

5-1-2009

# Federal Tax Implications of Sale-Leaseback Transactions

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## Federal Tax Implications of Sale-Leaseback Transactions

### Guide Information

Last Updated: Oct 29, 2010

Guide URL: <http://libguides.law.gsu.edu/FederalTaxImplications>

Description: Eileen O'Neill - Spring 2009 - Tax; Property and Real Estate

Tags: [property](#), [real estate](#), [tax](#)

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### Overview

With the current financial market crisis that has sprung from the massive devaluation of residential properties, mortgages, and mortgage-backed securities, many companies presently find it imperative to secure capital gains in order to offset the massive influx of losses these companies are now faced with. Another significant problem in the current market includes the lack of short-term credit which provides the necessary capital that allows many businesses to perform basic operating functions such as replenish inventory and make payroll.

One such way by which companies may increase their capital gains in order to offset capital losses is to sell their capital assets. Many companies, however, are not in a position to physically part with some of their capital assets, such as, for example, the headquarters in which the company runs its business. Additionally, with the current short-term lending crunch, some capital-intensive industries are having difficulties securing conventional financing and must find it elsewhere, lest their potential demise. One possible solution to these problems is through a financial arrangement known as a sale-leaseback transaction.

In a typical sale-leaseback transaction a seller sells property to a purchaser, yet retains long-term continued use through a leasehold. Essentially, the transaction is arranged so that the purchaser, as the lessor, relinquishes control over the property through a net lease (which gives the seller-lessee the same control and responsibility over the property); the seller retains a future interest in the property (generally through options to purchase), so that after a certain extensive time period, the seller-lessee may repurchase the property.

Generally the transaction is arranged so that the lease-term is long enough to secure the buyer-lessor's investment. The rental payments made by the seller-lessee over the course of the lease-term typically match the buyer-lessor's principal plus interest on the loan for the property and any initial investment made by him/her. The buyer-lessor retains a reversionary interest, subject to future options to purchase, or extensive lease renewal options, by the seller-lessee.

With such an arrangement, the seller-lessee secures capital, whilst retaining continued use over the property, and the buyer-lessor, as owner, may receive tax benefits such as deductions on depreciation and interest arising from loan indebtedness. The seller-lessee may also take deductions on rental payments; these deductions generally outweigh the depreciation deductions the seller-lessee foregoes in giving up ownership of the property.

More importantly, the seller-lessee can convert an illiquid fixed asset into cash and increase its store of working capital. This increase in capital not only provides the seller-lessee money to work with, but it enables the seller-lessee to increase its current ratio (of current assets to fixed assets), which makes the seller-lessee appear more credit-worthy to conventional short-term lenders. With the current tightening of short-term money markets, this attribute is extremely valuable. Furthermore, it provides an alternative financing arrangement for the seller-lessee if unable to secure conventional lending and offers a higher rate of return for the buyer-lessor than would be yielded in a conventional mortgage loan.

Structuring a genuine sale-leaseback transaction that will be honored for tax purposes requires careful planning and forethought. Historically, sale-leaseback transactions were deemed sham transactions. What essentially made these transactions void for tax purposes were the financial arrangements underlying them. Through crafty financial maneuvering, the financial arrangements were constructed in such a way to make risk for both parties nonexistent. In very general terms, the purchaser would take out a loan from a third party mortgagor and use the loan proceeds to pay for the purchase of the property. Those proceeds furnished the rent payments for the seller-lessee's use of the property and those rent payments paid back the purchaser's loan, rendering the financial arrangement almost entirely circular and off-setting.

Another aspect of these sale-leaseback transactions that prompted the IRS to invalidate many of them for tax purposes was the lack of true ownership possessed by the buyer-lessor. Generally the leasehold consisted of a "net lease", whereby the seller-lessee was obligated to pay for improvements on the property, property taxes, and insurance - responsibilities normally undertaken by a true owner. Thus, where the lessee acts as a genuine owner, courts and the IRS will raise an eyebrow as to which party is claiming depreciating deductions.

It was clear through certain sale-leaseback and LIFO transactions that the only real benefits conferred to the buyer-lessor were the tax benefits received. It comes as no surprise then that the IRS paid little heed to the form of these transactions. As a result, many leveraged sale-leasebacks transactions have been invalidated in the last few decades.

What distinguishes genuine sale-leaseback transactions from those historically invalidated are the motivations and economic realities behind them. Where a sale-leaseback transaction is imbued with considerations beyond mere tax deductions, a sale-leaseback transaction has a greater chance of being respected for tax purposes. Some of the factors taken into consideration by Courts in finding sale-leaseback transactions valid for federal tax purposes include the need for capital and the existence of regulatory or practical business constraints that disallow or seriously hamper access to traditional financing.

With the current trend of the market, these factors could bring promise of a new era in which sale-leaseback transactions are viewed without disdain. There are many considerations that come into play; therefore familiarization with case law, IRS Rulings, and expert commentary are essential before one embarks on a transaction that historically had a sour reputation for its recurring stamps of invalidity by the government. With thorough research and prudent planning, sale-leaseback transactions may bring significant mutual benefits to the parties involved and offer some respite in today's downtrodden market.

## Purpose

The purpose of this research guide is to enable the user to identify the comprehensive outlay of legal sources devoted to the federal tax treatment of sale-leaseback and lease-in/lease-out (LILO) transactions. Sale-leaseback transactions are still widely used today and can present beneficial tax implications if planned wisely; effective planning cannot be had without knowledge of the array of legal sources that deal with the proper structuring of sale-leasebacks. Moreover, an extensive area of the law deals precisely with the sort of maneuvering in sale-leaseback or LILO arrangements that will be deemed 'shams' for federal tax purposes. This bibliography should serve as a useful source of information for those interested in implementation of sale-leaseback transactions, or alternatively, for those who would simply like to inform themselves of the basic federal tax principles underlying the federal tax treatment of these transactions.

## About the Author

Eileen O'Neill is a 2009 J.D. Candidate at the Georgia State University College of Law in Atlanta, Georgia. During the course of her studies Eileen O'Neill has developed a strong interest in tax law, particularly federal income taxation. She received her undergraduate degree in political science and anthropology from the University of Georgia in Athens, Georgia, in August 2000. This bibliography was compiled for Advanced Legal Research, a class taught by Professor Nancy Johnson.

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## Disclaimer

This research guide is not comprehensive. It should not be understood to constitute legal advice and should not be relied upon for that purpose. Please consult the appropriate government agency or a qualified attorney for advice before relying on the materials contained herein. This guide was last updated in March, 2009.

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## Primary Sources

### Relevant Statutes

IRC Sections 162, 163 and 167 are the most commonly implicated sections in the context of sale-leaseback transactions. These Code sections concern deductions for loan indebtedness, rental expenses, and depreciation, respectively, and will be respected only if the purchaser-lessor genuinely incurs indebtedness, the seller-lessee is a true lessee, and the purchaser-lessor is a true owner for purposes of depreciation deductions. (For an example of these sections' applicability in the sale-leaseback context, see the Frank Lyon case below).

IRC Section 465 governs the 'at-risk' rules for deductions on the loss of an activity engaged in by the purchaser-lessor in the carrying on of a trade or business. If the purchaser's investment bears no risk of loss (if there is no realistic profit) then Section 465 will disallow losses the purchaser-lessor otherwise would have been allotted under Section 165.

IRC Section 470 is applicable where the seller-lessee is a tax-exempt entity. The purchaser-lessor may be engaging in the sale-leaseback or LILO transaction in order to secure tax benefits that the seller-lessor cannot utilize as a tax exempt entity. (For an example of Section 470's applicability in the LILO context, see the BB&T case below).

#### Internal Revenue Code Section 162:

- (a) In general.--There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including-
- (1) a reasonable allowance for salaries or other compensation for personal services actually rendered;
  - (2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and
  - (3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity. 26 U.S.C.A. § 162(a) (2008).

#### Internal Revenue Code Section 163:

- (a) General rule --There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness. 26 U.S.C.A. § 163(a) (2008).

#### Internal Revenue Code Section 167:

- (a) General rule--There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)-- (1) of property used in the trade or business, or (2) of property held for the production of income. 26 U.S.C.A. § 167(a) (2008).

#### Internal Revenue Code Section 465:

- (a) Limitation to amount at risk.--
- (1) In general.--In the case of--
    - (A) an individual, and
    - (B) a C corporation with respect to which the stock ownership requirement of paragraph (2) of section 542(a) is met,

engaged in an activity to which this section applies, any loss from such activity for the taxable year shall be allowed only to the extent of the aggregate amount with respect to which the taxpayer is at risk (within the meaning of subsection (b)) for such activity at the close of the taxable year.

[(b) omitted]

(c) Activities to which section applies.-

(1) Types of activities.--This section applies to any taxpayer engaged in the activity of--

(A) holding, producing, or distributing motion picture films or video tapes,

(B) farming (as defined in section 464(e)),

(C) leasing any section 1245 property (as defined in section 1245(a)(3)),

(D) exploring for, or exploiting, oil and gas resources or

(E) exploring for, or exploiting, geothermal deposits (as defined in section 613(e)(2)) as a trade or business or for the production of income.

(3) Extension to other activities.--

(A) In general.--In the case of taxable years beginning after December 31, 1978, this section also applies to each activity-- (i) engaged in by the taxpayer in carrying on a trade or business or for the production of income, and (ii) which is not described in paragraph (1). 26 U.S.C.A. § 465(a),(c) (2008).

Internal Revenue Code Section 467(b)(4):

(4) Disqualified leaseback or long-term agreement.--For purposes of this subsection, the term "disqualified leaseback or long-term agreement" means any section 467 rental agreement if--

(A) such agreement is part of a leaseback transaction or such agreement is for a term in excess of 75 percent of the statutory recovery period for the property, and

(B) a principal purpose for providing increasing rents under the agreement is the avoidance of tax imposed by this subtitle.

(5) Exceptions to disqualification in certain cases.--The Secretary shall prescribe regulations setting forth circumstances under which agreements will not be treated as disqualified leaseback or long-term agreements, including circumstances relating to--

(A) changes in amounts paid determined by reference to price indices,

(B) rents based on a fixed percentage of lessee receipts or similar amounts,

(C) reasonable rent holidays, or

(D) changes in amounts paid to unrelated 3rd parties. 26 U.S.C.A. § 467(b)(4) (2008).

Internal Revenue Code 470:

(a) Limitation on losses.--Except as otherwise provided in this section, a tax-exempt use loss for any taxable year shall not be allowed. 26 U.S.C.A. § 470(a) (2008).

## Case Law

### ***i. Pre-Frank Lyon cases:***

Helvering v. F. & R. Lazarus & Co., 308 U.S. 252 (1939), aff'g, 101 F.2d 728 (6th Cir. 1939), aff'g, 32 B.T.A. 633 (1935).

Here in a two-party transaction, the seller-lessee actually claimed depreciation as the owner of the property even though the bank held legal title; the IRS argued that the bank holding legal title as a result of the sale-leaseback should be allotted the depreciation deductions. The Supreme Court held that the arrangement was in actuality a loan; the bank holding legal title was not really the owner of the properties. Thus, the seller-lessee was able to take depreciation deductions.

Am. Realty Trust v. United States, 498 F.2d 1194 (4th Cir. 1974), aff'g, No. 8-73-A, 1973 WL 659 (E.D.Va. July 24, 1973).

Here the Fourth Circuit employed a facts and circumstances test, giving great deference to the jury in its determination that the transaction was a good faith purchase and 'lease-back' and not a mere 'financial arrangement'.

Sun Oil Co. v. Comm'r, 562 F.2d 258 (3rd Cir. 1977), rev'g, 35 T.C.M. (CCH) 173 (1976).

The Third Circuit Court placed a strong focus on the 'burdens and benefits on ownership' doctrine effectively rendering a split among the Circuit Courts to which the Supreme Court finally addressed in *Frank Lyon*, below.

### ***ii. Frank Lyon:***

Frank Lyon Co. v. United States, 435 U.S. 561 (1978), rev'g, 536 F.2d 746 (8th Cir. 1976).

Attempting to quell the disparity amongst the Circuit Courts the Supreme Court held that, "[w]here ...there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties. Expressed another way, so long as the lessor retains significant and genuine attributes of a traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes. What the attributes are in any particular case will necessarily depend upon its facts". The Supreme Court found that the particular sale-leaseback in that case would be respected for federal income tax purposes because the purchaser-lessor Frank Lyon was personally liable for the construction and mortgage loans on the property, and he invested a considerable amount of his own money into the property, thereby subjecting himself to substantial risk in his investment.

### ***iii. Post Frank Lyon cases:***

Dunlap v. Comm'r, 74 T.C. 1377 (1980), rev'd on another issue, 670 F.2d 785 (8th Cir. 1982).

Tax Court noted that the presence of a third party aligned this case with *Frank Lyon*, distinguishing *Lazarus*. The non-recourse nature of notes, and rent equaling principal & interest on mortgage neutral factors satisfied the business purpose and economic substance tests.

Hilton v. Comm'r, 74 T.C. 305 (1980), aff'd, 671 F.2d 316 (9th Cir. 1982).

In this case the Tax Court's analysis appears right in sync with the Supreme Court's holding in *Frank Lyon*.

Here the Court exercises a conjunctive 'economic substance' and 'business purpose' test, and also expands *Frank Lyon* by including the 'prudent abandonment' test. Here, although the seller-lessee had a clear business purpose (it looked to the sale-leaseback as an arrangement in which to finance use of the properties, as other contractual obligations limited the amount of debt it could incur. This way the obligation could be listed as rent, rather than debt-service, on its books) the Court's main concern was whether "the buyer-lessors [had] substantial legal and economic significance aside from tax considerations, or [whether] the interest [was] simply the purchased tax by-product of [the seller-lessee's] economically impelled arrangement with the insurance companies". The Court explicitly noted that "[u]nder the *Frank Lyon* test, petitioners must show not only that their participation in the sale-leaseback was not motivated or shaped solely by tax avoidance features that have meaningless labels attached, but also that there is economic substance to the transaction independent of the apparent tax shelter potential".

Rice's Toyota World Inc. v. Comm'r, 81 T.C. 184 (1983), aff'd in part and rev'd in part on another issue, 752 F.2d 89 (4th Cir. 1985).

The Fourth Circuit in this commonly cited case introduces a two-pronged disjunctive 'economic substance' and 'business purpose' test under *Frank Lyon*. Both Courts found neither economic substance nor business purpose where the purchaser-lessor's return did not exceed investment.

Estate of Thomas v. Comm'r, 84 T.C. 412 (1985).

Here the Court looks strongly at the 'burdens and benefits of ownership' and dismisses the 'imprudent abandonment' test. The transaction was held valid because of the risk involved as to whether residual value of equipment bore loss or gain; the prospect of gain was reasonable.

Sanderson v. Comm'r, 50 T.C.M. (CCH) 1033 (1985).

Despite the firm application of a conjunctive test (regarding the economic substance and business purpose tests) employed by the Tax Court in *Hilton*, the Court flip-flopped again in *Sanderson*, where it exercised a disjunctive analysis, leaving a general impression that the essence of the transaction ultimately drives the Tax Court's conclusion as to whether the transaction is valid for federal tax purposes, the precise application of legal standards merely supporting the Court's particular decision as to whether the substance of the transaction is in sync with its form. This case is particularly worth noting because the sale-leaseback transaction was deemed valid primarily because the seller-lessee, J.C. Penney, had financing restraints that called for the need for capital (which is in contravention to *Hilton*, above, where the seller-lessee's motivations were noted but essentially dismissed).

Illinois Power Co. v. Comm'r, 87 T.C. 1417 (1986).

Here the Court relies on *Sun Oil*, above, by placing primary emphasis on fact that rental payments were not tied to the fair market value, and *Frank Lyon*, above, in ascertaining whether there a realistic expectation of profit irrespective of tax benefits.

L. W. Hardy Co. v. Comm'r, 52 T.C.M. (CCH) 1540 (1987).

Here after finding that there was a realistic profit to deem the transaction not "sham in substance", the Court next considers whether the taxpayer held sufficient burdens and benefits of ownership for federal tax purposes. The relevant factors under this doctrine (by which the transaction was deemed valid) include: the presence of an equity interest, the existence of a useful life of property beyond lease term, renewal rentals at end of lease term at fair market value, the expectation of a 'turn around' point which would result in the investors' realizing income in excess of deductions in the later years, and net tax benefits during the leaseback term less than the unrecovered cash investment.

Torres v. Comm'r, 88 T.C. 702 (1987).

This Court elaborated on factors for the economic substance doctrine, including whether the projections of cash flow and residual value were reasonable at the time at which the taxpayer enters into the transaction, and burden and benefits of ownership factors, including: the existence of useful life of the property in excess of the leaseback term; the existence of a purchase option at less than fair market value; renewal rental at the end of the leaseback term set at fair market rent; and 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.

Levi v. Comm'r, 91 TC 838 (1988).

This Court introduced other considerations under the 'economic substance' doctrine, including the presence of arm's length negotiations, the relationship between sales price and fair market value, the structure of financing, and the degree of adherence to the contract terms.

Gilman v. Comm'r, 59 T.C.M. (CCH) 465 (1990), aff'd, 933 F.2d 143 (2nd Cir. 1991).

Here the Second Circuit goes into a lengthy analysis as to whether to employ a disjunctive or conjunctive application of the economic substance and business purpose doctrines. Its decision to use a disjunctive analysis underscores the confusion and uneven application amongst the Circuit Courts and the Tax Courts as to the correct standard.

Kirchman v. Comm'r, 862 F.2d 1486 (11th Cir. 1989).

Here the 11th Circuit held that motive is irrelevant if substantive sham exists; transactions whose sole function is to produce tax deductions are substantive shams.

Rose v. Comm'r, 88 T.C. 386 (1987), aff'd, 868 F.2d 851 (6th Cir. 1989).

Similar to *Kirchman*, above, the Sixth Circuit's essential inquiry is whether the transaction had any practicable economic effect other than the creation of economic tax losses. The Court determined it will not inquire into whether a transaction's primary objective was for the production of income or to make a profit, until it determines that the transaction is bona fide and not a sham.

Shriver v. Comm'r, 54 T.C.M. (CCH) 1422 (1987), aff'd, 899 F.2d 724 (8th Cir. 1990).

This Court determined that *Rice's Toyota's* two-pronged analysis is not mandated by *Frank Lyon*, but merely one way to apply its holding.

Casebeer v. CIR, 54 T.C.M. (CCH) 1432 (1987), aff'd, 909 F.2d 1360 (9th Cir. 1990).

Here the Ninth Circuit elaborates on factors under the business purpose doctrine, including the buyer-lessor's experience in computer leasing transactions, the extent of their investigation into the fair market value and residual value of the equipment prior to investing, the extent of such investigation by their professional advisors, and their testimony at trial regarding their motivation for entering into the transactions.

James v. Comm'r, 87 T.C. 905 (1986), aff'd, 899 F.2d 905 (10th Cir. 1990).

Here the 10th Circuit chooses not to apply *Rice's Toyota* two-pronged analysis.

Coleman v. Comm'r, 53 T.C.M. (CCH) 598 (1987), aff'd, 16 F.3d 821 (7th Cir. 1994).

The Seventh Circuit held that the 'benefits and burdens of ownership' doctrine is dispositive of the outcome; whether the transaction resembled a mere financial arrangement is not of primary importance and should not be basis of reversal. The Court emphasized that where the only real benefits of ownership in sale/leaseback transactions are tax deductions, a lack of substantial financial risk on the transaction is bound to prove fatal any question regarding the existence of real economic substance. In other words, a purported sale-leaseback transaction which affords no burden of ownership for the alleged purchaser-lessor, or any real benefit other than tax deductions, will be deemed a sham for federal taxation purposes.

BB&T Corp. v. United States, 523 F.3d 461 (4th Cir. 2008), aff'g, No. 1:04CV00941, 2007 WL 37798 (M.D.N.C. Jan. 4, 2007).

This recent 4th Circuit Court of Appeals case provides a solid view of the law surrounding most LIFO transactions. Here the Court employed several doctrines, including 'economic substance', 'business purpose', 'substance over form', and 'benefits and burdens of ownership' to come to its conclusion that the LIFO was invalid for federal tax purposes. The 4th Circuit found that in sum, BB&T did not retain significant and genuine attributes of a traditional lessor. First, every right and obligation BB&T obtained under the Head Lease was transferred back to the lessee in the Sublease. Secondly, the only money that changed hands was that given to the lessee as an incentive for doing the deal. Third, through a purchase option, which for the lessee was the economically viable option, the lessee could regain all dominion over the property. Finally, the transaction was set up to provide minimal risk and no additional obligations to BB&T for its investment. Essentially the Court found that in substance, the transaction was a financing arrangement rather than a genuine lease/sublease. Accordingly, BB&T rental payments were not entitled to a §162(a)(3) deduction. As for the §163 interest deduction, the Court held that BB&T's loan did not constitute genuine indebtedness, because the lease and debt payments were structured to be offsetting in a manner that warranted virtually no further financial output from the parties after the closing. Because BBT did not acquire a genuine leasehold interest or incur genuine indebtedness, the Government was entitled to deny BBT's claimed tax deductions.

AWG Leasing Trust v. United States, 592 F. Supp. 2d 953 (N.D. Ohio 2008).

In this recent SILO case (sale in-lease out), the Court, following the Sixth Circuit ruling in *Rose v. Commissioner*, above, determined that it would set out first, whether the transaction has any practicable economic effects other than the creation of income tax losses. If so, then the Court would decide whether the taxpayer was motivated by profit to participate in the transaction. If both were found the Court would then turn to the "substance over form" test. Here although economic substance was found, the burdens and benefits of ownership test was not met, and thus the SILO was not a true sale.

## Rules and Regulations

### i. Revenue Rulings

Revenue Rulings are public administrative rulings by the IRS that apply the law to particular factual situations. A revenue ruling can be relied upon by all taxpayers. Public administrative rulings are part of second tier authorities and generally do not prevail over legislative regulations, the Internal Revenue Code, Court Cases and Treaties. However, they hold higher weight than tier 3 authorities such as legislative history and private letter rulings. Revenue Rulings can be used to avoid certain IRS penalties.

Rev. Rul. 2002-69, 2002-2 C.B. 760

Here the IRS ruled that a taxpayer may not deduct currently, under IRC §§162 and 163, rent or interest paid or incurred in connection with a LILO transaction that properly is characterized as conferring only a future interest in property. Where appropriate, the Service will continue to disallow the tax benefits claimed in connection with LILO transactions upon other grounds, including that the substance over form doctrine requires their recharacterization as financing arrangements and that they are to be disregarded for lack of economic substance.

### ii. IRS Notices

The IRS issues notices to provide guidance before revenue rulings and regulations are available. Notices and Announcements may contain substantive guidance regarding the tax laws or contain guidance to taxpayers of a procedural nature. Generally, Notices and Announcements are used when expeditious guidance is needed. Since Notices and Announcements that contain substantive or procedural guidance are intended to be relied on by taxpayers, they are the equivalent of revenue rulings and revenue procedures.

Rev. Rul. 87-138, 1987-2 C.B. 287.

1. I.R.S. Notice 2005-13, I.R.B. 2005-9, February 11, 2005: SILOS deemed 'listed transactions'. A listed transaction is a reportable transaction that is the same as, or substantially similar to, a transaction specifically identified by the IRS as a tax avoidance transaction.

2. I.R.B. Notice 2005-29, I.R.B. 2005-29, March 10, 2005: This Notice provides that Code Section 470 suspends "tax-exempt use loss" deductions generated by leases of "tax-exempt use property" in sale-in, lease-out transactions involving tax-exempt entities and partnerships.

### iii. Litigation Guideline Memorandum

Litigation Guideline Memoranda provide information and instruction on litigating procedures and methods, and standards and criteria on issues and matters of significant interest to litigating attorneys in the Office of Chief Counsel.

IRS Litigation Guideline Memorandum, 1987 WL 754211 (May 19, 1987). This Memorandum discusses proper litigation strategies IRS attorneys should employ regarding multiple party sale-leaseback transactions following the Sanderson Tax Court case. Important factors include existence of a bona fide sale, existence of bona fide indebtedness, whether transaction is a sham or mere financial arrangement, the presence of cash flow and future appreciation for purpose of the economic substance doctrine, existence of a business purpose, existence of a proper motive, and whether the business entity is a genuine multiple-party transaction or a joint venture/partnership.

### iv. Field Service Advisory Opinions

Field Service Advice (FSA) provide non-binding case-specific written advice issued by the National Office of Chief Counsel to field personnel of either the Internal Revenue Service or the Office of Chief Counsel to help them develop an issue or determine litigation hazards for both substantive and procedural matters. FSAs are a good resource for determining how the IRS may react to or interpret a particular situation. However, taxpayers rely on FSAs at their own risk and the IRS is not bound by them. One could use an FSA as a negotiating tool, but even that might be questionable if the IRS field personnel in a particular case understands that an FSA is merely advisory and doesn't bind the agency.

IRS FSA 199927039, 1999 WL 481993 (July 9, 1999). In this Advisory Opinion, the IRS, based on a particular set of facts involving a sale-leaseback transaction with a foreign corporation, introduces a non-exclusive five-factor economic substance test, and also elaborates on factors to look for regarding business purpose test, sale vs. secured financing, the step transaction doctrine, alternative characterizations, and other theories.

### v. IRS Letter Rulings:

A Private letter ruling is a written statement issued to the taxpayer by the IRS in which interpretations of the tax law are made and applied to a specific set of facts. The function of the letter ruling, usually sought by the taxpayer in advance of a contemplated transaction, is to advise the taxpayer regarding the tax treatment he can expect from the I.R.S. in the circumstances specified by the ruling. Unless the Secretary establishes otherwise by regulations, a "written determination" may not be used or cited as precedent by another taxpayer. Written determinations include both private rulings, technical advice memoranda, and rulings from the IRS Office of Chief Counsel. Although Letter Rulings may not be used or cited as precedent by other taxpayers, many courts have cited Letter Rulings as evidence of IRS practice, and the trend is to view them as persuasive authority. At the very least they provide insight into the IRS position on the law and serve as a guideline for taxpayers structuring similar tax transactions. Every Letter Ruling and TAM is assigned one or more Uniform Issue List (UIL) numbers by the Internal Revenue Service. The UIL is a list of index terms used by the IRS in describing legal problems arising under the Internal Revenue Code. Materials that have been indexed according to the system can be located using the UIL number. Actions on Decision and General Counsel's Memoranda are also indexed according to this system.

I.R.S. P.L.R. 200346007 (July 9, 2003): This Private Letter Ruling addresses the common issue regarding sale-leaseback transactions, which is, whether a sale-leaseback transaction is genuinely a sale, or alternatively, whether the transaction should be recharacterized as a financing arrangement. Listing a number of criterion the Service found uncertainly with regard to the issue. The Service concluded, among other things, that in the particular set of facts the sale-leaseback will be respected if Taxpayer's purported valuations of property on two repurchase dates were based on arms length determinations of the fair market value of the property, at the time the agreement was entered into. If, however, the valuations were based primarily on factors other than fair market value of the property, and the parties intended that the Taxpayer, absent unforeseen circumstances, repurchase the property, the transaction should be recharacterized as a financing arrangement. The Letter Ruling then determines the kind of tax treatment that would apply to each scenario. Uniform Issue List Nos. 1001.15-01, 1031.00-00.

I.R.S. P.L.R. 200821032 (Feb. 14, 2008): In this Chief Counsel Advisory Ruling, based on a particular set of facts, the IRS Chief Counsel determined that deductions claimed by Taxpayer under IRC §168 for depreciation, IRC §163 interest expense, and IRC §162 for amortized transaction costs, with respect to the

sale-leaseback transaction, should be disallowed because the taxpayer failed to acquire ownership interest, did not incur recourse liability, nor he acquire any property subject to nonrecourse debt. Under the circumstances the transaction costs were incurred in order to obtain tax benefits. Uniform Issue List Nos. 0162.00-00, 0163.00-00, 0167.15-03.

#### vi. [IRS Coordinated Issue Paper](#)

A major objective of the IRS Large and Mid-Size Business Division's Issue Management Strategy is to identify, coordinate and resolve complex and significant industry wide issues by providing guidance to field examiners and ensuring uniform application of the law. Uniformity is achieved through the issuance of coordinated issue papers, which, following review by the Office of Chief Counsel, are issued by the Commissioner, Large and Mid-Size Business Division. Although these papers are not official pronouncements on the issues, they do set forth the Service's current thinking.

IRS Coordinated Issue Paper, "Losses Claimed and Income to Be Reported from Lease-In/Lease-Out Transactions, UIL 9300.07-00" (Oct. 17, 2003), *Doc 2003-22889 (38 original pages)*, 2003 TNT 204-12 (LILO Coordinated Issue Paper). This Coordinated Issue Paper goes into a lengthy analysis over the structure, financial aspects, law, and legal theories surrounding LILO transactions. The Paper first provides a factual overview of the structure of a typical LILO transaction. Next the Paper discusses the 'future interest' rationale, a substance over form argument, which is the Service's primary argument for the disallowance of tax benefits claimed in connection with LILO transactions. The Paper distinguishes LILO transactions from sale-leasebacks under [Frank Lyon](#) primarily through the offsetting obligations of a headlease and sublease and stresses that the defeasance arrangements make the transaction one without risk. Finally the Service discusses how the particular LILO will be treated for federal tax purposes and includes the related statutory provisions, including IRC Section 6662, which allows penalties to be applied to underpayments attributable to the disallowance of losses and deductions claimed from those parties participating in a LILO transaction.

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## Secondary Sources

### Law Review Articles and Other Periodical Sources

Michael A. Yuhas, James A. Fellows, [Sale-Leasebacks Revisited: The Old and the New of Federal Tax Law](#), 31 Real Est. L.J. 9 (2002).

This law review article focuses on tax consequences from real estate leases, and looks toward both the past and present aspects of the law. The two particular areas that are the subject of the article are the standard sale-leaseback arrangement and the synthetic lease. The article addresses recent court decisions and other developments in the law that have put the issue of these real estate leasing transactions into the forefront of professional tax literature. This law review article also provides an overview of the typical sale-leaseback transaction, the reasons for effectuating the transactions, federal income tax issues, and changes in the current law.

Marvin Milich, [The Real Estate Sale-Leaseback Transaction: A View Toward the 90's](#), 21 Real Est. L.J. 66 (2002).

This Article explores the advantages and disadvantages of the sale-leaseback with a view toward its use as a practical financing tool in real estate transactions. It also looks to recent case law with an eye toward its application in governing the area of sale-leaseback transactions and outlines a sale-leaseback that comports with the law and adequately addresses the concerns of both the Courts and the IRS.

Stephan L. Hodge, [Sale-leasebacks: A Search for Economic Substance](#), 61 Ind. L.J. 721 (1985).

This Journal covers the economic and financial aspects of sale-leaseback transactions, including tax and non-tax benefits, and delves thoroughly into the judicial treatment of these transactions, which naturally includes an extensive discussion of the economic substance doctrine. The Note is divided into three sections. The first section discusses the economic aspects of sale-leaseback financing, beginning with a description of some provisions of the modern sale-leaseback which make it closely resemble a secured financing arrangement. The first section of the Note concludes with an example of a modern sale-leaseback designed to illustrate that the transaction, analyzed on a pre-tax basis, rarely is a profitable proposition for the buyer-lessor. The second section focuses on judicial treatment of sale-leaseback transactions for tax purposes whereby the issue often becomes whether the transaction more closely resembles a secured financing arrangement or a sale coupled with a lease. This section of the Note focuses on three recent decisions in which the courts have applied a pre-tax profit requirement before they would uphold the transaction as styled by the parties. The third section of this Note contains a criticism of judicial analysis, especially of the emerging pre-tax profit requirement. The Note concludes with a proposed mode of analysis that considers the substantial social and economic benefits which sale-leaseback financing offers.

### Tax Law Articles and Journals

The majority of articles listed below are from the magazine *Tax Notes*. Published by [Tax Analysts](#), *Tax Notes* features weekly in-depth articles, special reports, and commentary analyzing proposed and enacted tax legislation, court decisions, regulations and other administrative guidance, and new trends in the administration of tax law. In each issue, you'll find articles by tax experts, leading practitioners, academics, and policy experts regarding important federal tax news and policy. One can subscribe to *Tax Notes* through its website: <http://www.taxanalysts.com/>. Note: full text articles are not currently available online.

1. James W. Wetzler, *Notes on the Economic Substance and Business Purpose Doctrines*, *Tax Notes*, July 2, 2001, at 127. This article explores the role that the economic substance and business purpose doctrines should play in federal and state tax administration and tax planning. This article does not address sale-leaseback transactions per se, but focuses mostly on the different modes of tax planning and how the economic substance and business purpose doctrines affect issues of tax-motivated restructuring activity within the spectrum of tax planning. Because sale-leasebacks and LILOs are tax-motivated restructuring activities, familiarity with the economic substance and business purpose doctrines is essential.
2. Kenneth J. Kies, *'Leave Us A Loan': A Rebuttal to Claims that Defeasance Invalidates Lease Transactions*, *Tax Notes*, Feb. 9, 2004, at 763. This article rebuts the IRS' stance concerning leasing transactions that security deposit or "defeasance" arrangements indicate a lack of economic risk (and thus, economic substance) and makes the stance that presence of these arrangements should not provide any basis for challenging the tax treatment of leasing transactions. The article describes how a basic LILo transaction works and then analyzes potential tax issues involved in leasing transaction deposit security arrangements. The discussion focuses on LILo transactions but is applicable to other leveraged leasing transactions using similar deposit security arrangements.
3. B. Cary Tolley III, *Leasing to Tax-Exempt Entities: Setting the Record Straight*, *Tax Notes*, April 12, 2004, at 244. This article addresses President Bush's tax proposals for the 2005 budget which sought to include material tax increases for lessors engaged in sale-leaseback financing activity with tax exempt entities. This article attempts to "set the record straight" that the public characterizations of these transactions as fraudulent tax shelters are erroneous. The article describes the primary contentions the government has with such transactions and directly responds to each argument in support of the view that the government's characterization of these leasing transactions is unfair and against

public policy.

4. Philip R. Fink, *Sale-and-Leaseback of Real Property*, The Tax Advisor, May 2001, at 328. This article offer tax planning suggestions for the closely held corporation interested in entering into a sale-leaseback transaction with real property, as such as transaction may offer the parties both financial and tax benefits. The articles covers issues to be aware of, including timing and economic substance questions, disguised dividends, and the self-rental rule. It includes four tests that should be met to ensure that the sale-leaseback is considered valid, and concludes that no one factor is dispositive of the outcome.

## Books

### Legal Encyclopedias

American Jurisprudence, [Sale-leaseback or Financing Transaction](#), 34 Am. Jur. 2d Federal Taxation § 16751 (2009).

This AmJur is helpful for one just beginning to try to understand the basic nature of sale-leaseback transactions. The article provides a brief description of what a sale-leaseback transaction is, discusses the *Frank Lyon* case, above, the 'burdens and benefits of ownership' doctrine, and the 'economic substance' doctrine.

American Jurisprudence, [Real Estate Transaction As Sale and Leaseback for Income Tax Purposes](#), 39 Am. Jur. 2d Proof of Facts § 651 (2008).

This AmJur provides an extensive analysis on sale-leaseback transactions, including the status of the current law and relevant factors to consider. The precise topic of the article is whether a real estate transaction is truly a sale-leaseback rather than a financing arrangement or exchange of like-kind property. This article is particularly helpful when such question may arise in a tax proceeding in which the Internal Revenue Service attempts to disallow deductions for such things as depreciation, rental payments, interest, and investment tax credit by the parties to a putative sale-leaseback arrangement, on the grounds that the arrangement actually constituted a financing device or exchange of like-kind property.

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## Websites and Internet Research

### Westlaw

Westlaw is an online subscription legal research service for lawyers and legal professionals. Most legal documents on Westlaw are indexed to the West Key Number System, which is West's master classification system of U.S. law. Other significant Westlaw features include KeyCite, a citation checking service, and a customizable tabbed interface that lets customers easily access their most-used resources. The use of the Key Numbers and Digest system allow you to browse the index and then narrow in on your topic; the terms and connectors feature allows you to develop very specific search criteria. Westlaw supports Natural Language and Boolean searches.

For assistance in Westlaw's KeyCite feature, See KeyCite Tutorial: <http://lawschool.westlaw.com/shared/marketinfoldisplay.asp?code=RE&id=2&subpage=1>  
Click on Discover Westlaw > Understand Westlaw > KeyCite. (Note: you must first be a subscriber to Westlaw to access this tutorial).

### CCH Tax Research Network

CCH is a paid subscription service for the tax practitioner. The service provides access to the IRS code, administrative regulations, publication and rulings as well as court holdings.

### Thomas

Thomas is operated by the Library of Congress. The site provides a great resource for legislative history, and following pending legislation. Searching is easiest with a bill number, but the site also allows several ways to browse including: by Senate or House, by specific committee or by legislative session.

### LexisNexis

LexisNexis is also an online subscription legal research service which contains all current United States statutes and laws and nearly all published case opinions from the 1770s to the present, and all publicly available unpublished case opinions from 1980 onward. Similar to Westlaw, Lexis also provides citing references and the authoritative treatment on a particular case, law, or legal topic. It provides both terms searching as well as table of contents searches.

For assistance in the LexisNexis citator feature, See Shepard's Tutorial: <http://web.lexis.com/help/multimedia/shepards.htm> (Note: you must first be a subscriber to LexisNexis to access this tutorial).

### TaxAlmanac

TaxAlmanac is a free online resource for tax professionals. This is a great website to look up Internal Revenue Code provisions, regulations, notices, etc, especially if you know the

particular code section or regulation you are looking for. This website also includes a topics and discussions section. No articles pull up with regard to the topic of sale-leaseback transactions through an advanced search but a general search will bring up the statutes and regulations that touch on sale-leaseback transactions.

### Legal Information Institute

Legal Information Institute is operated by Cornell University Law School as a free site for legal information. The site is a great source for access to the both the Federal and State Constitutions, several federal codes and many federal and state court opinions.

### Popular On-Line Search Engines

Popular on-line search engines such as [Google](#) or [Yahoo](#) provide an excellent way to begin your research. The services are free and can provide an opportunity to become comfortable with a topic before using paid subscription services. Legal terms and topic are well suited for on-line search engines because they are unique enough to provide more specific results.

### BNA TAX Management

The Bureau of National Affairs, Inc. (BNA) is an independent, privately owned publisher of specialized online and print news and information for professionals in business and government. The company reports on legislation, regulations, court decisions and policy. BNA's Tax Portfolio service gives the user focused searching ability for tax law. The Tax & Accounting Management Center has both a word searching tool and an index search tool. The BNA Tax Management Portfolio can also be accessed through Westlaw. If you have a subscription to BNA Tax and Accounting Center, you can access the Portfolios mentioned above by Clicking on the 'Federal Tax' tab, then 'U.S. Income Portfolio Index', then click on 'S', to 'Sales and Leasebacks' (or 'E' for 'Equipment Leasing').

### Legal Bitstream

Legalbitstream is a free online tax law research website that provides an excellent resource for tax law professionals when looking for IRS documents other than Code provisions. Databases include updated Internal Revenue Service documents and case law opinions from all federal courts that issue federal income and estate tax law guidance. The web-site is organized and easy to use. The search engine provides users with precise searches that retrieve all relevant documents for users without having to sift through irrelevant documents. The federal tax case law is selected to be included in the databases if it interprets other tax cases, the Internal Revenue Code, Treasury Regulations, or IRS forms. As of July 2007, federal tax case law is included for years 1990 to the present. Legalbitstream can currently be used at no cost and without registration, however upon further completion of the databases and improvement to the software in the future, the website may become a fee-based service. A search of "sale-leaseback" uncovers a number of cases and Revenue Rulings that have arisen since 1990 (although only the Revenue Ruling listed herein is particularly noteworthy for purposes of this bibliography).

### GPO Access

GPO Access is operated by the United States Government Printing Office. The site is free and offers a variety of government documents. It is most useful for view Code of Federal Regulations, and for searching for updated regulations.

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