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OBJECTIVE: TAX AVOIDANCE; *CLAY BROWN* AND THE THREE-PARTY SALE AND LEASEBACK

I.

THE THREE-PARTY SALE AND LEASEBACK

In the recent decision of *Commissioner v. Clay B. Brown*,[1] the Supreme Court held that the sale of a business to an exempt organization as part of a three-party sale and leaseback does not automatically deprive the seller of capital gains treatment. That decision will surely result in an even greater utilization of "bootstrap" transactions as a method of tax avoidance,[2] for the dreams of the entrepreneur can now be realized with a minimum of risk. The three-party sale and leaseback, as well as other "bootstrap devices," can be safely employed to secure an effective return of profits at capital gains rates.

The three-party sale and leaseback involves several basic transactions. First, the stock of the vendor, typically a closely-held corporation, is purchased by a "middleman," usually a tax-exempt organization. The original corporation is then liquidated, with a stipulated amount of the liquidated assets being paid to the sellers as a down payment. A new operating company is then formed under the control of either the seller or a trusted associate with nominal capital. Finally, the newly-formed company leases the fixed assets of the liquidated corporation from the "middleman," the consideration being a fixed percentage (usually 80 per cent) of the net profits of the operating company. The "middleman" is in turn obligated to pay a percentage of this sum (usually 90 per cent) to the seller in satisfaction of a non-interest bearing note or similar obligation given to secure the purchase price of the stock.

The primary motive behind the sale and leaseback is, as previously noted, tax avoidance.[3] The rental payments of the operating company are deductible as operating expenses, and, if the "middleman" is an exempt organization, these payments are not taxable.[4] In addition, the seller treats his return from the sale as capital gain.

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1. 380 U.S. 563 (1965).
2. For an exhaustive analysis of the many facets of the "bootstrap sale" see Lanning, *Tax Erosion and the "Bootstrap Sale" of a Business*, 108 U. PA. L. REV. 623, 943 (1960). See also, Moore & Dohan, *Sales, Churches, and Monkeyshines*, 11 TAX L. REV. 87 (1956); Alexander, *The Use of Foundations in Business*, 15 N.Y.U. INSTITUTE ON FEDERAL TAXATION 591 (1957); Comment, *The Three-Party Sale and Lease-back*, 61 MICH. L. REV. 1140 (1963).
3. See, Cary, *Corporate Financing, Through the Sale and Lease-back of Property: Business, Tax and Policy Considerations*, 62 HARV. L. REV. 1 (1948), for an extensive discussion of the advantages of the sale and lease-back in the area of corporate finance. The article contains an excellent discussion of the non-tax advantages of the sale and lease-back.
4. The exempt organization's status will usually result in a higher purchase price for the seller due to the fact that it is capable of a quicker pay-back than a taxable buyer (earnings before taxes higher). But a taxable buyer may be on an equal footing with an exempt organization if he has operating loss carryovers, or if the amount of depreciation and other non-cash deductions generated by the transferred assets are sufficient. See Dauber, Jewell & Hall, *Supreme Court in* Brown *Allows Capital Gain on "Bootstrap" Sale to Charity*, 23 J. TAXATION 2, 3 (1965).

Finally, there may be an added tax advantage to the seller where his property is of a nondepreciable character or has been fully depreciated; for the sale and leaseback in effect results in a writing-off of the entire property, including land and other nondepreciable assets. Indeed, the rental payments themselves provide one method of securing accelerated depreciation. The relevance of this "depreciation factor" with regard to the *three-party* sale and leaseback is, however, dependent upon effective control or at least ownership of the stock of the operating company remaining in the hands of the sellers of the liquidated corporation.

Considerations of corporate finance and the control factor noted above point up the particular suitability of the exempt organization as the "middleman" in a leaseback arrangement. The private investor is unlikely to favor the leaseback over other types of loans, even though the average return from leaseback transactions has been estimated at 3/8 per cent higher than any other form of debt financing, since rental payments received under the lease would be reportable on the investor's tax return while the repayment of a loan would have no taxable effect. It is this indifference of the exempt organization as to how receipts from an investment are to be reported on its return that makes the widespread use of the sale and leaseback practicable.[5]

II.

THE EXEMPT ORGANIZATION

The exemption from taxation provided by section 501(a) of the Internal Revenue Code of 1954 is extended by section 501(c)(3) to:

> Corporations, and any community chest, fund, or foundation, *organized and operated exclusively* for religious, charitable, scientific, testing for the public safety, literary or educational purposes, or for the prevention of cruelty to children or animals, *no part of the net earnings of which inures to the benefit of any private shareholder or individual. . . .*

Definition of the requirements set forth by this section has entailed considerable legislative and judicial effort.[6]

A. *The Organization Requirement*

While the best evidence of the purpose of an organization is usually found in its articles of incorporation,[7] the charter is not conclusive, and extrinsic evidence may be admitted to prove a charitable purpose.[8] Nor

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5. Cary, *supra* note 3, at 28.
6. See cases collected at 69 A.L.R.2d 871 (1960).
7. Estate of Sharpe v. Commissioner, 3 T.C. 612 (1944), *aff'd,* 148 F.2d 179 (3d Cir. 1945).
8. See, *e.g.,* Commissioner v. Battle Creek, 126 F.2d 405 (5th Cir. 1942); Roche's Beach, Inc. v. Commissioner, 96 F.2d 776 (2d Cir. 1938); Cochran v. Commissioner, 78 F.2d 176 (4th Cir. 1935).

will incorporation under general corporation laws, rather than as a non-profit organization, preclude exemption if, in fact, the corporation is organized for a proper purpose.[9] Such ambiguities may be resolved by discerning the actual purposes for which the corporation is operated,[10] which is largely a question of fact to be determined by an examination of the intentions and motives behind the formation of the charitable entity. In this regard, it has been stated that "[To] some degree, 'organized' cannot be divorced from 'operated,' for the true purposes of organization may well have to be drawn in final analysis from the manner in which the corporation has been operated."[11] Finally, it should be noted that a charter of a charitable corporation which delegates broad powers of administration to its directors will not compel a holding that the corporation was not organized exclusively to achieve proper ends — powers are not to be equated with purposes.[12]

As to the requirement of exclusiveness, the Supreme Court held, in *Better Business Bureau v. United States,*[13] that the presence of one non-exempt purpose, if substantial in character, would destroy the exemption, regardless of the number or importance of non-exempt purposes. That decision was interpreted by the Tax Court in *The Marian Foundation*[14] to require that a corporation be organized "primarily" for charitable purposes, and stated the test of exemption to be that "activities which do not serve directly to further an exempt purpose must be minor in comparison to exempt activities." The *Marian* decision, when viewed in the light of the purpose-power distinction of *Danz* clearly indicates that an exempt organization can engage in limited business activities and still retain its exempt status.

B. *The Operation Requirement*

But even if *organized* exclusively for charitable purposes, a corporation does not satisfy code requirements unless it is also *operated* exclusively for such ends. The question of operation, like that of organization, is essentially one of fact.[15] Probably the most crucial problem in this regard arises where exempt organizations engage in competition with private business. What appears to be the better view has favored a liberal con-

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9. See, *e.g.*, Debs Memorial Radio Fund, Inc. v. Commissioner, 148 F.2d 948 (2d Cir. 1945); Commissioner v. Battle Creek, Inc., 126 F.2d 405 (5th Cir. 1942).

10. Hillcrest Country Club, Inc. v. United States, 152 F. Supp. 896 (W.D. Mo. 1957); Kanawha-Roane Lands, Inc. v. United States, 136 F. Supp. 631 (S.D.W.Va. 1955).

11. Samuel Friedland Foundation v. United States, 144 F. Supp. 74, 85 (D.N.J. 1956).

12. Commissioner v. John Danz Charitable Trust, 284 F.2d 726 (9th Cir. 1960).

13. 326 U.S. 279 (1945).

14. 19 CCH Tax Ct. Mem. 99 (1960).

15. Marie and Alex Manoogian Fund v. United States, 24 T.C. 412 (1955), *appeal dismissed,* 232 F.2d 758 (6th Cir.), *cert. denied,* 352 U.S. 929 (1956); Cummins-Collins Foundation v. Commissioner, 15 T.C. 613 (1950).

struction in light of the expressed public policy to exempt income devoted to charity.[16]

Trinidad v. Sagrada Orden de Predicadores,[17] a case involving the sale of small quantities of goods by a religious order on a non-competitive basis illustrates this position. There the Supreme Court stated in dicta that the destination, and not the source, of income was the ultimate test of exemption. The *Sagrada* dicta was subsequently expanded to exempt income derived by a charity from its operation of a home for the aged in competition with private business,[18] and, in the controversial *Roche's Beach*[19] case, to allow exemption to a corporation whose entire earnings from the operation of a large bathing beach were channeled to the charity which owned all of its stock. Under the "destination of income test" there was no basis for distinguishing between a charitable corporation which carried on a private enterprise and a private corporation organized and operated to "feed" an exempt organization.

Judge Learned Hand strongly dissented in *Roche's Beach,* asserting that the tax-exempt status of a corporation should be dependent upon its own activities and purposes, rather than those of the ultimate recipient of the income. Judge Hand based his opinion upon section 103 of the Code,[20] which included within the category of exempt organizations a corporation organized for the purposes of collecting income to be subsequently paid over to such an organization. As it was "the purpose of subdivision 14 to tax all business income, however destined, unless the company was really not in business at all," the exemption of a feeder's income, and, implicitly, that of a charity which operated a business for profit, could not be justified under section 101(6).[21] Nevertheless, subsequent decisions sanctioned the application of "the destination of income approach" to the feeder as well as to the charity.[22]

The abuses involved where a charity or its feeder engage in competitive enterprise to secure tax-free income for the support of charitable activities are obvious; for the status of the charitable organization permits it to reinvest a greater amount of its profits than its non-exempt competitors. In addition, the exempt organization, through the use of the sale and leaseback arrangement, is able to borrow the amount of the purchase price and repay the loan (and interest) with rentals derived from the

16. Old Colony Trust Co. v. Helvering, 301 U.S. 379, 384 (1937); Helvering v. Bliss, 293 U.S. 144, 150 (1934).
17. 263 U.S. 578 (1924).
18. Sands Springs Home, 6 B.T.A. 198 (1927).
19. Roche's Beach, Inc. v. Commissioner, 96 F.2d 776 (2d Cir. 1938).
20. Now § 501(c)(2) of Int. Rev. Code of 1954.
21. Now § 501(c)(3) of Int. Rev. Code of 1954.
22. See, *e.g.,* C. F. Mueller Co. v. Commissioner, 190 F.2d 120 (3d Cir. 1951); Willingham v. Home Oil Mill, 181 F.2d 9 (5th Cir.), *cert. denied,* 340 U.S. 852 (1950); Commissioner v. Ortin, 173 F.2d 483 (6th Cir. 1949); Debs Memorial Radio Fund, Inc. v. Commissioner, 148 F.2d 948 (2d Cir. 1945). See the following cases *contra: e.g.,* United States v. Community Services, Inc., 189 F.2d 421 (4th Cir. 1951). *cert. denied,* 342 U.S. 932 (1952); Universal Oil Products Co. v. Campbell, 181 F.2d 451 (7th Cir.), *cert. denied,* 340 U.S. 850, *rehearing denied,* 340 U.S. 894 (1950); Bear Gulch Water Co. v. Commissioner, 116 F.2d 975 (9th Cir. 1941).

acquired property. After recouping the purchase price, the charity can continue to lease the property or sell at a clear profit. This type of activity meets objection on several grounds.[23] First, the charity is "trading on its exemption," since its sole contribution to the leaseback transaction is its tax exempt status. Secondly, where rentals are lower or the sales price higher than would be the case with a non-exempt purchaser-lessor, the sale and/or leaseback becomes, in effect a sale of the charity's exemption. Thirdly, continued use of the sale and leaseback by charities might eventually result in serious reductions in the over-all tax base.

The Revenue Act of 1950[24] was adopted by Congress to deal with these competitive problems and particularly those arising in the area of the sale and leaseback. The approach taken in the Act was to tax the income of exempt organizations on an equal basis with that of non-exempt organizations in so far as it was derived from an "unrelated trade or business."[25] The "destination of income test" was retained with regard to organizations other than feeders. With respect to feeders, however, Judge Hand's dissent in *Roche's Beach* became law. The Act provided that income derived from the operation of a trade or business carried on for profit would not be exempt merely because it is payable *in toto* to an exempt organization.[26] The tax thus imposed on business income is limited by section 511 to income received by exempt organizations *actively* engaged in the operation of an "unrelated trade or business." "Passive income," such as that received as dividends, interest, royalties and rents, is excluded from the tax.[27]

Section 514 is aimed specifically at the evils engendered by the sale and leaseback transaction. It provides an exception to the rental exclusion of section 512(b), by taxing as "unrelated business income" rents received from leases of real property for more than five years where there is an outstanding indebtedness at the end of the taxable year incurred by the lessor in acquiring or improving the property. Leases for five years or less, however, escape taxation. However, if there is an option to renew, the renewal period must be added to the term of the lease to determine whether it falls within the exclusion.[28] Further, income from the lease is subject to the tax if the property has been

23. Dane, *Taxation of Charities under Revenue Act of 1950,* 9 N.Y.U. INSTITUTE ON FEDERAL TAXATION 895, 896 (1951).

24. The Revenue Act of 1950 amended § 101 Int. Rev. Code of 1939, and added, §§ 421-24, 3813 and 3814. These sections are now §§ 501-04 and 511-14 of Int. Rev. Code of 1954. Citations with regard to the Act are keyed to the 1954 Code.

25. Int. Rev. Code of 1954, § 502.

26. The term "unrelated trade or business" is defined by § 513(a): "the term 'unrelated trade or business' means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501. . . ."

27. Int. Rev. Code of 1954, § 512(b).

28. Int. Rev. Code of 1954, § 514(b)(2)(A).

occupied by the same lessee for a total period of more than five years from or after the date the exempt organization acquired the property.[29]

The Revenue Act also listed certain prohibited transactions[30] and proscribed accumulations of income which are so "unreasonable in amount or duration" that the function of the organization constituting the basis for exemption cannot be accomplished.[31] The penalty for violation of these sections is loss of exemption.[32]

C. *Private Inurement of Income*

Section 501(c)(3) establishes the further limitation that net income of the organization may not inure to the benefit of any private shareholder or individual.[33] This section, however, has received a narrow construction. Thus, in *Ohio Furnace Company, Inc.*,[34] a foundation organized for educational purposes acquired the stock of Ohio Furnace, giving the seller a series of notes for the purchase price. The net earnings of the Furnace Company, in accordance with the terms of its charter, were paid to the foundation and constituted its only income. The foundation was obligated, in turn, by the terms of the sales agreement to pay substantially all of its earnings to the sellers of the stock. As a result, no disbursements of funds were made by the foundation for charitable purposes during the period in question. The Commissioner contended that the payments constituted an inurement of income to private individuals. The Tax Court rejected this contention, holding that the foundation's investment was a sound one made in good faith at arm's length and for a reasonable price, and that it could have been directed to no other end than to ultimately benefit the educational purposes of the organization. Several "private inurement cases" subsequent to *Ohio Furnace* have adopted the rationale of that case, emphasizing the soundness of the investment and the reasonableness of price as crucial factors.[35]

29. Int. Rev. Code of 1954, § 514(b)(2)(B).

30. Int. Rev. Code of 1954, § 503. Certain organizations exempt under § 501(c)(3) are excluded from the coverage of this section and § 504, *infra*, by § 503(b). The presence or absence of an arm's-length transaction is crucial in determining whether or not the transaction is prohibited. See, Powell, *Foundations: Prohibited Activities*, 14 N.Y.U. INSTITUTE ON FEDERAL TAXATION 61 (1956).

31. Int. Rev. Code of 1954, § 504(a). See Mansfield, *Foundations: Unreasonable Accumulations*, 14 N.Y.U. INSTITUTE ON FEDERAL TAXATION 47 (1956).

32. In the case of a violation of § 503(d), exemption is lost, in most instances, for the taxable years after the year during which the organization is notified of violation. Exemption can be reinstated upon application if the Secretary is satisfied that future violations will not occur (§ 503(a), (d)). In the case of violation of § 504, the exemption is lost only for the taxable year in which the unreasonable accumulation occurred (§ 504(a)).

33. Treas. Reg. No. 111 §§ 29.101-1, 29.101-2(d).

34. 25 T.C. 179 (1955).

35. Commissioner v. Howes Leather Co., 267 F.2d 382 (1st Cir. 1959); Knapp Bros. v. United States, 142 F. Supp. 899 (Ct. Cl. 1956); A. Shiffman, 32 T.C. 1073 (1959). In the *Shiffman* case, the Commissioner contended that the foundation's use of its income to repay its indebtedness constituted an unreasonable accumulation of income for non-exempt purposes. The court rejected this contention holding that even assuming that the use of the income of the foundation to pay an indebtedness incurred in acquiring property was an accumulation of income, in the case at bar (facts of case identical to *Ohio Furnace*), such accumulations were neither unreasonable nor for non-exempt purposes.

III.

THE *CLAY BROWN* DECISION

A. *Background*[36]

The *Clay Brown* leaseback arrangement was essentially the basic three-party sale and leaseback described above. Negotiations were real, at arm's-length and in good faith, and both parties had a clear business purpose in entering into the agreement. Clay Brown and Company was able to sell at a price agreeable to it,[37] and the foundation obtained funds from the retention of 10 per cent of the rental payments. After the note for the purchase price had been paid, the charity would obtain full title to the property.[38] Further, as the lease executed was for a five-year period, the rental payments received by the foundation would be tax-exempt.[39] Nor was the foundation under any obligation to make payments on the principal unless rental payments were received from the operating company. However, in the event that a designated minimum was not realized in any two consecutive years, the sellers could declare the entire balance due and payable. If payment was not then forthcoming, a mortgage on the fixed assets executed to secure the note could be foreclosed. The operating company was organized with "more than nominal capital,"[40] and its stock held by Clay Brown's attorneys, who also comprised its board of directors. No shareholders of Clay Brown and Company retained any interest in the newly-formed corporation, although a managerial contract was executed with Clay Brown which reserved to the holders of a majority interest in the principal note the right to appoint a successor should he later resign. Brown later relinquished this position and the right to appoint his successor was waived.

In a Revenue Ruling which concerned an agreement basically similar to the Clay Brown sale and leaseback, the Commissioner stated that the transaction should not be treated as producing a long-term capital gain for Federal income tax purposes.[41] Consequently, when the shareholders of Clay Brown and Company reported the amounts received under this agreement as capital gain the Commissioner assessed a deficiency, and respondents thereupon commenced the present action.

The Tax Court rejected the Commissioner's position, holding that the transaction constituted a bona fide sale consummated after arm's-

36. The facts presented below are essentially the findings of fact of the Tax Court (37 T.C. 461 (1961)).

37. As of January 31, 1953 the adjusted net worth of Clay Brown and Company was $619,457.63 of which $448,471.63 was accumulated earnings. The appraised value as of that date was $1,064,877. The sale price was $1,300,000 (date of sale was February 4, 1953).

38. The foundation's chief reason for entering the transaction was to obtain full title to the properties and sell them to procure money for use in cancer research.

39. Int. Rev. Code of 1954, § 514.

40. The operating company was capitalized at $25,000, the capital being paid in by its stockholders from their own funds.

41. Rev. Rul. 54-420, 1954-2 Cum. Bull. 128.

length negotiations which resulted in a reasonable price,[42] and that the sellers were entitled to capital gains treatment on their return from the sale.[43] The court deemed the fact that legal title was transferred for a consideration and the sellers would eventually yield all interest in the property controlling. Considerable reliance was placed on *Union Bank v. United States*,[44] a case factually similar to *Clay Brown*, where the Court of Claims found the sellers had retained only a security interest in the property and concluded that ". . . it is logically and legally impossible for an owner to part with his property for a consideration without selling it."[45] On appeal, the Tax Court's decision was affirmed.[46] The Supreme Court granted certiorari.[47]

B. *The Commissioner — An All or Nothing Approach*

The Commissioner made a substance over form argument, emphasizing the "economic realities"[48] of the sale and leaseback transaction. He contended that while *in form* there had been a sale, *in substance* the vendor retained such an economic interest in and control over the property as to preclude the possibility of there being a "sale or exchange" for capital gains purposes. The sellers of Clay Brown and Company had not sufficiently severed their interest in the property to warrant being considered as having converted a capital asset into a capital gain or loss. According to the Commissioner, there would be no "sale" of the stock until all payments had been made. The income transferred from the operating company to the sellers constituted a "return of profit" resulting from a gratuitous transfer of stock to the foundation,[49] and should therefore be taxed as ordinary income.[50]

42. Subsequent decisions have taken the same factual analysis approach with regard to determining if a bona fide sale has taken place as that taken in *Brown*. The existence of an arm's-length transaction, the adequacy of capitalization and the management of the operating company are important factors to consider. The existence of real negotiations is crucial in determining whether the purchase price is a reasonable one. See Royal Farms Dairy Co., 40 T.C. 172 (1963); Anderson Dairy, Inc., 39 T.C. 1027 (1963).

43. Clay B. Brown, 37 T.C. 461 (1961).

44. 285 F.2d 126 (Ct. Cl. 1961).

45. *Id.* at 128. The following cases are in accord with the rationale of *Union Bank* and the Tax Court's decision in *Clay B. Brown*: Royal Farms Dairy Co., 40 T.C. 172 (1963); Anderson Dairy, Inc., 39 T.C. 1027 (1963); Ralph M. Singer, 22 CCH Tax Ct. Mem. 996 (1963); Isis Windows, Inc., 22 CCH Tax Ct. Mem. 837 (1963); Oscar C. Stahl, 22 CCH Tax Ct. Mem. 996 (1963). *Cf.* Earnest G. Howes, 30 T.C. 909, *aff'd sub nom.*, Commissioner v. Johnson, 267 F.2d 382 (1st Cir. 1959); Estate of Truschel, 29 T.C. 433 (1957).

46. 325 F.2d 313 (9th Cir. 1963).

47. 377 U.S. 962 (1963).

48. The basis for this "economic realities" approach was laid in Gregory v. Helvering, 293 U.S. 465 (1935). That case involved a transaction which the Supreme Court held was "an operation having no business or corporate purpose — a new device which put on the form of a corporate reorganization as a disguise for concealing its real character. . . ." *Id.* at 469. The Tax Court had distinguished *Gregory* on the basis of its finding that there was a clear business purpose in the Clay Brown transaction.

49. Dauber, Jewell & Hall, *op. cit. supra* note 4, at 2.

50. Taxing the seller's returns as dividends, the Commissioner treated the business in their hands as a wasting asset under § 167 I.R.C., and allowed them to offset their bases in the stock against payments received.

1. *An Economic Interest Approach*

As the sellers' receipt of the purchase price depended solely upon the earnings of the operating company, they retained the economic risk, although legal title passed to the foundation. The Commissioner contended that this precluded a sale for capital gains purposes, reasoning that if the entire risk were to remain with the sellers, the foundation investing nothing and assuming no independent obligation to pay the purchase price, there would necessarily be a "price" for this risk bearing. Consequently, that portion of the purchase price over and above the fair market value of the stock would represent future earnings. As the purpose of the capital gains tax is to alleviate the appreciation of value accrued over a substantial period of time from being taxed at a high rate in the year of sale[51] and is not applied to future income, he argued that capital gains treatment under section 1222(3) I.R.C.[52] should be denied.

While there was no direct authority for this approach, a convincing analogy could be made to certain cases in the natural resources field, where the characterization of an agreement as a "sale or lease" by the parties was disregarded in order to ascertain the economic realities of the particular transaction. In these cases, where the seller retained an interest in the oil and gas in place and looked solely to their extraction for a return of capital, it was generally held that the payments constituted ordinary income subject to depletion allowance,[53] even though the parties might have characterized the particular transaction as a "sale." The fact that the seller's return was dependent solely upon production was deemed sufficient to render capital gains treatment inappropriate.

This position was adopted in *Burnet v. Harmel*,[54] a case which involved the leasing of oil and gas rights in exchange for cash bonus payments[55] and stipulated royalties[56] dependent upon production by the lessee. The Supreme Court, in denying capital gains treatment to the bonus payments as well as the royalties, ruled that passage of title to the lessee was only incidental to the use of the land for oil production. The operation viewed as a whole was not a sale or a conversion of capital assets:

> . . . it is evident that the taxation of the receipts of the lessor as income does not ordinarily produce the kind of hardship aimed at

51. Commissioner v. Gillette Motor Transport., Inc., 364 U.S. 130, 134 (1960).
52. Int. Rev. Code of 1954, § 1222(3) defines a long term capital gain as "gain from the sale or exchange of a capital asset held for more than six months, if and to the extent such gain is taken into account in computing gross income."
53. See, *e.g.*, Commission v. Southwest Exploration Co., 350 U.S. 308 (1956); Burton-Sutton Oil Co. v. Commissioner, 328 U.S. 25 (1946); Kirby Petroleum Co. v. Commissioner, 326 U.S. 599 (1946); Thomas v. Perkins, 301 U.S. 655 (1937); Palmer v. Bender, 387 U.S. 551 (1933); Burnet v. Harmel, 287 U.S. 103 (1932). *But see* Barker v. Commissioner, 250 F.2d 195 (2d Cir. 1957); Crowell Land and Mineral Corp. v. Commissioner, 242 F.2d 864 (5th Cir. 1957); Maude W. Olinger, 27 T.C. 93 (1956).
54. 287 U.S. 103 (1932).
55. A cash bonus payment is a cash down payment.
56. A royalty is a right to receive a certain percentage of the proceeds of mineral exploitation, usually a one-eighth interest.

> by the capital gains provision of the taxing act. Oil and gas may or may not be present in the leased premises, and may or may not be found by the lessee. If found, their abstraction from the soil is a time-consuming operation and the payments made by the lessee to the lessor do not normally become payable as the result of a single transaction within the taxable year, as in the case of a sale of property.[57]

Implicit in this decision is the proposition that where a vendor's return is dependent upon production yielding income recurrently over a period of more than one year, he has retained such an economic interest in the property as to render capital gains treatment improper.[58]

Perhaps the closest parallel to the sale and leaseback transaction in the oil and gas cases is to be found in transactions where the consideration consists solely of oil production payments, that is, an amount payable to the transferor out of proceeds from the sale of the oil transferred in the form of a specified amount of a certain fraction of production. When the transferor has received the purchase price, his interest in the oil in place terminates and the entire risk of production falls to the transferee. In one such case, *Thomas v. Perkins,*[59] the Supreme Court held that the lessor's income was taxable at ordinary income rates. While the fact that the transferor's right to the oil payments was fixed in amount and would not vary directly with the severance of minerals from the soil was indicative of a "sale," it was outweighed by the fact that the lessor's income was dependent on production and could only be realized over a period of years.

Subsequently, in *Anderson v. Helvering,*[60] the *Perkins* decision was limited to situations where oil payments were derived solely from production. There the agreement provided that oil payments to the transferor be paid from half of the oil produced and from any sale of land. The Court held that, as the payments could be satisfied from the sale of the property itself, the economic risk argument was inapplicable and "the reserved payments must be treated as payments received upon a sale. . . ."[61] This rationale imposes a "necessity restriction" on the application of the economic interest approach. If payments to the lessor are not necessarily dependent upon production, and there is a possibility of payment from another source, the transaction will be regarded as a "sale" warranting capital gains treatment. The Commissioner asserted that this "necessity restriction" was not applicable to the Clay Brown situation since the sellers' return was solely dependent on the production of the operating company.

57. Burnet v. Harmel, 287 U.S. 103, 106 (1932).
58. See Lanning, *supra* note 2, at 650. In Palmer v. Bender, 287 U.S. 551 (1933), the Supreme Court held that the right to a depletion allowance (and therefore whether the return of the "seller" is to be treated as ordinary income or capital gain) is dependent on retention of economic interest and not retention of ownership.
59. 301 U.S. 655 (1937).
60. 301 U.S. 404 (1940).
61. *Id.* at 412.

2. *Retention of Control*

Control of the fixed assets of the operating company, in effect, remained in Clay Brown and his associates. The Commissioner contended that as the sellers retained this substantial control, they had not sufficiently severed their interest so as to warrant capital gains treatment. Again the "economic realities" of the transaction were stressed.

An analogous situation existed in *Higgins v. Smith*,[62] where the loss on the sale of securities by a sole stockholder to his wholly-owned corporation for no valid business purpose was denied. The Court reasoned that as the "command of income and its benefits" remained in the seller, he was the true owner of the property and had incurred no loss. And as was stated in *Corless v. Bowers*:[63] ". . . taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed — the actual benefit for which the tax is paid."[64] Applying this thesis to the sale and leaseback transaction, the Commissioner argued there must be a substantial change in the seller's economic position so as to make it reasonable to treat him as a recipient of income for tax purposes,[65] and contended that such a change had not been effected by the Clay Brown arrangement.

B. *The Court's Decision*

1. *Definition of a "Sale"*

The Supreme Court in holding that capital gains treatment was appropriate in *Clay Brown*, rejected the Commissioner's contention that the method or source of payment is crucial in defining a sale within the meaning of section 1222(3) I.R.C. Instead it adopted the ordinary meaning of that term as being merely dependent upon the seller's transfer of a property interest, and ruled that a sale is transacted whenever there is "a transfer of property for a fixed sum payable in money." And retention of a mere creditor's interest as opposed to a proprietary one, as was the case in *Clay Brown*, was not deemed a sufficient basis to deny the existence of a sale. Nor does the presence of a recapture provision in the agreement to take effect upon default transform a creditor's interest into one proprietary in nature.

The Court asserted that the literal meaning of the term "sale" adopted in *Clay Brown* was in no way inconsistent with the purposes behind the

62. 308 U.S. 473 (1940). The approach taken in *Higgins* was based on Gregory v. Helvering, *supra* note 48.

63. 281 U.S. 376 (1930). *Accord*, Griffiths v. Helvering, 308 U.S. 355 (1939).

64. *Id.* at 378.

65. *Cf.* Commissioner v. Sunnen, 333 U.S. 591 (1948); Helvering v. Clifford, 309 U.S. 331 (1940).

capital gains provisions of the Code. Indeed, the substantial accumulated earnings of Clay Brown and Company were held to be sufficient evidence of the appreciated value of the vendor's stock sold.[66] Dismissing the Commissioner's assertion that this "excessive burden" was not present since payment would be realized over a period of years, the Court relied heavily upon Congressional rejection of a recent Treasury proposal which would have treated payments on the sale of a capital asset which are deferred over more than five years and contingent on future income as ordinary income.[67] The Court deemed it significant that the proposal did not challenge the occurrence of a sale in such a transaction. But even more important was Congress' failure to deny capital gains treatment to contingent payments deferred over more than five years.

2. *The Commissioner's Argument — "A Case of Overkill"*

In rejecting the Commissioner's argument that the seller's retention of risk and control prevented the execution of a sale for capital gains purposes,[68] the Court dismissed the "realities approach," adverting to the fact that the sellers of Clay Brown had no interest in the foundation or the operating company. While Clay Brown had the right to control and manage the operating company, he had subsequently relinquished it and the Court did not view the ownership of the operating company by Clay Brown's attorneys as a retention of control by the sellers.

The existence of an excessive purchase price was essential to the Commissioner's economic interest approach. However, the Court, relying on the Tax Court's determination that the sales price was within a reasonable range in light of the financial position of the seller and the result of real negotiations conducted at arm's-length, found the price to be reasonable. The oil and gas case analogy was rejected as inapplicable, since the extraction of mineral resources is an income-producing operation, and not a conversion of capital assets. Further, percentage depletion (and therefore ordinary income treatment) is solely dependent upon production, while the policy behind the capital gains tax is concerned with the appreciation in value of an asset over cost.[69]

But the Court's decision did not result in a complete rejection of the risk-shifting approach. By its consideration of the "excessive price issue," the Court implicitly recognized that a transaction would be struck down as "no sale" when the price was found to be unreasonable. Capital gains treatment would be improper in such a situation, not because risk

66. See note 37, *supra*.

67. *Hearings Before the Committee on Ways and Means of the House of Representatives*, 88th Cong., 1st Sess. at 154-56 (1963).

68. The dissenting opinion of Mr. Justice Goldberg, with whom Mr. Chief Justice Warren and Mr. Justice Black agreed, adopted the approach of the Commissioner.

69. The Court added that even if the oil and gas cases were deemed analogous, the doctrine of *Anderson v. Helvering* would preclude its application to the Clay Brown situation since the sellers, in case of default could foreclose their mortgage on the fixed assets of the foundation.

had not shifted, but rather because the lack of risk-shifting would be reflected in an excessive purchase price not attributable to appreciation in the value of the asset.

Mr. Justice Goldberg, dissenting, asserted that the logic of the Court would preclude such a restriction. The situation where an excessive price results from real bargaining at arm's-length would be no different in so far as risk-shifting, transfer of ownership and the consideration given by the buyer are concerned, than an instance in which a reasonable price had been reached in the same manner. He concluded that the Court would have no basis in light of its reasoning in *Clay Brown* to hold that such a transaction did not constitute a "sale" unless the price was shown to be grossly excessive.[70]

According to the majority, the Commissioner's approach was "a clear case of overkill if aimed at preventing the involvement of tax exempt entities in the purchase and operation of business enterprises. There are more precise approaches to this problem as well as to the question of the possibly excessive price paid by the charity or foundation."[71] Presumably, the Court was referring to section 503(c)(4) I.R.C. with regard to the "charity end" of the excessive price issue. That subsection provides that an exempt organization which makes a substantial purchase of property for more than an adequate consideration thereby forfeits its exemption. The more precise approach to the "seller end" of the problem suggested by the majority might consist of an attack directed specifically at the excessive price issue in lieu of the broadly-based argument in *Clay Brown* that the sales agreement resulted in a conversion of future income into capital gain. But even if this more precise argument is made, the poignancy of Mr. Justice Goldberg's dissent cannot be disregarded.[72]

IV.

OTHER TAX IMPLICATIONS OF A SALE AND LEASEBACK

A. *Rental Deductions of Operating Company*

Aside from challenging the "seller and charity ends" of the sale and leaseback arrangement, attack can also be directed at the rental

70. See Kolkey v. Commissioner, 254 F.2d 51 (7th Cir. 1958), where the agreement involved was struck down as a sham transaction. In that case, the price was grossly excessive within Mr. Justice Goldberg's definition of that term. (In *Kolkey*, the purchase price was $14,000,000 approximately four times the fair market value of the seller's business which was estimated to be $1,100,000.)

71. Commissioner v. Clay B. Brown, 380 U.S. 563, 579 (1965).

72. Mr. Justice Harlan, concurring, suggested an approach invoking the allocation of the amounts received by the sellers between interest exchanged and the risk retained by them. Capital gains treatment would be improper to the extent that the purchase price exceeded cost plus appreciated value and the excess would be taxable at ordinary income rates. While Mr. Justice Harlan's position might be considered theoretically sound, practically it is incapable of application, for the valuation of the stock of the closely-held corporation which is usually the seller in the sale and leaseback arrangement is extremely difficult if not impossible to determine.

deductions of the operating company.[73] While deductions for rentals are not limited to a reasonable amount by the Code,[74] section 162(a)(3) requires that amounts paid as rent in order to be deductible as "ordinary and necessary expenses" be a condition to the continued use and occupancy of the property involved.

In *Royal Farms Dairy Co.*,[75] a case involving a basic three-party sale and leaseback, the Tax Court reduced deductible rental payments from the 80 per cent figure specified by the parties to 50 per cent of the net income of the operating company. A clause in the lease provided for a reduction of the standard 80 per cent figure to 60 per cent when payments had reached a pre-determined amount deemed sufficient to insure the foundation's ability to repay the purchase price. The Tax Court found the 80 per cent standard figure had not been reached by negotiations on the lease, and concluded that the operating company should only be entitled to a deduction for the "fair rate of rental."[76] To the extent that the parties intended the rentals to be an indirect method of paying the original purchase price to the sellers, the payments could not be deducted.

In the later case of *Warren Brekke*,[77] the Tax Court disallowed all rental deductions to an operating company. The fact that the leased assets were transferred to a corporation wholly-owned by the sellers approximately five and one half years after the original transaction was deemed crucial. A similar result was reached in *Estate of Sol Goldenberg*,[78] which involved facts similar to those before the Court of Claims in *Union Bank v. United States*,[79] a case heavily relied upon in *Clay Brown*. There the court found that the primary purpose of the leaseback arrangement was to provide the foundation with funds to satisfy its obligation to the sellers, and reduced the 80 per cent figure established by the lease to 55 per cent.

It is clear that the operating company's rental deduction will be subject to strong attack by the Commissioner in the future, particularly since the percentage of profits to be paid to the foundation is usually a standard amount specified in the leaseback arrangement. If the Commissioner continues to be successful, the limitation of rental deductions to a "fair rate of rental" will have serious implications with regard to the three party sale and leaseback.

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73. O'Neill, *Sales of Businesses to Charities — The Brown Case and its Aftermath*, 43 TAXES 507 (1965).

74. Stanley Immerman, 7 T.C. 1030 (1946).

75. 40 T.C. 172 (1963).

76. A fair rental is an amount which will provide a fair return on the capital investment and which will allow recovery of the capital investment loss through depreciation. The existence of expert testimony as to a "fair rate of rental" is crucial in cases attempting to cut down the operating company's rental deduction. In some instances the lack of this type of evidence may preclude consideration of the rental issue. See Oscar C. Stahl, 22 CCH Tax Ct. Mem. 996 (1963); Isis Windows, Inc., 22 CCH Tax Ct. Mem. 837 (1963).

77. 40 T.C. 789 (1964).

78. 23 CCH Tax Ct. Mem. 810 (1964).

79. See note 44, *supra*.

B. *Effect of the Revenue Act of 1964*

Several provisions of the Revenue Act of 1964 are relevant to the sale and leaseback transaction.[80] Section 483(d), which is aimed at the normal arrangement whereby the foundation gives a non-interest bearing note for the purchase price of the sellers' stock, provides for the imposition of interest on deferred payments at the rate of 5 per cent compounded semi-annually where the contract fails to designate any part of the payments as interest. Sections 1245 and 1250 are relevant with regard to the liquidation sale. They provide for ordinary income taxation of that portion of the sales price or fair value of depreciable property which represents a recapture of depreciation. It has been estimated that Section 1245 alone would have resulted in a tax on Clay Brown and Company as of the date of liquidation of approximately $150,000.[81] The effect of this tax will surely be reflected in higher purchase prices in the future and, as the interest imposed on deferred payments by section 483(d), will provide a deterrence to the continued use of bootstrap devices.

V.

CONCLUSION

As the situation now stands, it is clear that the sale and leaseback can be employed *in the normal case* as an effective means of tax avoidance while exposing the vendors to a minimum of risk. It is also apparent that the public in general (via our system of progressive taxation) is the ultimate loser where the leaseback arrangement is utilized. The charity's use of its preferential position to secure "business income," and the seller's use of special tax treatment to secure capital gains on a "sale" of assets, while within the "letter of the law," are surely not consistent with the policy behind it. These inadequacies are attributable in great measure to a lack of legislative adeptness in the area, and are reflected in judicial decisions which place prime importance upon the "expressed will of Congress." The Treasury Department has indicated that it intends to propose legislation aimed at tax abuses flowing from the activities of exempt foundations.[82] The emphasis of future litigation will most likely be directed at the charity's tax exemption and the rental deduction of the operating company.[83] It will be interesting, indeed, to follow the results of these efforts.

Louis F. Nicharot

80. See Dauber, Jewell & Hall, *op. cit. supra* note 4, at 3.
81. *Ibid.*
82. *Treasury Department Report on Private Foundations,* (February 2, 1965).
83. Tech. Inf. Rel. 768 (October 5, 1965).