professional appraisal expert’s opinion).

B. Provide for a single year lease term that must be renegotiated each year. When renegotiating the rent, it is also advisable to obtain one independent professional appraisal as to the expert’s opinion concerning the rent.

C. Place the property on the open market for lease (the higher the rental the grantor actually pays, the greater the overall tax shift). Note, however, that to the extent rents are deemed “excessive,” they might be disallowed as deductions.

D. Provide that lease payments are made “as a condition to the continued use or possession of the premises.”

E. Trustee should establish–and strictly enforce–a payment schedule. (Where payments were made randomly, in different amounts, at the client’s convenience, and not according to a schedule determined by the trustee, it was held that the grantor failed to relinquish total control over trust property.)

**Question** – In what situations will the grantor be taxed on trust income?

*Answer* – The grantor will be taxed on trust income:

1. if the grantor or his spouse has retained a reversionary interest;

2. if the grantor or his spouse retains power to control beneficial enjoyment;

3. if the grantor or his spouse retains certain administrative powers;

4. if the grantor or his spouse retains the power to revoke the trust;

5. if the income is used to pay support and maintenance to a person whom the grantor or his spouse is legally obligated to support;

6. if the income can be distributed to, or accumulated for, the grantor or his spouse without the approval of an adverse party.

Note that avoiding these situations does not per se assure a rental deduction. These situations concern only the issue of “Is there a valid trust?” and “To whom is the income taxable?” Although the two issues are concurrently operative, and are treated by the IRS as mutually exclusive.

One possible solution is to have someone other than the client or his spouse fund the trust. For instance, the client’s parents could put cash into an irrevocable trust for the client’s children. A loan to the trust from relatives or a third party, such as a bank, could be used to fund the purchase. The trust could use that cash to purchase assets owned solely by the client in his own name. The trust could then lease the assets to the client’s corporation.

**Question** – What are the best types of property to use in a gift-leaseback?

*Answer* – The best types of property are *tangible* assets used in the client’s trade, business, or profession, such as land, depreciated buildings (beware of recapture), office equipment (such as computers, word processors, photocopiers), library, trucks and machinery, and other tangibles and office accoutrements needed in business.

**Question** – Will *cash* work in a gift-leaseback?

*Answer* – A client *could* fund the trust with cash. The trustee could then acquire new equipment and lease it to the grantor or the grantor’s corporation or purchase equipment from the grantor and then lease it back. (Note that some authorities feel the “transfer of cash” method is more vulnerable to IRS attack than the “transfer of property” method where the cash is used to buy property already owned by the grantor.)

**Question** – Is geographical location of the taxpayer a consideration in planning a transfer and leaseback arrangement?

*Answer* – It is with respect to your client’s chances of prevailing in litigation with the IRS. Figure 40.1, “Your Odds in the Circuits,” shows at a glance sections of the country where the outlook is favorable, unfavorable, or chancy.

**Question** – How important is business purpose and economic substance?

*Answer –* For transactions entered into after March 30, 2010, Congress has codified the economic substance test[[14]](#endnote-14) which requires that transactions, including a sale leaseback transaction, change the taxpayer’s economic position in a meaningful way and have a substantial non-federal income tax purpose. Failure to meet both tests will negate the tax benefits and subject the transaction to a 20% penalty on the underpayment (40% if not adequately disclosed). The penalty may not be abated. Except for the penalty, this new rule does not really change the requirements previously imposed by court cases and rulings which state that both business purpose and economic substance are essential to tax success. For instance, in Field Service Advice (FSA) 200011004, the Service expressed doubt that the taxpayer's leveraged lease transaction had either business purpose or economic substance. It didn't give credibility for federal income tax purposes to the purported sale and leaseback and would therefore not give basis credit and therefore reduce or disallow depreciation deductions. It would also disallow interest deductions on “debt” incurred by the taxpayer used to “purchase” the property.

Recent cases have clearly illustrated that the IRS and the courts will give credibility for tax purposes to a transaction only where it is genuine both as to form *and* substance. In other words, the taxpayer must have entered into the arrangement compelled or encouraged by a business or profit motive and with assumptions based on market-place realities. Stated differently, the transaction must be “imbued with tax-independent considerations” rather than being shaped solely by tax-avoidance features with self-serving, yet otherwise meaningless, labels.

The IRS and the courts, in ascertaining whether or not a transaction meets these criterion, look to two issues, the taxpayer's subjective business motivation and the objective economic substance of the transactions. Planners have only to ask:

1. Did the taxpayer have one or more business purposes (other than merely to avoid tax) in entering into this maneuver?

2. Was there economic substance – beyond just the creation of tax benefits?

For tax purposes, the IRS and the Courts will invalidate and give no credibility to a transaction which has no economic or commercial objective and which was entered into solely for the purpose of tax reduction. So no matter how pristine or proper the outward form appears to be, the IRS and the Courts can feel free to go beyond that outer skin and look at the reality of the situation to determine the proper tax treatment each of the parties to the transaction should receive. Even a series of otherwise legitimate transactions can be disregarded if the IRS can put the pieces of the puzzle together and prove to a court that, when viewed as a whole, the transaction has no economic substance. That's exactly what occurred in FSA 200011004. The taxpayer structured a sale-leaseback that – when taken as a whole – had no reasonable business purpose aside from the possible tax savings. In fact, the only context in which this transaction could make sense was in the avoidance of income tax.

One test the courts will use is the “true owner” test. Does the taxpayer have a real stake in the risks and rewards? For instance, is the taxpayer really liable for purported debt? How likely is it that the taxpayer might suffer a loss or enjoy a gain? Will the taxpayer have a real economic loss (beyond a tax loss) if things don't go as planned? If the taxpayer can't re-lease the property at the end of the lease term, will the taxpayer suffer? Or does the taxpayer lack any real liability for the transaction financing? Is there a series of artificial games being played that eliminate either real risk or real reward – other than tax risks and rewards? Does the transaction have more than a de minimis economic effect on a taxpayer? Near absolute limitations on the taxpayer's risk of loss (and opportunity to profit) deprive a transaction of meaningful economic substance. Has real risk been negated by the use of nonrecourse financing? Is the opportunity for pre-tax profit remote because the leased property is unlikely to have residual value? Here, the taxpayer's transaction was structured in a way that almost entirely eliminated the risk of loss from physical depreciation of the rail cars.

Nor could the taxpayer realize any significant upside gain because a third party was given the option of purchasing the rail cars at the end of the lease term under favorable conditions if the cars in fact had significant residual value. Even if the third party didn't exercise that option, the taxpayer was required by contract to sell the railroad cars and pay over any excess of the train cars residual value over their purchase price to the third party. The potential to profit was capped from inception, as the likelihood of loss was almost entirely limited. In arriving at a conclusion that there was no reasonable expectation of profit apart from the tax benefits of the transaction, courts will take a real world approach: For example, they will (and should) take into consideration the time value of money – and the money value of time.

Even if the form of a transaction is held to be valid, the IRS and courts might still deny deductions to the taxpayer on the basis that someone other than the taxpayer is the real owner. For instance, according to the logic above, if the taxpayer here never received the benefits and burdens of ownership of the rail cars, then the taxpayer is not entitled to the deductions and/or depreciation that property generates. Once again, the potential of gain or loss from the residual value or sale or re-lease of property is the acid test of ownership in sale-leasebacks. If the taxpayer is indirectly guaranteed to recover its costs, that is indicative of a lack of economic substance. Here, the taxpayer was assured from the start that it would receive a specified amount as a termination payment even if the rail cars lack any residual value and even if the third party didn't exercise its purchase option.

**Question** – What tests are used by courts to ascertain if the buyer is really a buyer in a sale leaseback?

*Answer* – Some courts use the following questions to determine if the buyer really is a buyer.

1. What is the size and extent of the purchaser's equity interest in the property? (If beneficial ownership in the property never vests in the taxpayer, that fact supports characterizing the transaction as a financing.)

2. Does the useful life of the property extend beyond the term of the lease?

3. Is the lease renewal or purchase option at the end of the lease term based on a formula or price representing an arm’s length fair market value of the equipment at that time?

4. Does the projected residual value of the equipment plus the cash flow generated by the rental of the equipment make it possible for investors to break even?

5. Is it likely a turnaround point will be reached when depreciation and interest deduction are less than income received from the lease?

6. Are the net tax savings for the investors less than their initial cash investment?

7. What is the reasonable potential for realizing a profit or loss on the sale or release of the equipment? (If the taxpayer's potential for realizing a profit (income in excess of its expenses) is “locked-in,” i.e., a fixed amount, this is indicative of a financing transaction.)

8. Is the agreement in question more like a lease or a conditional sale contract.

**Question** – How do the courts determine if there is a lease?

*Answer* – There can be no lease(back) if what is really intended is something other than a lease. Courts will consider these factors:

1. Are portions of the periodic payments specifically allocated to equity to be acquired by the lessee?

2. Will the lessee acquire title upon payment of the required amount of rentals?

3. Does the total amount which the lessee is required to pay for a relatively short period of use constitute an inordinately large proportion of the total sum required to be paid to secure the transfer of title?

4. Do the rental payments materially exceed the current fair rental value? (Do the rental payments include an element other than compensation for the use of property?)

5. Can the property be acquired under a purchase option at a price which is nominal in relation to the value of the property at the time when the option may be exercised, or is relatively small when compared with the total payments made?

6. Is there a specific portion of the payments designated or identifiable as interest?

**Question** – What criterion do courts use to determine if there was in fact a sale or gift?

*Answer* – There can be no leaseback if there was no sale (or gift). So it is important to document that there was a sale - as distinguished from a loan (where the original owner never really relinquishes ownership). Courts will consider these factors:

1. Does the assignee of property have the right to repayment? If so, this indicates that an assignment may be a loan-type investment secured by the right to future revenue (a nonrecourse secured loan).

2. Are there amounts deposited in a bank or some other place that directly or indirectly guarantee repayment? This is, of course, a characteristic of a loan.

If the court determines that (assuming that the debt is bona fide) the transaction is a secured financing and not a sale and leaseback, the result will be that the funds the taxpayer pays and characterizes as rental payments are really loans. They must be repaid to the taxpayer and so are not taxable income to the borrower, the party that receives the money – nor is it deductible by the taxpayer.

**Question** – What factors will the court examine in making this determination of whether cash paid to one party is a bona fide loan – or is taxable income?

*Answer* – A court will ask:

1. Does a note or other evidence of indebtedness exist?

2. Is there a written loan agreement?

3. Is there a fixed schedule for repayment?

4. Has any security or collateral been required?

5. Was interest (no matter how classified) charged?

6. Was there a demand for repayment? Have there been repayments?

7. Do the facts indicate the parties intended for the transaction to be a loan?

8. Was the borrower was solvent at the time of the loan?

**Question** – What factors will a court examine to ascertain the validity of the debt?

*Answer* – The question is important because, if there is no genuine debt, then the taxpayer can't use it as part of his basis for depreciation purposes. Nor can interest payments be deducted if they arise from transactions that have no purpose, substance or utility apart from their anticipated tax consequences.

Factors a court will examine to determine the genuineness of debt include:

1. Does the purchaser acquire equity in the property by making payments and have an economic incentive to pay off the note? If not, debt will not be considered bona fide.

2. Is the overall transaction valid? If so, the debt will not be. Is money moving in a circle without any economic substance? Is there an “internal accounting circle” in which no meaningful cash will every really be exchanged?

Be sure the donor does not retain any control over the property once it is transferred. Carefully document each step of the transaction. The agreement for the leaseback must be in all respects an arm’s length transaction, in writing, independently and professionally reasonably appraised, and have a bona fide business purpose and economic substance.

CHAPTER ENDNOTES

1. . See Rev. Rul. 55-540, 1955-2 CB 39; Rev. Proc. 75-21, 1975-1 CB 715, as modified by Rev. Proc. 79-48, 1979-2 CB 529; Est. of Franklin, 64 TC 752 (1975); *Narver v. Comm*., 76 TC 53 (1980); *Hager v. Comm*., 76 TC 759 (1981). [↑](#endnote-ref-1)
2. . See *Oakes v. Comm*., 44 TC 524 (1965); *Audano v. U.S*., 428 F.2d 251 (5th Cir. 1970). [↑](#endnote-ref-2)
3. . IRC Secs. 1245, 1250. [↑](#endnote-ref-3)
4. . IRC Sec. 162. Can a sale-leaseback result in a deductible loss? Yes, says the Tax Court, if there is a bona fide sale and not an exchange of like-kind property. But, in the favorable case of *Leslie, Co. v. Comm*., 64 TC 247 (1975), the IRS has non-acquiesced. Nonacq. 1978-2 CB 1. [↑](#endnote-ref-4)
5. . IRC Secs. 641, 652, 662. [↑](#endnote-ref-5)
6. . 3 F.3d 591 (2nd Cir. 1993), aff’g 98 TC 584 (1992). [↑](#endnote-ref-6)
7. . See Internal Revenue Manual § 25.18.1.2.12 (02-15-2005), Management and Control. [↑](#endnote-ref-7)
8. . *Van Zandt v. Comm*., 341 F.2d 440 (5th Cir. 1965) aff’g. 40 TC 824, cert. den. 382 U.S. 814. [↑](#endnote-ref-8)
9. . *Oakes v. Comm*., 44 TC 524 (1965). [↑](#endnote-ref-9)
10. . See Rev. Rul. 55-540, 1955-2 CB 39. In *Serbousek v. Comm*., TC Memo 1977-105, the Tax Court allowed a rent deduction on a gift-leaseback of a medical building. In that case, a taxpayer (1) gave up all beneficial control over the property; (2) paid a reasonable rent; (3) had a business purpose for the lease (he needed the building for his practice); and (4) retained no equity in the property during the lease period. See also *Lerner v. Comm*., 71 TC 290 (1978), acq. in result 1984-1 CB 1. *May v. Comm*., 76 TC 7 (1981).

For an example of how not to arrange a gift-leaseback, see *Frank Lyon Co. v. U.S*., 38 AFTR 2d 76-5019 (8th Cir. 1976); *Hilton v. Comm*., 74 TC 305 (1980). [↑](#endnote-ref-10)
11. . IRC Secs. 167, 168, 162; Treas. Reg. §1.162-4. [↑](#endnote-ref-11)
12. . See Valuation Formula Clauses for the Noncharitably Inclined, B.K. Duffey and P.J. Durrey, 38 Estate Planning, No. 6, 30 (June 2011); Estate Planning by the Numbers- Define-Value and other Formula Transfers, S. T. Dyer and R. Ramirez, 37 Estate Planning, Number 5 (May 2010); *Estate of Anne Y. Petter V. Comm*., (2011, CA9) 653 F. 3d 1012; *Joanne M. Wandry, et al. v. Comm*., TC Memo 2012-88, where the court upheld a defined gift clause and held that there is no well-established public policy against formula clauses. [↑](#endnote-ref-12)
13. . See Rev. Rul. 55-540, 1955-2 CB 39; Rev. Proc. 75-21, 1975-1 CB 715, as modified by Rev. Proc. 79-48, 1979-2 CB 529. See also AOD 1984-037. [↑](#endnote-ref-13)
14. . IRC Sec. 7701(o) and Sec. 6662(i); See Tax Practice Responsibilities: Codification of Economic Substance Affects AllTax Practitioners, J. F. Bresnahan, II, G. M. Fowler and A. M. Mattson, The Tax Adviser, 42.8 (Aug. 2011).

**Figure 40.1**

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| **YOUR ODDS IN THE CIRCUITS** |
| **Second, Eighth and****Ninth Circuits** | **Third and Seventh****Circuits** | **Fourth Circuit** |
| New York, Vermont, Connecticut, North Dakota, South Dakota, Nebraska, Minnesota, Iowa, Missouri, Arkansas/Montana, Washington, Oregon, Idaho, Nevada, California, Arizona, Alaska, Hawaii, and Guam | Pennsylvania, New Jersey,Delaware and the Virgin Islands/Wisconsin, Illinois, and Indiana | West Virginia, Virginia, Maryland, North Carolina, South Carolina |
|  |  |  |
| Courts should side with the taxpayer if | Courts will side with taxpayer if Eighth and Ninth Circuit tests are met. | Courts are tougher here than in Eighth, Ninth, Third and Seventh Circuits, and deduction still possible where grantor gives up control and title to property is placed in valid irrevocable trust. |
| 1. Taxpayer doesn’t maintain control over property (satisfied by independent trust). |
|
|
| 2. Rental payments are reasonable and terms of rent reduced to writing. |
|
|
| 3. Leaseback has a business purpose. |
|  |  |  |
| See *Quinlivan v. Comm.*, 599 F.2d 269 (8th Cir. 1979); *Brooke v. Comm.*, 468 F.2d 1155 (9th Cir. 1972); *Rosenfeld v. Comm.*, 83-1 USTC ¶9341 (2nd Cir. 1983). | See *Brown v. Comm.*, 180 F.2d 926 (3rd Cir. 1950). | See *Perry v. U.S.*, 520 F.2d 235 (4th Cir. 1975), cert. den. |
| **Fifth Circuit** | **Circuits That Have Not Ruled on Gift Leasebacks** |
| Mississippi, Louisiana, Texas | All others |
|  |  |
| Taxpayers have consistently failed in attempts to obtain rental deductions. (This court looks at the purpose of the arrangement as well as the arrangement itself and this Circuit has demanded that the taxpayer show a business reason for *both* the leaseback and the gift itself.) But this court has not held that all intra-family trust leasebacks are economic nullities; nor has it held that “economic reality” was unattainable with trust leasebacks. It appears that the Fifth Circuit is placing undue weight on the origin of the trustee’s title in the property, a factor which is not otherwise considered relevant in cases dealing with rental payment deductibility. | Taxpayers likely to face litigation but likelihood of |
| success is highest if |
| 1. independent trustee used |
| 2. arm’s length lease signed after negotiation with trustee |
| 3. duration of trust exceeds length of lease |
|  |  |
| See *Van Zandt v. Comm.*, 341 F.2d 440 (5th Cir. 1965), cert. den.  | Although there are cases on gift leasebacks in these circuits (cited below), none of these met all the tests set forth by the Tax Court, so it is not known how an Appeals Court in one of these circuits would react to a properly structured arrangement. See *Duffy v. U.S.*, 487 F.2d 282 (6th Cir. 1973). |
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 [↑](#endnote-ref-14)