INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Communications Technology & Media, LMSB

Taxpayer's Name:

Taxpayer's Address:
Taxpayer's Id. No. (TIN):
Years Involved:

LEGEND:

The Facility =
XCorp =
Broker =
Appraiser1 =
Appraiser2 =
Appraiser3 =
Appraiser4 =
Advisor =
ZZZ =
YYY =
YCorp =
ZCorp =

ACorp =
BCorp =
CCorp =

Donee =
z% =
County X =
Year 1 =
Year 13 =
Xx Street =
Date 1 =

Date 2 =
Date 3 =
Date 4 =
Year 69 =

$A	=	$V	=
$B	=	$W	=
$C	=	$X	=
$D	=	$Y	=
$E	=	$AA	=
$F	=	$BB	=
$G	=	$CC	=
$H	=	$DD	=
$J	=	$EE	=
$K	=	FF	=
$L	=	GG	=
$M	=	$HH	=
$N	=	$JJ	=
$O	=	$KK	=
$P	=	$LL	=
$Q	=	$MM	=
$R	=	$NN	=
$S	=	$OO	=
$T	=	$QQ	=

ISSUES:

(1) Should the form of the sale/leaseback transaction entered into by Taxpayer be respected for federal income tax purposes, or should it be recharacterized as a financing arrangement?

(2) If the form of the sale/leaseback transaction is not re-characterized as a financing arrangement, does the Taxpayer's amount realized on the sale of the Facility include the fair market value of the Taxpayer's leasehold interest in the Facility, which purportedly allows Taxpayer to lease the property at less than fair rental value?

(3) If the form of the sale/leaseback transaction is not re-characterized as a financing arrangement, is the sale/leaseback a like-kind exchange and, consequently, a transaction for which no gain or loss should be recognized under § 1031?

CONCLUSIONS:

(1) Whether a sale/leaseback transaction should be respected for federal income tax purposes depends on whether the benefits and burdens of ownership have passed to the purported buyer, which must be ascertained from all of the facts and circumstances, including the intentions of the parties. In the present case, many factors suggest that the purported owner's rights are comparable to those of a mortgagee rather than an owner of property. Conversely, many factors suggest a true sale. However, there are some significant factual disagreements between Taxpayer and the IRS audit team, most notably relating to the valuation of the subject property on two repurchase dates. If, as the Taxpayer contends, the valuations were based on arm's length determinations, at the time the agreement was entered into, of the fair market value of the property at the repurchase dates, the form of the sale/leaseback transaction should be respected. If, however, as the audit team contends, the valuations were based primarily on factors other than the fair market value of the property, and the parties intended that the Taxpayer would, absent unforeseen circumstances, repurchase the property, the transaction should be recharacterized as a financing arrangement.

(2) If the form of the sale/leaseback transaction is respected and not re-characterized as a financing arrangement, the Taxpayer's amount realized on the sale of the Facility must include not only the amount paid by the purchaser, but also the fair market value of any property received from the purchaser. Thus, if as the audit team contends, the leaseback agreement allows Taxpayer to lease the Facility at less than fair rental value and the stated amount paid to Taxpayer on the sale of the Facility was less than the Facility's fair market value, the fair market value of the bargain rent must be included as part of Taxpayer’s amount realized. Conversely, if, as Taxpayer contends, the amount paid for the Facility was equal to its fair market value on the date of its sale, and, consequently, there was no bargain rent in the leaseback agreement, Taxpayer’s only amount realized is the stated amount paid for the property.

(3) The sale/leaseback transaction is not a like-kind exchange as described in § 1031.

FACTS:

Background

As a way to raise funds, Broker proposed that Taxpayer participate in a sale/leaseback of its corporate headquarters building (the Facility). The Facility had been constructed between Year 7 and Year 9 at a total cost of approximately $A. The proposed sale/leaseback agreement excluded certain personal property and components of the building that are classified as other than 39 year real property for tax purposes. The approximate cost of the assets subject to the agreement totaled $B, and the assets had an adjusted basis of approximately $C as of December Year 11. The transaction was structured under the Participation Agreement, dated Date 3, Year 11, and was entered and signed by Taxpayer (as seller and lessee); ZCorp (as buyer and Owner Participant); ACorp (as the Owner Trustee); BCorp (as the Indenture Trustee); and CCorp as (Loan Participant).

Steps in the Sale/leaseback Transaction

Pursuant to section 2.1 of the Participation Agreement, on Date 3, Year 13, Taxpayer sold to ACorp, and ACorp acquired the Facility for $D. ACorp agreed to pay the property cost to Taxpayer. Concurrently with such sale and purchase, (a) Taxpayer delivered the Facility to ACorp and ACorp accepted delivery, (b) ACorp leased the Site from Taxpayer pursuant to the ground lease, and (c) ACorp leased the Facility to Taxpayer.

Under section 2.2 of the Participation Agreement, on Date 3, Year 13, ZCorp participated in the payment of the property cost by making an equity investment in the beneficial ownership of the Facility in an amount equal to $E or 10% of the total cost. ACorp applied this amount to the property cost. Also, CCorp participated in the payment of the property cost by making a non-recourse secured loan, evidenced by the notes to ACorp, for the remaining amount of $EE. BCorp applied the loan amount, on behalf of ACorp, toward the property cost.

Pursuant to section 2.3(b) of the Participation Agreement, on Date 3, Year 13 the transaction was instituted using the following steps:

1. ZCorp transferred its investment amount to Taxpayer on behalf of ACorp;

2. CCorp transferred its loan amount to Taxpayer on behalf of ACorp;

3. Taxpayer executed and delivered to ACorp the deed of all of its right, title and interest in and to the Facility;

4. ACorp executed and delivered the indenture and granted a security interest and mortgage in the indenture estate to BCorp. ACorp also issued, sold and delivered notes, authenticated by BCorp, against payment of the purchase price in an aggregate principal amount equal to the loan amount. In addition, with the proceeds of the sale of the notes and the proceeds of the investment, ACorp purchased all right, title and interest of Taxpayer in and to the Facility. Also, as ground lessee, ACorp leased the site from Taxpayer and then leased the entire property back to Taxpayer;

5. BCorp executed and delivered the indenture; then authenticated, registered and delivered the notes to CCorp, and executed the receipt for the original of the lease;

6. Taxpayer and ZCorp executed and delivered a "Tax Indemnity Agreement;" and

7. CCorp purchased the notes.

<u>Synopsis of the Tax Planning Aspects of the Sale/leaseback Transaction</u>

On Date 2, Year 11, Broker provided a cash flow analysis of the proposed sale/leaseback transaction to Taxpayer, based on a fair market value of $F (for both the building and land) and an estimated tax loss of $G. The analysis assumed that Taxpayer would exercise an early buy-out option and reacquire the building in Year 33. Using various discount rates, the analysis showed that the after-tax advantage of participating in the sale/leaseback transaction would range from $H at a discount rate of 4.51% to $J at a discount rate of 15%.

The source of the $F estimated value used by Broker is unknown, but may have been based on an appraisal of the building as of January 1, Year 13, by Appraiser2 for property tax purposes. Appraiser2 valued the building and land at $K, consisting of $L for the building and $M for the land. In arriving at the $K figure, Appraiser2 reduced the value of the building for the estimated value of unfinished space as of January 1, Year 13. In addition, the building total included short-lived assets that were not part of the proposed sale/leaseback transaction. In another document, the short-lived assets were estimated to be 18.5% of the building total. After reducing the Appraiser2 appraisal total for the estimated value of short-lived assets, Appraiser2's appraisal indicates a value of $N for the building and land as of January 1, Year 13.

Broker recommended that Appraiser1 be hired to perform an appraisal of the property to be used in the sale/leaseback transaction. Broker and Taxpayer personnel met with Appraiser1 on November 5, Year 13 to discuss how the property would be appraised. The appraiser's notes of the meeting indicate that Appraiser1 was advised that Taxpayer wanted to maximize its tax loss. Various features of the building were also discussed, as well as a "typical" fair market value figure of $O.

Advisor also advised Appraiser1 that Taxpayer would also engage Appraiser1 to provide a separate report pertaining to the fair rental value of the Facility. The separate report was not to be shown to or discussed with the lessor in the sale/leaseback transaction. Advisor stated that the context for the separate report was a sublease transaction between Taxpayer affiliates. For purposes of the separate report, Taxpayer instructed Appraiser1 to assume a 10 year term with level rents, with an option to renew for another 10 years at the same amount. The separate report reflects a fair rental value of $P per year for years 1-20 of the lease term and $Q for years 21-25 using a discounted cash flow and a 3.2% annual increase. The first appraisal by Appraiser1 reflects a fair rental value of $R in years 1-5, $S in years 6-10, and $T in years 11-15. Broker then designed a sale/leaseback transaction in which Taxpayer would have undisturbed use of the Facility and would be able to buy the property back at various dates in the future at a stated price.

At some point Appraiser1 advised Taxpayer and Broker that the Facility would have an appraised value that was significantly higher than the preliminary estimate. On December 6, Year 13, Broker prepared a revised economic analysis, using a new building value and dropping the underlying land from the sale/leaseback transaction. The revised analysis generated a smaller projected tax loss. The cover sheet for the fax transmission stated the following:

> Since we are eliminating the land altogether, the up-front loss is reduced by a large amount. This obviously hurts the economics, but the deal is still rich.

Appraiser1 subsequently appraised the property at $D for the building only, a figure that produced a tax loss of $V. Taxpayer ended up using a tax basis for the property of $C on the return as filed, instead of the tax basis that had been used in the Broker analysis on December 6, Year 13. This caused the actual tax loss to be higher than the amount projected by Broker.

The Internal Revenue Service hired Appraiser3 to value the building as of Date 3, Year 13 and at the repurchase option dates. Appraiser3 estimated that the fair market value of the Facility as of Date 3, Year 13 was $W.

As noted above, Taxpayer, under the Participation Agreement, was permitted to lease the Facility for a number of years. Appraiser1 valued the fair rental of the Facility, excluding the land and fixtures, at $KK per square foot per year as of Date 3, Year 13. However, when Taxpayer leased the building back from ZCorp, the rent Taxpayer was obligated to pay was $LL per square foot during the initial lease term, which was equal to the interest payable to CCorp.

No principal payments are required during the initial lease term. Review of the Summary and Terms of Conditions distributed to the potential buyers of the building indicates that the lease payments were to be computed to minimize the net present value cost to Taxpayer. The rental payments to be made by Taxpayer during the initial lease term were computed to provide a net economic return to ZCorp (as lessor) and were not based on fair rental value of the Facility. Taxpayer has never maintained that the rent charged was based on fair rental value. The Appropriations Request submitted to the finance committee of Taxpayer's Board of Directors for approval of the transaction contains the following information regarding the rent amounts:

> Rent is the equivalent of interest only on a 25-year non-amortizing note at an interest rate of 88 [basis points] over 25-year Treasury Bills . . . .

As noted above, the potential buyers of the building were instructed to propose rent structures that would minimize the net present value cost to Taxpayer. Accordingly, ZCorp proposed making rent payments exactly equal to the interest that would be due on the CCorp loan, which had an interest rate of z%.

Under the arrangement ultimately adopted, ZCorp as lessor has the right to require Taxpayer to renew the lease at the end of the initial lease term if Taxpayer does not exercise its option to purchase the Facility. The renewal lease payments are slightly larger than the interest and principal payments due CCorp during this period. ZCorp's right to require Taxpayer to renew the lease allowed the parties to treat the lease as a capital lease for book purposes.

Taxpayer has the right to purchase the building on the Early Buy Out (EBO) date of Date 4, Year 22 at the EBO price of $X. Taxpayer also has the right to purchase the property at the end of the initial lease term on Date 4, Year 39 at the Fixed Purchase Price Option (FPPO) of $Y.

The outside appraiser (Appraiser3) hired by the Service estimated the value of the building at the buy out option dates. The outside appraiser estimated that the Facility would have a fair market value of $AA on the EBO date and a value of $BB on the FPPO date.

As discussed above, ZCorp provided an equity investment of 10% of the cost of the property. ZCorp required Taxpayer to enter into a letter of credit agreement. The agreement requires Taxpayer to issue a letter of credit in favor of ZCorp for the equity portion of the stipulated loss value if the credit rating of Taxpayer falls to certain levels. CCorp required Taxpayer to enter into a purchase agreement. The agreement allows CCorp to put the notes to Taxpayer at the end of the initial lease term.

Taxpayer did not sell the land on which the Facility is located. Taxpayer and ZCorp entered into a ground lease on the same day as the sale. The ground lease expires on Date 4, Year 59 and contains 4 renewal periods of 5 years each. The ground lease requires Taxpayer to pay the base rent to itself as long as Taxpayer is the lessee of the building. If Taxpayer is not the lessee of the building, ZCorp is responsible for the base rent on the ground lease.

Starting in Year 14, Taxpayer made monthly entries to a reserve account for the eventual repurchase of the building. Assuming that Taxpayer exercises its option to repurchase the building after 26 years at a price of $Y, ZCorp will have an economic profit of $CC (before transaction costs).

<u>ACorp's Rights to Sell or Transfer</u>

ACorp's rights to sell, transfer or otherwise dispose of any interest in the property are governed by the provisions set forth in sections 11(d), 11(e), 21 and 22 (h) of the lease and 5.3(a) of the Participation Agreement.

Pursuant to section 11(d) of the lease, to secure the indebtedness evidenced by the notes, ACorp will assign to BCorp, for the benefit of CCorp, its right, title, and interest in the lease including the right to receive all payments of rent and its right, title and interest in the property. Taxpayer consented to such assignment and to the terms of the indenture and agrees to pay directly to BCorp all amounts of rent due or to become due to ACorp.

Under section 11(e) of the lease, during the lease term ACorp may not transfer, sell or convey the property, or any of its interest therein, or assign rights and obligations under this lease without the prior written approval of Taxpayer. However, if the lease is terminated, an event of default occurs as a result of bankruptcy, or an event of default occurs and the lease is declared in default, ACorp may do any of the foregoing without any manner of limitation or restriction on transfer. Transfers in violation of the agreement are null and void.

Notwithstanding any provision of the lease to the contrary, no future subleases of any portion of the property shall be, are intended to be, or shall be deemed to be, collaterally or absolutely assigned to lessor (ACorp).

Tax And Book Treatment Of Sale/leaseback

On the Year 13 Form 1120 consolidated tax return of Taxpayer, a loss on the sale of the building was reported on Schedule M-1. The loss for tax purposes was computed as follows: Adjusted basis in assets sold, $C, minus the sales price, $D, equals the $V loss.

For book purposes, the transaction was treated as a financing arrangement and Taxpayer treated the lease as a capital lease under GAAP. No loss was shown on the books.

Other Value Information Regarding The Facility

As noted above, Appraiser2 completed an appraisal dated January 1, Year 13, for property tax purposes. The appraisal showed significant discounts for size and usable space and included all the buildings at Taxpayer's office park. The appraisal, submitted to the County X Appraisal District, estimated the fair market value of the Facility to be $L.

The County X Appraisal District reviewed the appraisal completed by Appraiser2. The County X Appraisal District questioned the appraisal and hired an outside appraiser to revalue the buildings at Taxpayer's office park. County X hired Appraiser4, which estimated the value of the Facility to be $DD as of January 1, Year 14. Appraiser4 did not take substantial discounts for size and usable space. This appraisal is much closer to the adjusted basis and construction cost of the building.

During Year 13, Taxpayer decided to donate an office building (7 years older than the Facility and located in the Facility’s office park) to Donee. The donation occurred in Year 14. The value placed on the donated building was $MM per square foot, compared to the $NN per square foot value used for the Facility. Also, Appraiser1 indicated that the fair rental value of the donated building was $OO per square foot, compared to $QQ for the Facility (including land and fixtures). The higher appraised value allowed Taxpayer to take a larger charitable deduction for the donation.

Disclosed Business Purposes of Sale/leaseback Transaction

The audit team interviewed ZZZ, a former Taxpayer employee. ZZZ signed the sale/leaseback closing documents on behalf of Taxpayer. ZZZ was asked to explain the business purpose of the sale/leaseback transaction. ZZZ stated that the primary business purpose was to secure long term financing, at a reasonable cost for the building. The secondary purpose was to give Taxpayer options at the end of the lease that ownership does not offer. ZZZ indicated that Taxpayer did not know if it would still exist at the end of the lease period or, if it did exist, what its circumstances would be. For example, Taxpayer was concerned that the size of the Facility may exceed the needs of Taxpayer in 25 years. ZZZ said it took several years to find a buyer for the old headquarters building located on Xx Street and it sold for less than expected. Because Taxpayer now leased the Facility, it could simply move out at the end of the lease term.

The audit team requested all internal documents prepared at the time the sale/leaseback transaction was being considered. The documents received indicate that (1) the taxpayer wanted to obtain financing, (2) the tax loss substantially reduced the cost of borrowing, and (3) without the tax loss the cost savings was insignificant compared with other forms of borrowing. The internal documents do not indicate that Taxpayer personnel based the decision to participate in the sale/leaseback transaction on a desire to have options at the end of the lease term.

Taxpayer's Factual Presentation of the Case

As noted throughout this memorandum, there are a number of significant factual disagreements between the audit team and Taxpayer concerning the transaction at issue. The major factual discrepancies are summarized below.

According to Taxpayer, during the summer of Year 13, Broker discussed the possibility of Taxpayer selling the Facility to raise capital while still having use of the Facility under a leaseback agreement. The Facility is FF square feet, which makes it one of the largest corporate headquarters buildings in its region. Taxpayer contends that few purchasers could occupy a building of that size, and adapting the building for multiple tenants would be difficult and expensive.[1]

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[1] The audit team disputes the assertion by Taxpayer that the market for the Facility was so limited because of its size, in view of the fact that the Facility's design with separate wings made it easily adaptable to at least 5 separate buyer/users.

Prior to the construction of the Facility, Taxpayer's headquarters was located on Xx Street (the Xx Street HQ). Taxpayer tried to dispose of the Xx Street HQ for several years prior to selling it in September of Year 13. When the Xx Street HQ was 25 years old, it was obsolete for Taxpayer's business operations. Taxpayer's difficulty in selling the Xx Street HQ were well known to personnel planning the sale and leaseback of the Facility and, according to Taxpayer, was a major factor motivating Taxpayer to engage in this transaction.[2]

On behalf of Taxpayer, Broker distributed bid packages to prospective purchasers who might be interested in purchasing the Facility. The bid package included a description of the property and a summary of proposed terms of the transaction, and requested prospective purchasers to bid on the property. The highest bid for the property was from YCorp (ZCorp's parent). YCorp was unrelated to Taxpayer. Pursuant to YCorp's request, the land underneath the Facility was not part of the sale. Also not part of the sale were certain items of personal property and other components of the building that are not classified as 39-year property for tax purposes.[3]

Taxpayer contends that it wanted to get the highest price it could for the Facility in order to maximize the amount of capital raised from the sale of the building.[4] One of the written terms of the proposed transaction was that the Facility would be sold for fair market value, as determined in an appraisal performed by a recognized appraisal firm satisfactory to YCorp. Appraiser1 was hired by YCorp and Taxpayer to perform the appraisal on the Facility to determine (1) the fair market value of the Facility building; (2) the economic useful life of the Facility; and (3) the residual value of the Facility at specific times during the lease. Appraiser1 determined that (1) the fair market value of the Facility building (exclusive of land, fixtures and site improvements) on Date 3, Year 13 was $D; (2) the remaining economic life of the Facility building on Date 3, Year 13 was GG years; and (3) the fair market value of the Facility on Date 4, Year 22 and Date 4, Year 39 would be

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[2] The audit team disputes that problems involved in selling the Xx Street HQ were of relevant concern to the transaction planners involved in this case. The zoning of the property on Xx Street contributed to the difficulties in selling the Xx Street property. There was no reason to believe that similar problems would inhibit a later sale of the Facility.

[3] The audit team disputes the assertion that the land was excluded from the sale at YCorp's request.

[4] The audit team disputes the assertion that Taxpayer wanted to sell the Facility at the highest possible price in view of the fact that it declined to sell the land after its appraised value increased. In addition, notes of Taxpayer's appraiser indicate that Taxpayer stated that it wanted to maximize its tax loss.

$HH and $JJ, respectively.[5]

Pursuant to the sale/leaseback documents, Taxpayer has the right to purchase the Facility on each of the repurchase dates at prices slightly higher than the predetermined market values as determined by Appraiser1. Taxpayer does not foresee it exercising its option to purchase the Facility on the EBO date of Date 4, Year 22. The decision whether to exercise its right to purchase the Facility on the FPPO date of Date 4, Year 39, will depend on the office needs of Taxpayer at that time.[6]

The negotiations concerning the sale/leaseback of the Facility were at arm's length between unrelated parties. Taxpayer insists that the terms of the transaction were commercially reasonable and typical of this type of transaction.[7] While an office building donated to Donee in Year 14 was valued at more than double the per square foot amount of the Facility, Taxpayer contends that the valuation disparity was attributable to the the donated structure's smaller size (about 3 percent the size of the Facility), which makes it more readily marketable to a larger number of potential buyers. Taxpayer also asserts that there was a higher percentage of usable space for potential renters in the donated building.[8]

Finally, Taxpayer insists that the repurchase amounts were not set at a below-market

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[5] The audit team disagrees with the values determined by Appraiser1 based on the appraisals made by other appraisers.

[6] Taxpayer is currently accruing a reserve to repurchase the Facility on the FPPO date. This fact may be interpreted as a sign of Taxpayer's intent to reacquire the Facility. However, the office space needs of the taxpayer have declined significantly since Year 13.

[7] In the view of the audit team, though it may be true that negotiations were conducted between unrelated parties, the negotiations were not over the purchase price of the building. The negotiations conducted focused on the overall terms of the agreement and the economic return to be received by the purchaser. According to the audit team, ZCorp was not a purchaser, and the transaction was not a true sale, there being no evidence that the purchase price was ever negotiated. Rather the amount given as the purchase price was just a "plug figure" used to make the financing agreement work.

[8] The audit team determined that the Facility has 13% more usable space than the donated building. Also, according to the audit team, the relative size of the structures is not a significant factor in determining value because the Facility could be readily converted to multi-tenant use.

amount.[9] Rather, Taxpayer contends that, at the time the agreement was entered into, the fair market value of the Facility as of the two repurchase dates was determined, and the repurchase amounts were set at an amount slightly above the fair market value amounts. Thus, ZCorp, as purchaser in this transaction, receives a profit from the operation, retention and sale of the Facility.[10]

LAW AND ANALYSIS:

Issue # 1: Sale v. Financing

The first issue to be addressed is whether Taxpayer's sale/leaseback transaction should be recharacterized as a financing arrangement. A substantial corpus of case law holds that the substance of a transaction must be respected over the form adopted by the parties. More than seventy years ago, the Supreme Court observed that "taxation is not so much concerned with refinements of title as it is with actual command over the property taxed -- the actual benefit for which the tax is paid." *Corliss v. Bowers*, 281 U.S. 376, 378 (1930). Since that time, the Supreme Court has, on many occasions, articulated general principles for distinguishing transactions that are valid for tax purposes from those that are not:

> In a number of cases, the Court has refused to permit the transfer of formal legal title to shift the incidence of taxation attributable to ownership of property where the transferor continues to retain significant control over the property transferred. *E.g., Commissioner v. Sunnen*, 333 U.S. 591 (1948); *Helvering v. Clifford*, 309 U.S. 331 (1940). In applying this doctrine of substance over form, the Court has looked to the objective economic realities of a transaction rather than to the particular form the parties employed. The Court has never regarded "the simple expedient of drawing up papers," *Commissioner v. Tower*, 327 U.S. 280, 291 (1946), as controlling for tax purposes when the objective economic realities are to the contrary. "In the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding." *Helvering v. Lazarus & Co.*, 308 U.S. at 255. *See also Commissioner v. P. G. Lake, Inc.*, 356 U.S. 260, 266-267 (1958); *Commissioner v. Court Holding Co.*, 324 U.S. 331, 334 (1945). Nor is the parties' desire to

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[9] The audit team believes that the EBO and FPPO prices are so far below market that Taxpayer will be economically compelled to reacquire the Facility on the FPPO date.

[10] The audit team does not dispute Taxpayer's profit contention. Rather, it asserts that ZCorp's income will derive not from operation of the Facility as lessor, but from its position as a mortgagee receiving interest income.

> achieve a particular tax result necessarily relevant. *Commissioner v. Duberstein*, 363 U.S. 278, 286 (1960).

Frank Lyon Co. v. United States, 435 U.S. 561, 572-573 (1978).

The present case raises the issue of whether the form of Taxpayer's transaction as a sale/leaseback should be respected for tax purposes. If, notwithstanding the form chosen by the parties to the transaction, the Facility is still owned by Taxpayer, then the transaction must be treated as a financing device with all tax ramifications following. Such a determination depends on whether the benefits and burdens of ownership of the Facility were truly transferred by Taxpayer.

According to the Tax Court in *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C, 1221 (1981), whether the benefits and burdens have passed from a seller to a buyer "is a question of fact that must be ascertained from the intentions of the parties as evidenced by the written agreements and read in light of attending facts and circumstances." The court's opinion in *Grodt & McKay Realty* enumerates eight factors which have been considered by courts in making this determination. The eight factors are:

(1) Whether legal title passes, *Commissioner v. Segall*, 114 F.2d 706, 709 (6th Cir. 1940), *cert. denied*, 313 U.S. 562 (1941); *Oesterreich v. Commissioner*, 226 F.2d 798, 802 (9th Cir. 1955));

(2) How the parties treat the transaction, *Oesterreich v. Commissioner*, *supra at* 803;

(3) Whether an equity interest was acquired in the property, *Haggard v. Commissioner*, 241 F.2d 288, 289 (9th Cir. 1956); *Oesterreich v. Commissioner*, *supra at* 803; *see* *Mathews v. Commissioner*, 61 T.C. 12, 21-23 (1973), *revd*., 520 F.2d 323 (5th Cir.1975), *cert. denied*, 424 U.S. 967 (1976);

(4) Whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments, *Wiseman v. Scruggs*, 281 F.2d 900, 902 (10th Cir. 1960);

(5) Whether the right of possession is vested in the purchaser, *Wiseman v. Scruggs, supra at* 902; *Commissioner v. Segall*, *supra* at 709;

(6) Which party pays the property taxes, *Harmston v. Commissioner*, 61 T.C. 216, 229 (1973), *aff'd*, 528 F.2d 55 (9th Cir. 1976);

(7) Which party bears the risk of loss or damage to the property, *Harmston v. Commissioner*, *supra at* 230; and

(8) Which party receives the profits from the operation and sale of the property, *Harmston v. Commissioner*, *supra at* 230. *See generally Estate of Franklin v. Commissioner,* 64 T.C. 752 (1975), *aff'd on other grounds*, 544 F.2d 1045 (9th Cir. 1976).

In the sale/leaseback context, the Tax Court has also considered the following factors as being relevant in determining whether a sale has occurred: (1) the existence of a useful life of the property in excess of the leaseback term; (2) the existence of a purchase option at less than fair market value; (3) renewal rental at the end of the leaseback term set at fair market rent; and (4) the reasonable possibility that the purported owner of the property can recoup his investment in the property from the income producing potential and residual value of the property. *Torres v. Commissioner*, 88 T.C. 702 (1987); *Estate of Thomas v. Commissioner*, 84 T.C. 412 (1985); *Mukerji v. Commissioner*, 87 T.C. 926 (1986).

In the present case, an evaluation of the eight factors set forth in *Grodt & McKay Realty,* fails to produce a conclusive determination as to whether the form of the sale/leaseback transaction should be respected. In our opinion, the first, third, and fourth criteria favor sale treatment; the fifth, sixth, and seventh criteria favor financing arrangement treatment; and the second and eighth criteria are neutral as to which treatment should prevail. Likewise, an evaluation of the four factors relating specifically to sale-leaseback transactions fails to produce a conclusive determination because of the factual disagreements between Taxpayer and the IRS audit team.

The first criterion in *Grodt & McKay Realty, Inc.,* relates to whether legal title has passed to the buyer. The facts indicate that, simultaneous with the closing and delivery of funds, Taxpayer must execute and deliver the property deed to the buyer and deliver to the buyer all title and interest in and to the Facility. Thus, it appears that legal title has passed, which favors a determination that a true sale has occurred.

The second criterion, how the parties treat the transaction, does not favor either sale or financing treatment. On the one hand, the documents and agreements were prepared in the form of a sale and Taxpayer, for tax purposes, treated the transaction as a sale. Yet, for book purposes, the transaction was treated as a financing arrangement. ZZZ, a former high ranking employee of Taxpayer stated his doubts that Taxpayer would have engaged in the transaction if it were required to show the property as sold at a loss for financial accounting purposes. Moreover, circumstances indicate there was a need to generate immediate cash flow for working capital to fund business operating costs.

The next criterion, that the putative buyer acquire equity in the property, seems to favor characterization of the transaction as a true sale. ZCorp, as Owner Participant in the transaction, apparently acquired an equity interest in the property by investing its own capital and becoming obligated as a debtor for the balance of the purchase price. As a result of entering into the transaction in this fashion, ZCorp became entitled to receive rents, had the right to compel Taxpayer to extend the lease for a set period if Taxpayer failed to exercise its buy-out options, and had the right to receive funds in excess of its purchase price in the event the options were exercised. Also, ZCorp would continue as owner of the property if no options were ever exercised after the lease with Taxpayer expired.

The fourth criterion, that the contract create a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments, also seems to favor characterization of the transaction as a true sale. Taxpayer executed and delivered a deed to the Facility to the buyer and funds representing the purchase price (*i.e.*, the investment amount from ZCorp as Owner Participant and the loan amount from CCorp as Loan Participant) were transferred and made available to Taxpayer.

The next three criteria listed in *Grodt & McKay Realty, Inc.*, (whether the right of possession is vested in the purchaser; which party pays the property taxes; and which party bears the risk of loss or damage to the property) may tend to denial of characterization of the transaction as a true sale. Under the net-lease arrangement, Taxpayer never gave up possession of the Facility, and continued insuring the structure against risks of losses by destruction and liability. Presumably, as a net-lessee, Taxpayer continues to be responsible for payment of property taxes assessed against the subject property as well. However, net leasing of real estate has become the norm in the property rental industry and net leases do not generally result in attribution of fee ownership to lessees.

The final criterion listed, concerning which party receives the profits from the operation and sale of the property, is inconclusive. As a lessee, Taxpayer receives the profits from the operation of its business within the Facility. On the other hand, ZCorp, as lessor through ACorp, receives a return in the form of rents and the

possibility of profits when it sells the building either back to Taxpayer or to a third party. The fact that the rents are below market rates and are at an amount during the initial lease term only sufficient to service the loan (interest only) on the property may detract from characterization of the transaction as a true sale. However, each rent payment after the initial lease term will exceed the amount of principal and interest payable and will thus be available to Owner Participant for discharging the debt obligation.

In summary, an examination of the factors in *Grodt & McKay Realty, Inc,* fails to produce a conclusive determination regarding whether the form of the sale/leaseback transaction in the present case should be respected. As to the four factors dealing specifically with sale/leasebacks, without question the property has a useful life in excess of the leaseback term. No determination can be reached on at least two of the other factors, however, in light of the factual disagreements in the present case.

Much is made of the fact that the investment of the purported purchaser is protected by the stipulated loss values that would be paid in the event of a casualty or termination of the lease. Also noted, in a similar vein, is the fact that a letter of credit must be given by Taxpayer in the event of a decline in Taxpayer's credit-worthiness, and that Taxpayer would benefit from the appreciation of the property by exercising either an early purchase option or a fixed price purchase option. Moreover, if the value of the property declined below the fixed price purchase option and Taxpayer decided not to purchase the property, then the purchaser-lessor would be able to extend the lease term and force Taxpayer to pay rent, thereby protecting its investment.

However, these factors are also inconclusive. Also, the standby letter of credit is a security device used routinely in installment sale situations as recognized in § 15a.453-1(a)(3) of the Income Tax Regulations. Therefore, the existence of a letter of credit can hardly be construed as evidence for one side or the other as to whether a sale has occurred. As for the risks and benefits derived from market fluctuations of the subject real estate, these are shared by the seller-lessee and the purchaser-lessor. It is true that Taxpayer may have an advantage if the value of the Facility increases sufficiently to make it economically feasible to exercise its options. But if the options are not exercised by Taxpayer for whatever reason, the purchaser-lessor will enjoy or endure the benefits of appreciation and the risks of loss. The fact that the Owner Participant (ZCorp) is insulated from either happenstance does not conclusively show that the transaction is a financing arrangement and not a sale.

A case with facts similar to those of the present case is *Frank Lyon Co. v. United States*, *supra*. In *Frank Lyon*, a bank explored various means of financing the construction of a new building that was to serve as it headquarters and principal banking facility. However, various circumstances, including sundry regulatory obstacles, prevented the bank from obtaining the financing needed to complete the project. To overcome the obstacles, the bank entered into sale/leaseback agreements with the petitioner, Frank Lyon Co. (Lyon). The Government argued that the form of the transaction should be disregarded and recharacterized as a financing arrangement. Interest and depreciation deductions were denied on grounds that Lyon was not the true owner of the building.

In rejecting the government's position, the Supreme Court noted that the transaction was the product of arm’s length negotiations between multiple (more than two) parties with conflicting interests. There was no clear case made on the facts that the rent charged by Lyon was unreasonable, or that the exercise prices on the repurchase options were not set at reasonable amounts. Furthermore, Lyon was the real obligor of debt obligations used to finance its acquisition of the building and thus was entitled to deduct the interest stemming from such obligations. Although the question of the identity of the true owner of the building was not free from doubt, the fact that Lyon had invested its own capital in the building and was primarily obligated on notes used to finance the balance of construction costs entitled Lyon to the depreciation deductions.

The Court also found there were tax-independent considerations at stake and the transaction was not shaped solely by tax considerations. The bank wanted the new building and the sale/leaseback transaction as structured apparently was the most practical way of obtaining it. The Court concluded that where there is a genuine multiple-party transaction with economic substance compelled or encouraged by business or regulatory realities, imbued with tax-independent considerations, and not shaped solely by tax-avoidance features that have meaningless labels attached, the allocation of rights and duties effectuated by the parties should be honored. Expressed another way, so long as the lessor (Lyon) retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes.

As in *the Frank Lyon case*, the transaction at issue in the present case resulted from negotiations between multiple parties, including Taxpayer, the Owner Participant and the Loan Participant. The parties involved were unrelated and independent. While the rent charged Taxpayer as lessee was, according to the IRS audit team, below market rate for at least the initial lease term, the cash paid by the buyer/lessor to acquire the Facility was, according to the audit team, also well below the fair market value of the property. Thus, both Taxpayer as seller/lessee and ZCorp as Owner Participant and buyer/lessor, enjoyed mutually offsetting advantages to the transaction. It does not appear that either party enjoyed any notable windfall at the expense of the other. Rather, the offsetting advantages that all parties enjoyed appear to be the fruit of arm’s length negotiations.

Also, as in *Frank Lyon*, there were tax-independent considerations motivating the transaction at issue. There are credible indications that Taxpayer's experience in direct real estate ownership has not always been economically advantageous. Factors such as uncertainty about future needs for building space, real estate market fluctuations, and ability to sell a structure such as the Facility, all may have motivated Taxpayer to engage in the sale/leaseback transaction.

Thus, on one hand, many factors cause us to doubt that the transaction entered into by Taxpayer constituted a true sale, and to question Taxpayer's characterization of ACorp as the Facility's true owner for the benefit of ZCorp. In particular, many of the purported owner’s rights are comparable to those of a mortgagee rather than an owner of property. To the contrary, however, many factors suggest that the transaction was a true sale and that Taxpayer is merely the lessee and not the owner of the Facility. For example, even if ZCorp exercises its option to require Taxpayer to renew the lease at the end of the initial lease term, the useful life of the Facility extends beyond the term of the purported lease between Taxpayer and ZCorp. On balance, however, we believe the case turns on the repurchase options granted to Taxpayer in the agreement.

Taxpayer has the right to purchase the Facility on the EBO date for $X. Taxpayer also has the right to purchase the property on the FPPO date for $Y. If the $X and $Y repurchase amounts were, as contended by the IRS audit team, determined without regard to the fair market value of the Facility as of the EBO and FPPO dates, were instead tied to the unamortized balance of the ZCorp notes as of those dates, and were set at such a discount that the parties intended that Taxpayer would, absent unforeseen circumstances, be compelled to repurchase the Facility, the transaction should be treated as a financing arrangement.[11] On the other hand, if, as contended by Taxpayer, the fair market value of the Facility as of the repurchase dates was the true basis for the EBO and FPPO repurchase prices, or the option prices were not set at such a discount that Taxpayer would be compelled to repurchase the property, then the form of the transaction should be respected and the sale/leaseback transaction should not be recharacterized as a financing arrangement.

Issue #2: Sale of Property with Bargain Leaseback

If the form of the transaction is respected as a sale and leaseback of the Facility, the second issue for our determination concerns whether Taxpayer properly determined its amount realized, and thus its loss, in connection with the sale of the Facility. Under §1001(a), a taxpayer has a loss from the sale of property to the extent the taxpayer's adjusted basis of the property, as provided in §1011, exceeds the amount realized from such sale. Section 1001(b) provides that the amount realized from the sale of property is the sum of any money received plus the fair market value of any property (other than money) received.

Section 1011(a) provides, for purposes of this analysis, that the adjusted basis for determining the gain or loss from the sale or other disposition of property is the basis of such property as determined under § 1012. Under § 1012, the basis of property is its cost, adjusted as provided in § 1016.

Taxpayer incurred a loss on the sale of the Facility if its amount realized in connection with the sale is less than the adjusted basis of the Facility, which is $C. Without question, the $D sales price of the Facility must be taken into account in computing Taxpayer's amount realized. However, if, as the audit team contends, the Facility was worth $W, we do not agree with the position of the Taxpayer that the only amount realized on the sale was the $D sales price. As a general principle, the value of two property interests exchanged in an arm's length transaction are either equal in fact or are

[11] In that event, Taxpayer's economic status with respect to the Facility would be substantially identical to that of a borrower mortgaging the facility whose obligation is discharged upon the making of a final, balloon payment.

presumed equal for federal income tax purposes. *See Philadelphia Park Amusement Co. v. United* States, 126 F. Supp. 184 (Ct. Cl. 1954).

As part of the transaction at issue, Taxpayer received a leasehold interest in the Facility. The leasehold interest gave Taxpayer the right to use the Facility in exchange for lease payments that were, according to the audit team, substantially below the fair rental value for such property. [12] Accordingly, if Taxpayer received a bargain-rent benefit as part of the sale/leaseback of the Facility, its amount realized under § 1001(b) on the sale of the Facility must include the fair market value of such bargain-rent benefit.

Several cases have considered facts similar to those of the present case where a real estate transaction constituted a sale with a bargain leaseback of property. In such cases, the courts have held that the amount realized by the seller includes the fair market value of any bargain rent benefit for the use of property.

In *Alstores Realty Corporation v. Commissioner*, 46 T.C. 363 (1966), the taxpayer acquired a building for $750,000 in cash, which was below the value of the property and $250,000 below the seller's asking price. The taxpayer, as part of the same transaction, also granted the seller a right to 2 1/2 years' rent-free occupancy of specified portions under a leaseback agreement. The fair market value of the right of occupancy under the space-occupancy agreement was found to be $253,090.75.

The taxpayer in *Alstores* argued that it had obtained not a fee interest in the building but only a remainder interest in such property, and the seller retained a right to occupancy not as a lessee but as a legal owner of a reserved term for years. The Tax Court, however, rejected the taxpayer's argument and determined that the taxpayer acquired the benefits and burdens of ownership of the entire property. Thus, the Court held that the seller's amount realized within the meaning of section 1001(b) was not only the $750,000 cash it received, but also the fair market value of rent-free occupancy agreement, which was held to be $253,090.75. *See also Steinway & Sons v. Commissioner*, 46 T.C. 375 (1966), a case involving the seller of the property that was the subject of the *Alstores* case, wherein the Tax Court also determined that the seller had increased proceeds equal to the value of the bargain rent that was allowed under the terms of the sale.

A similar result occurred in *Eller v. Commissioner*, 77 T.C. 934 (1981). In *Eller*, the taxpayers sold a trailer park, but retained the rent-free use of their dwelling unit, which was

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[12] The submission included only Appraiser1's fair rental value. In light of the fact that Appraiser1's appraisal of the fair market value of the Facility was substantially less than that of the other appraisers, we can reasonably assume that the other appraisers fair rental value would be substantially greater than that of Appraser1.

located on the property, for a two-year period. The taxpayers reported only the cash proceeds received on the sale of the property, failing to include as part of the amount realized the fair rental value of the taxpayers' right of occupancy of their dwelling unit. The Tax Court noted that the determination of the taxpayers' amount realized turns on whether the taxpayers conveyed their entire fee interest in the dwelling without reservation and leased it back for a 2-year period, or whether they merely conveyed a remainder interest in it. Finding that the benefits and burdens of ownership of the dwelling unit passed to the buyers, the Tax Court held that their rent-free right of occupancy constitutes part of the taxpayers' amount realized from the sale of the trailer park property.

In the present case, the $D purchase price for the Facility was, according to the facts submitted by the audit team, significantly less than the Facility's fair market value. While there may have been sufficient business purposes for disposing of the Facility, even at a loss, there is no evident business reason for Taxpayer disposing of the Facility solely for the $D cash price represented at such a substantial discount below the fair market value. Thus, we conclude that, since the parties acted at arm's length, the value of the bargain rent approximates the difference between the fair market value of the Facility and the $D paid to Taxpayer in connection with the sale of the Facility. Accordingly, Taxpayer's loss on the sale of the Facility is the difference between Taxpayer's adjusted basis of the Facility, $C, and Taxpayer's amount realized on the sale of the Facility, including the fair market value of the bargain rent benefit in connection with the use of the Facility.

If Taxpayer's contention is correct that the purchase price of the Facility was equal to its fair market value on the date of sale, the leaseback agreement should have provided fair market value rents. In an arm’s length transaction, there is simply no business reason for a lessor to lease property at less than fair rental value, absent other circumstances such as the lessor acquiring the property from the lessee at less than market value. Accordingly, if the fair market value of the Facility at the time of its sale was equal to the $D stated purchase price, and no bargain rent element was present in the leaseback agreement, Taxpayer’s only amount realized on the sale of the Facility was the $D paid to Taxpayer.

Issue #3: Application of § 1031 Like-kind Exchange Rules

The third issue for our consideration is whether the sale/leaseback transaction was a like-kind exchange and, consequently, a transaction for which no gain or loss should be recognized under § 1031. Section 1031 provides that no gain or loss will be recognized when property held for the productive use in a trade or business or for investment is exchanged solely for property of like kind. If the exchange is for like-kind property as well as other property or money, no loss will be recognized and gain will be recognized only to the extent of such money and the fair market value of the other property received. Under § 1.1031(a)-1(c) of the regulations, if a taxpayer who is not a dealer in real estate exchanges real property for a leasehold interest of 30 years or more in real estate, the property exchanged is considered to be of like kind.

The Service has used the regulations under § 1031 to disallow losses recognized in connection with a sale/leaseback when the leaseback term is 30 years or more. If the Service can successfully assert the argument that the sale/leaseback is a like-kind exchange, no loss from the exchange may be recognized.

In the present case, the initial term of the lease is less than 30 years (26 years) and the renewal option of 14 years belongs to ZCorp as buyer-lessor, rather than to Taxpayer. Thus, the right to force renewal of the leasehold for additional years is a property right belonging not to Taxpayer but to the buyer-lessor. Taxpayer transferred its fee estate in the Facility to ZCorp and received a leasehold interest in the Facility for a term of less than 30 years for which it lacks power to extend. *Compare* Rev. Rul. 78-72, 1978-1 C.B. 258, which holds that a 25-year leasehold subject to three 10-year renewal periods optional to the exchanging taxpayer is of like kind to unimproved real property. Accordingly, since the initial term of the lease is less than 30 years and the renewal option does not belong to Taxpayer, the transaction should not be recharacterized as a like-kind exchange even if the other elements of § 1031 are met.

CAVEAT(S)

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.