



---

Winter 1-1-1986

## Rice'S Toyota World, Inc.: Fourth Circuit Extends Sham Transaction Doctrine To Equipment Leasing Tax Shelter

Follow this and additional works at: <https://scholarlycommons.law.wlu.edu/wlulr>



Part of the [Tax Law Commons](#)

---

### Recommended Citation

*Rice'S Toyota World, Inc.: Fourth Circuit Extends Sham Transaction Doctrine To Equipment Leasing Tax Shelter*, 43 Wash. & Lee L. Rev. 317 (1986).

Available at: <https://scholarlycommons.law.wlu.edu/wlulr/vol43/iss1/15>

This Comment is brought to you for free and open access by the Washington and Lee Law Review at Washington and Lee University School of Law Scholarly Commons. It has been accepted for inclusion in Washington and Lee Law Review by an authorized editor of Washington and Lee University School of Law Scholarly Commons. For more information, please contact [christensena@wlu.edu](mailto:christensena@wlu.edu).

## COMMENT

### *RICE'S TOYOTA WORLD, INC.*: FOURTH CIRCUIT EXTENDS SHAM TRANSACTION DOCTRINE TO EQUIPMENT LEASING TAX SHELTER

Taxpayers have the legal right to structure financial transactions in a manner that minimizes tax liability.<sup>1</sup> The sham transaction doctrine, however, permits courts to disregard certain transactions for tax purposes.<sup>2</sup> In certain circumstances courts apply a business purpose test to determine whether a particular transaction is a sham.<sup>3</sup> Other courts, however, implement an economic substance test to determine whether a transaction is a sham.<sup>4</sup> While

---

1. See, e.g., *Frank Lyon Co. v. United States*, 435 U.S. 561, 580 (1978) (courts recognize that tax laws affect formation of many business transactions); *Commissioner v. Brown*, 380 U.S. 563, 579-80 (1965) (Harlin, J., concurring) (courts realize that tax planning is economic reality and that taxpayers consider effect of tax laws in evaluating financial transactions); *Helvering v. Gregory*, 69 F.2d 809, 819 (2d Cir. 1934) (tax laws do not require taxpayers to choose tax alternatives that best benefit government; increasing one's personal income tax liability is not patriotic duty), *aff'd*, 293 U.S. 465 (1935); *McLane v. Commissioner*, 46 T.C. 140, 145 (1966) (court will not necessarily disallow transaction because transaction contains some tax benefits).

2. See, e.g., *Boyter v. Commissioner*, 668 F.2d 1382, 1387 (4th Cir. 1981) (implementing sham transaction doctrine to uphold deficiency assessed against taxpayers who obtained divorces in foreign countries close to end of tax years, to enable taxpayers to file separate tax returns utilizing lower rates); *Boynton v. Commissioner*, 649 F.2d 1168, 1172 (5th Cir. 1981) (utilizing sham transaction doctrine to uphold deficiency assessed against taxpayers who allocated income in manner that allowed taxpayer to shift income from partners in high tax bracket to partners in lower tax brackets), *cert. denied*, 454 U.S. 1146 (1982); *Davis v. Commissioner*, 585 F.2d 807, 812 (6th Cir. 1978) (disallowing sale and leaseback transaction involving apartment building on basis that transaction was sham); see *infra* notes 49-59 and accompanying text (analysis of cases decided using sham transaction doctrine).

3. See, e.g., *Commissioner v. Court Holding Co.*, 324 U.S. 331, 334 (1945) (analyzing business purpose for form of business adopted by taxpayer in evaluating whether entity constituted sham); *Gregory v. Helvering*, 293 U.S. 465, 469 (1935) (examining business purpose of corporate reorganization to determine whether transaction constituted sham); *Rosenfeld v. Commissioner*, 706 F.2d 1277, 1282 (2d Cir. 1983) (evaluating business purpose to determine whether gift leaseback transaction constituted sham). In *Gregory v. Helvering*, the United States Supreme Court first developed the business purpose test in disallowing a corporate reorganization for tax purposes. See *Gregory*, 293 U.S. at 469. In *Gregory*, the taxpayer effectuated a corporate reorganization in compliance with the tax laws. *Id.* at 467. Subsequently, the taxpayer liquidated the newly formed transferee corporation. *Id.* The Supreme Court determined that the taxpayer effectuated the reorganization for the sole purpose of converting ordinary dividend income into capital gains. *Id.* at 470. Because the reorganization lacked the business purpose that the tax laws contemplated, the Supreme Court disallowed the reorganization. *Id.* at 469; see *infra* note 46 and accompanying text (discussion of transactions evaluated using business purpose test). See generally, Rice, *Judicial Techniques in Combating Tax Avoidance*, 51 MICH. L. REV. 1021, 1041-46 (1953) (discussing business purpose test).

4. See, e.g., *Knetsch v. United States*, 364 U.S. 361, 369 (1960) (evaluating economic

the application of the sham transaction doctrine does not necessarily imply fraudulent activity, courts use the doctrine to look beyond the form of a transaction and evaluate the transaction's true substance.<sup>5</sup> In evaluating the form of a transaction, courts frequently combine broad judicial tax doctrines,

---

substance of investment transaction to determine whether transaction constituted sham); *Grodt & McKay Realty Inc. v. Commissioner*, 77 T.C. 1221, 1243 (1981) (analyzing economic substance of cattle sale transaction to determine whether transaction constitutes sham); *May v. Commissioner*, 31 T.C.M. (CCH) 279, 280 (1972) (evaluating economic substance of transaction involving sale of television films to determine whether transaction constituted sham). In *Knetsch v. United States*, the United States Supreme Court developed the economic substance test, in disallowing a series of investment transactions for tax purposes. See *Knetsch*, 364 U.S. at 369. In *Knetsch*, the taxpayer engaged in a series of investment transactions designed solely to generate interest deductions. *Id.* at 369. Because the transactions provided no economic benefit to the taxpayer, apart from tax benefits, the Supreme Court disallowed the transactions as shams. *Id.*; see *infra* note 100 and accompanying text (analysis of *Knetsch v. United States*); *infra* notes 46-57 and accompanying text (analysis of transactions evaluated using economic substance test).

5. See, e.g., *Commissioner v. Court Holding Co.*, 324 U.S. 331, 334 (1945) (courts base tax liability upon substance of transaction and not transaction's form); *Helvering v. Lazarus & Co.*, 308 U.S. 252, 255 (1939) (courts and Internal Revenue Service analyze substance of transactions rather than technical form selected by taxpayers); *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221, 1236 (1981) (in evaluating validity of transactions, courts analyze business and economic realities of transactions rather than forms and labels). See generally, Blum, *How the Courts, Congress and the IRS Try to Limit Legal Tax Avoidance*, 10 J. TAX'N 300 (1959) [hereinafter cited as Blum, *Limit Legal Tax Avoidance*] (courts implement sham transaction doctrine to look beyond form of financial transactions). In *Helvering v. Lazarus & Co.*, the United States Supreme Court analyzed the true substance of a sale and leaseback transaction, in allowing a depreciation deduction for tax purposes. *Lazarus*, 308 U.S. at 255. The taxpayer in *Lazarus* transferred legal title in certain buildings to a bank land trust. *Id.* at 253. Nevertheless, taxpayer claimed deductions for depreciation on the buildings. *Id.* The Commissioner of Internal Revenue (Commissioner) disallowed the depreciation deduction because the taxpayer had transferred legal title to the bank land trust. *Id.* In analyzing the true substance of the lease transaction, the Supreme Court determined that the transaction was a mere financing arrangement and allowed the taxpayer to retain the depreciation deduction. *Id.* at 255.

Courts are likely to penetrate the form of a transaction and evaluate the transaction's substance when a taxpayer engages in self dealing. See Bittker, *Pervasive Judicial Doctrines in the Construction of Internal Revenue Code*, 21 How. L.J. 693, 707 (1978) [hereinafter cited as Bittker, *Judicial Doctrines*]. Courts scrutinize self dealing transactions closely because taxpayers often select the transaction's form solely for the tax consequences. *Id.* In arm's length transactions, however, taxpayers usually engage in negotiations that result in economically realistic terms. *Id.* In negotiations, one party often will lose a tax advantage when the other party gains a tax advantage. *Id.* Accordingly, arm's length transactions are less vulnerable to substance over form attacks. *Id.* See generally Underwood, *Form and Substance in Tax Cases*, 16 VA. L. REV. 327 (1930) (discussing court's use of substance and form in tax cases).

In various situations the form of a transaction will control over the transaction's substance, regardless of tax motives. See, e.g., I.R.C. § 101(a) (West 1985) (excluding amounts received under life insurance contracts, by reason of death of insured, from gross income); *id.* § 472 (allows taxpayer to adopt last-in-first-out inventory accounting method); *id.* § 451 (gives taxpayer election to adopt cash basis of accounting for tax purposes). See generally, Blum, *The Importance of Form in the Taxation of Corporate Transactions*, 54 TAXES 613 (1976) (overview of principles for determining role of form in tax cases).

thus blurring a given doctrine's independent significance.<sup>6</sup> Courts hesitate to apply the sham transaction doctrine due to the strong negative implications that the doctrine imports.<sup>7</sup> In *Rice's Toyotal World, Inc. v. Commissioner*,<sup>8</sup> the United States Court of Appeals for the Fourth Circuit explicitly combined the business purpose and economic substance tests to determine what constitutes a sham transaction in analyzing the validity of a sale and leaseback<sup>9</sup> transaction for tax purposes.<sup>10</sup>

---

6. See B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 15.06 (4th ed. 1979). When courts disregard the form of a transaction to evaluate the substance, courts generally do not specify which judicial concepts either individually or in combination the court is applying. *Id.* Accordingly, decisions based on some variant of a substance over form analysis yield little precise or consistent analysis. *Id.*; see Bittker, *supra* note 5, at 707 (discussing court's application of judicial doctrines such as business purpose, step transaction, and substance over form doctrines).

7. See B. BITTKER & J. EUSTICE, *supra* note 6 at ¶ 15.07 (courts consider disallowing entire transactions as sham as drastic measure); Blum, *supra* note 5, at 300 (classification of transaction as sham is courts method of revealing emotional reaction to taxpayer's scheme).

8. 752 F.2d 89 (4th Cir. 1985), *aff'g*, 81 T.C. 184 (1983).

9. See Cook, *Sales and Leasebacks*, TAX MGMT. (BNA) No. 36-3d, A-1 (1981). A sale and leaseback transaction generally involves the sale of property to a buyer with the buyer simultaneously leasing the asset back to the seller for a term of years, representing the useful life of the asset. *Id.* The parties usually structure the lease payments made by the seller to the buyer to amortize the purchase price and provide a return for the buyer. *Id.*

Parties enter into sale and leaseback transactions for various financial and tax reasons. See Stewart, *Taxation of Sale and Leaseback Transactions—A General Review*, 32 VAND. L. REV. 945, 949-54 (1979). The sale and leaseback transaction is financially beneficial to the seller because the transaction improves financial leverage and liquidity by replacing the disposed property from seller's balance sheet with the more liquid notes or cash received from the sale. *Id.* With a more liquid balance sheet, the seller can enter the financial markets more easily to obtain additional financing for other investments. *Id.* The sale and leaseback transaction also enables the seller to obtain 100% financing of a capital asset. *Id.* Generally, lenders will agree only to finance 75% to 80% of an asset's purchase price. *Id.* Another advantage of the sale and leaseback transaction is the fact that the seller is obligated only to use the property for the lease term. See Zeitlin, *Tax Planning in Equipment—Leasing Shelters*, 21 MAJOR TAX PLANNING 621, 624 (1969). Consequently, if the sale and leaseback involves equipment, which could become obsolete, the burdens of ownership will not hinder the seller in replacing the equipment at the end of the lease term. *Id.* From the buyer's perspective, sale and leaseback transactions often generate a higher rate of return than other available investments because sellers usually pay a premium rental fee in exchange for 100% financing by the buyer. See Stewart, *supra*, at 951.

The tax advantages of sale and leaseback transactions to the seller include being able to deduct lease rental payments even when the leased property is a nondepreciable asset, such as land, or a fully depreciated asset. *Id.* Additionally, if the fair market value of the asset has decreased below the asset's book value, the seller can effectuate the sale and leaseback transaction recognizing a loss on the disposition. *Id.* If the fair market value of the asset has appreciated above the asset's book value, the seller can effectuate a gain on the disposition by executing a sale and leaseback transaction. *Id.* The taxpayer may apply the gain to net operating loss carryovers that are about to expire. *Id.*

Sale and leaseback transactions offer various tax advantages to the buyer. *Id.* at 953. The buyer, as owner of the property, can deduct the depreciation expense from the property. *Id.* Additionally, the buyer can deduct interest on debt used to purchase the property, depending

Rice's Toyota World, Inc. (Rice's Toyota), an automobile dealership in Greensboro, North Carolina, entered into a sale and lease back transaction with Finalco, Inc. (Finalco), an equipment leasing tax shelter broker.<sup>11</sup> Previously having purchased a six-year old computer for \$1,297,643, Finalco sold the computer to Rice's Toyota for \$1,455,277.<sup>12</sup> Rice's Toyota paid for the computer by giving Finalco a recourse promissory note for \$280,000, payable over three years, and two nonrecourse promissory notes totaling \$1,205,227, payable over eight years.<sup>13</sup> Finalco agreed to lease the computer

---

on the method of financing. *Id.* The depreciation and interest deductions can offset the income produced by the leaseback. *Id.* In addition, if the buyer adopts an accelerated method of depreciation, the overall sale and leaseback transaction could result in a deductible loss, available to offset other income. *Id.* Another tax advantage that sale and leaseback transactions offer to the buyer is that, if the property qualifies, the buyer can claim an investment tax credit. *See Cook, supra*, at A-4.

Some courts attack the validity of sale and leaseback transactions by classifying the transactions as financing agreements. *See, e.g., Sun Oil Co. v. Commissioner*, 562 F.2d 258, 269 (3d Cir. 1977) (because lessee bore burdens of ownership and terms of lease resembled conventional financing, court recognized sale and leaseback transaction as mere financing arrangement for tax purposes); *American Realty Trust v. United States*, 498 F.2d 1194, 1197 (4th Cir. 1974) (evaluating purchase option price in determining sale and leaseback did not constitute mere financing agreement); *Lockhart Leasing Co. v. Commissioner*, 446 F.2d 269, 272 (10th Cir. 1971) (because purchase option price included in lease term equaled property's fair market value, court considered sale and leaseback valid for tax purposes). Another court has disallowed loss deductions resulting from a sale and leaseback transaction by classifying the transaction as a like-kind exchange. *See Century Elec. Co. v. Commissioner*, 192 F.2d 155, 158 (8th Cir. 1951), *cert. denied*, 342 U.S. 954 (1952). In *Century Elec. Co. v. Commissioner*, the United States Court of Appeals for the Eighth Circuit concluded that a sale and leaseback merely constituted an exchange of an asset for a functionally equivalent leasehold in the identical asset. *Id.* at 160. Accordingly, the Eighth Circuit disallowed the loss deductions resulting from the sale and leaseback transaction. *Id.*; *see I.R.C. § 1031* (West 1985) (like-kind exchange of property owned for investment or productive use). A third method that courts use to disallow sale and leaseback transactions for tax purposes is by declaring that the transaction lacks economic substance. *See infra* notes 89-91 and accompanying text (overview of cases where courts have analyzed validity of sale and leaseback transactions based on economic reality). *See generally* REV. RUL. 55-540, 1955-2 C.B. 39, 41-44 (Commissioner's guidelines for determining tax effect of lease transactions); REV. PROC. 75-21, 1975-1 C.B. 715 (Commissioner's guidelines for obtaining advance rulings on recognition of lease transactions for tax purposes); *Equipment Leasing Tax Shelters*, in EXAMINATION TAX SHELTERS HANDBOOK 852 (Revenue Agent's criteria for determining whether transaction is leasing arrangement or mere financing agreement) [hereinafter cited as Examination Tax Shelter Handbook]; BITTKER & MENIKOFF, *Restructuring Business Transactions for Federal Income Tax Purposes*, 1978 Wis. L. Rev. 715, 717 (discussing criteria used to determine whether lease transaction is sale or lease for tax purposes).

10. 752 F.2d at 91.

11. *Id.*

12. *Id.* The Rice's Toyota lease transaction involved a six-year old mainframe computer and related peripheral equipment. 81 T.C. at 192.

13. 81 T.C. at 192. In *Rice's Toyota*, Rice's Toyota paid the recourse debt of \$280,000 in four installments at 12% interest. *Id.* The parties agreed to amortize the nonrecourse debt over a 96 month period, bearing simple interest of 8%. Appellee's Brief at 3, *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89 (4th Cir. 1985); *see Javaras, Nonrecourse Debt in Real Estate and Other Investments*, 56 TAXES 801, 801 (1978) (nonrecourse debt is debt secured solely by property, with no personal obligation of debtor).

back from Rice's Toyota for eight years, but with the lease payments contingent upon Finalco receiving adequate revenues from subleasing the computer.<sup>14</sup> Prior to entering into the sale and leaseback transaction with Rice's Toyota, Finalco had executed a five-year sublease with Owen-Illinois Corporation.<sup>15</sup> The sale and leaseback transaction generated a \$10,000 net annual cash flow to Rice's Toyota for at least the first five years.<sup>16</sup> The lease agreement between Rice's Toyota and Finalco also entitled Finalco to a thirty percent remarketing fee for either selling or re-leasing the computer at the end of the five-year sublease.<sup>17</sup> The Commissioner of Internal Revenue (Commissioner) contested the amount of depreciation and interest expense deductions, related to the sale and leaseback transaction, taken by Rice's Toyota in computing its taxable income for the tax years ending 1976, 1977, and 1978.<sup>18</sup> Rice's Toyota filed a petition with the United States Tax Court (Tax Court) for a redetermination of the Commissioner's assessment of a deficiency in federal income tax due from Rice's Toyota.<sup>19</sup>

The Tax Court identified three tax liability issues in evaluating the sale and leaseback transaction.<sup>20</sup> The issues included whether the Tax Court should allow Rice's Toyota to deduct the depreciation expense related to the computer, the interest expense related to the recourse note, or the interest expense related to the nonrecourse notes.<sup>21</sup> After evaluating Rice's Toyota's motives for entering the transaction and the economic realities of the transaction, the Tax Court determined that Rice's Toyota entered the transaction for no purpose other than tax avoidance.<sup>22</sup> In addition, the Tax Court stated that the transaction showed no potential to generate a profit, and therefore lacked economic substance.<sup>23</sup> Accordingly, the Tax Court upheld

---

14. 81 T.C. at 195.

15. *Id.* at 194. In *Rice's Toyota*, Finalco did not guarantee that the lease transaction could generate a cash flow after the expiration of the five-year sublease. *Id.* at 195.

16. *Id.* at 192. Rice's Toyota's monthly nonrecourse debt payments of \$16,925 and Finalco's \$17,758 monthly rental payments netted to an annual cash flow of \$10,000. *Id.*

17. 752 F.2d at 91. In *Rice's Toyota*, Finalco's representative testified at trial that Finalco agreed to waive the 30% fee to insure Rice's Toyota a gain on the transaction. Appellee's Brief at 26, n.12, *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89 (4th Cir. 1985). The United States Tax Court (Tax Court), however, disregarded Finalco's representative's testimony because the oral agreement to waive the 30% re-leasing fee ignores the language of the leasing agreement, and none of the testimony from representatives' of Rice's Toyota supported waiver. *Id.* The lease agreement entitled Finalco to only the 30% fee if Finalco could re-lease or sell the computer. 81 T.C. at 195. Because Rice's Toyota had no experience in the computer industry, the United States Court of Appeals for the Fourth Circuit determined that Rice's Toyota could not re-lease or sell the computer without Finalco's assistance. 752 F.2d at 94.

18. 81 T.C. at 185.

19. *Id.*

20. *Id.* at 195-98.

21. *Id.* at 185.

22. *Id.* at 210.

23. *Id.*

the deficiency asserted against Rice's Toyota, holding that the sale and leaseback transaction constituted a sham.<sup>24</sup>

Rice's Toyota appealed the Tax Court decision to the Fourth Circuit,<sup>25</sup> asserting that Rice's Toyota entered the transaction with the intent to earn a profit and that the transaction feasibly could earn a profit.<sup>26</sup> Alternatively, Rice's Toyota asserted that, even if the transaction constituted a sham, the court should allow the interest deduction taken on the recourse note.<sup>27</sup> The Fourth Circuit determined that Rice's Toyota entered the transaction with no business purposes other than tax avoidance and the sale and leaseback transaction objectively lacked economic substance.<sup>28</sup> Accordingly, the Fourth Circuit determined that the sale and leaseback transaction constituted a sham.<sup>29</sup> The Fourth Circuit, therefore, affirmed the Tax Court's decision in part by upholding the disallowance of the entire depreciation expense deduction and the interest expense deduction from the nonrecourse loan.<sup>30</sup> The Fourth Circuit, however, reversed the Tax Court's decision in part by allowing the interest expense deduction from the recourse note.<sup>31</sup>

The Fourth Circuit made a factual analysis to determine whether sufficient evidence existed to support the Tax Court's finding that Rice's Toyota entered the transaction with no subjective business purpose and that the transaction objectively lacked economic substance.<sup>32</sup> In making the determinations, the *Rice's Toyota* court focused primarily on factors relating to the computer's residual value.<sup>33</sup> The Fourth Circuit concluded that the president of Rice's Toyota's failure to analyze the computer's residual value, while knowing that the transaction needed substantial residual value in order to earn a profit, indicated that Rice's Toyota entered the transaction with no subjective business purpose.<sup>34</sup> In determining that the lease transaction

---

24. *Id.*

25. 752 F.2d at 91. The taxpayer or the Commissioner may appeal a Tax Court decision to the proper United States Court of Appeals. I.R.C. § 7482(a) (West 1985). Proper venue for an appeal rested in the Fourth Circuit because Rice's Toyota was a North Carolina corporation. *See id.* § 7482(b)(1)(B) (circuit in which taxpayer's principal place of business is located is proper venue for redetermination of corporate tax liability).

26. Appellant's Brief at 26, *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89 (4th Cir. 1985).

27. *Id.* at 40.

28. 752 F.2d at 96.

29. *Id.*

30. *Id.*

31. *Id.*

32. *Id.* at 92-95; *see Commissioner v. Court Holding Co.*, 324 U.S. 331, 333-34 (1945) (whether transaction lacks substance and thus constitutes sham is question of fact and reviewable only under clearly erroneous standard).

33. 752 F.2d at 92-94; *see infra* notes 58-67 and accompanying text (analysis of Fourth Circuit's conclusion based on computer's residual value); *see also* A. Rosenberg, EVALUATING TAX SHELTER OFFERINGS addendum 6 (1982) (residual value refers to value of investment over balance of liabilities that taxpayer must discharge at time taxpayer disposes of investment).

34. 752 F.2d at 92. In *Rice's Toyota*, the Finalco representative visited Rice's Toyota to discuss the investment aspects of the lease transaction with Rice's Toyota's president, accountant,

objectively lacked economic substance, the Fourth Circuit relied primarily on the fact that the computer's residual value, as projected by expert witnesses, was insufficient to recoup Rice's Toyota's investment.<sup>35</sup> In addition to focusing on the computer's residual value, the Fourth Circuit noted that the nonrecourse debt balance exceeded the computer's fair market value and that Rice's Toyota paid an inflated price for the computer.<sup>36</sup> Because the nonrecourse debt balance exceeded the computer's fair market value, the Fourth Circuit inferred that Rice's Toyota intended to abandon the transaction prior to the realization of taxable income.<sup>37</sup> In addition, the *Rice's Toyota* court inferred that Rice's Toyota's willingness to pay the inflated purchase price indicated that the president of Rice's Toyota considered only

---

and counsel. 81 T.C. at 188. Finalco's representative indicated that the president of Rice's Toyota must consider the computer's residual value in determining the lease transaction's potential for profit. *Id.* Rice's Toyota's accountant also informed the president of Rice's Toyota that a substantial residual value would be necessary in order to make the lease transaction profitable. *Id.* Despite the warnings regarding the need for substantial residual value, the president of Rice's Toyota declined Finalco's representative's offer to provide an independent appraisal of the computer equipment. *Id.* The president of Rice's Toyota testified that he did not rely on expert advice or appraised values in making his investment decision. Appellant's Brief at 7, *Rice's Toyota World, Inc. v. Commissioner* 752 F.2d 89 (4th Cir. 1985). The president of Rice's Toyota testified that he made investment decisions based on the people involved, the product, and the potential return. *Id.* Additionally, the president of Rice's Toyota testified that, when an investment looked either too good or too conservative, he generally avoided the investment. *Id.*

35. 752 F.2d at 94. The *Rice's Toyota* court concluded that Rice's Toyota owned only a 70% interest in the computer because the lease agreement entitled Finalco to 30% of all revenues from re-leasing or selling the computer. *Id.*; see *supra* note 16 and accompanying text (lease transaction provided \$10,000 annual cash flow to Rice's Toyota). Accordingly, the Fourth Circuit determined that, because the original five-year sublease would return only \$50,000 of the \$280,000 recourse investment, Rice's Toyota would have to realize a \$286,000 residual value to recoup the remaining \$230,000 recourse investment. 752 F.2d at 94.

36. 752 F.2d at 93-94; see *infra* notes 68-74 and accompanying text (analysis of Fourth Circuit's conclusions based on disparity between computer's fair market value and nonrecourse loan balance).

37. 752 F.2d at 93. The Fourth Circuit supported the court's inference that Rice's Toyota intended to abandon the transaction prior to the realization of taxable income based on the United States Court of Appeals for the Ninth Circuit's decision in *Estate of Franklin v. Commissioner*. *Id.*; see *Estate of Franklin v. Commissioner*, 544 F.2d 1045, 1048 (9th Cir. 1976) (disallowing sale and leaseback of building that taxpayer purchased with nonrecourse loans exceeding building's fair market value); *infra* notes 72-74 and accompanying text (analysis of *Estate of Franklin*). In *Rice's Toyota*, Finalco structured the lease transaction to generate tax losses in the first four years and taxable income in the final four years of the lease. 81 T.C. at 182. Rice's Toyota argued that it could not abandon the transaction to avoid taxable income in the final four years of the transaction. 752 F.2d at 94. Rice's Toyota noted that, in *Commissioner v. Tufts*, the United States Supreme Court held that a taxpayer who sold property encumbered by a nonrecourse loan must include the unpaid amount of the nonrecourse loan in the computation of the amount the taxpayer realized on the sale. *Id.*; see *Commissioner v. Tufts*, 461 U.S. 300, 317 (1983) (requiring taxpayer to include outstanding, nonrecourse mortgage in amount realized when taxpayer sold building). Because the Supreme Court did not decide *Tufts* until after Rice's Toyota entered the transaction, the Fourth Circuit reasoned that *Tufts* had no significance in the evaluation of Rice's Toyota's motivations for entering the transaction. 752 F.2d at 94.



the transaction's tax benefits.<sup>38</sup> Accordingly, the Fourth Circuit determined that, because the transaction lacked both business purpose and economic substance, the transaction constituted a sham.<sup>39</sup>

Upon determining that the lease transaction constituted a sham, the *Rice's Toyota* court evaluated the lease transaction's true substance to determine whether Rice's Toyota could deduct the interest and depreciation expenses.<sup>40</sup> In evaluating the lease transaction's true substance, the Fourth Circuit stated that Rice's Toyota had no equitable basis to support a depreciation deduction because the outstanding balance of the nonrecourse note exceeded the computer's fair market value.<sup>41</sup> Additionally, the *Rice's Toyota* court concluded that the disparity between the computer's fair market value and the outstanding balance of the nonrecourse note disqualified the nonrecourse note's ability to support a deduction for interest expense.<sup>42</sup> In evaluating the deductibility of the recourse loan interest expense, however, the *Rice's Toyota* court determined that the recourse loan could support an interest expense deduction.<sup>43</sup> The Fourth Circuit distinguished the recourse loan from the nonrecourse loan based on Rice's Toyota's unlimited obligation to repay the recourse loan.<sup>44</sup> The *Rice's Toyota* court refuted the Tax Court's position that, once a court classifies a transaction as a sham, the entire transaction loses validity for tax purposes.<sup>45</sup>

The Fourth Circuit correctly looked to the subjective business purpose<sup>46</sup>

---

38. 752 F.2d at 93.

39. *Id.* at 95.

40. *Id.*

41. *Id.* The *Rice's Toyota* court supported the disallowance of the depreciation deduction based on the Ninth Circuit's analysis in *Estate of Franklin v. Commissioner. Id.*; see *Estate of Franklin v. Commissioner*, 544 F.2d 1045, 1048 (9th Cir. 1976) (disallowing depreciation expense deduction because nonrecourse purchase price exceeded related asset's fair market value); *infra* notes 72-74 and accompanying text (analysis of *Estate of Franklin*).

42. 752 F.2d at 95.

43. *Id.* at 96.

44. *Id.*

45. *Id.*; see 81 T.C. at 207 (Tax Court held that Rice's Toyota could not deduct recourse interest because sham transaction doctrine rendered entire transaction invalid).

46. See 752 F.2d at 92 (*Rice's Toyota* court selected objective business purpose test as one element of sham transaction definition); *Commissioner v. Culbertson*, 337 U.S. 733, 742 (1949) (evaluating form of business adopted by taxpayer to determine whether taxpayer owed additional tax). In *Commissioner v. Culbertson*, the United States Supreme Court held that, to determine whether taxpayers enter a transaction with a business purpose, courts should evaluate the transaction's components, the taxpayer's actions in executing the transaction, the taxpayer's testimony, the testimony of independent parties and any other factors that offer insight to the taxpayer's intent. *Culbertson*, 337 U.S. at 742; see also *Poggetto v. United States*, 306 F.2d 76, 80 (9th Cir. 1962) (subjective standard applied to determine whether business form served valid business purpose); *Harkness v. Commissioner*, 193 F.2d 655, 657 (9th Cir. 1951) (subjective standard applied to determine whether partnership form lacked valid business purpose), *cert. denied*, 343 U.S. 945 (1952).

and objective economic substance<sup>47</sup> tests in defining a sham transaction.<sup>48</sup> In prior decisions, the Fourth Circuit applied either a subjective business purpose or objective economic substance test to determine whether a transaction constituted a sham.<sup>49</sup> Other federal circuit courts also have applied either the business purpose test or the economic substance test to determine whether a transaction is a sham.<sup>50</sup> For example, the United States Court of Appeals for the Sixth Circuit, in *Davis v. Commissioner*,<sup>51</sup> reviewed the business purpose of a sale and leaseback transaction involving apartment buildings to determine whether a transaction constituted a sham.<sup>52</sup> The *Davis* court concluded that the lease transaction constituted a sham because the parties entered the lease transaction solely to receive the benefits of the tax deductions.<sup>53</sup> The United States Court of Appeals for the Tenth Circuit, in

---

47. See 752 F.2d at 94 (*Rice's Toyota* court selected objective economic substance as one element of sham transaction test). Courts generally look at objective economic realities to determine whether a transaction contains economic substance. See, e.g., *Frank Lyon Co. v. United States*, 435 U.S. 561, 573 (1978) (evaluating objective realities of lease transactions in determining whether lease transaction contained economic substance); *Knetsch v. United States*, 364 U.S. 361, 364 (1960) (analyzing transaction's objective economic benefits to taxpayer apart from tax reduction in determining transaction was sham); *Hilton v. Commissioner*, 74 T.C. 305, 348 (1980) (reviewing objective factors surrounding lease transaction to determine whether economic substance existed aside from tax considerations), *aff'd per curiam*, 671 F.2d 316 (9th Cir. 1982).

48. See 752 F.2d at 95 (*Rice's Toyota* court combined business purpose and economic substance tests in defining sham transaction).

49. See, e.g., *Boyter v. Commissioner*, 668 F.2d 1382, 1387 (4th Cir. 1981) (Fourth Circuit evaluated economic substance of taxpayer's transaction to determine whether transaction constituted sham); *Bridges v. Commissioner*, 325 F.2d 180, 185 (4th Cir. 1963) (Fourth Circuit focused on transaction's economic substance in disallowing investment transaction for tax purposes); *Funai v. Commissioner*, 181 F.2d 890, 895 (4th Cir. 1950) (Fourth Circuit considered business purpose of form of business adopted by taxpayer in evaluating whether sham existed); see *infra* notes 105-110 and accompanying text (analysis of *Bridges v. Commissioner*).

50. See, e.g., *May v. Commissioner*, 723 F.2d 1434, 1437 (9th Cir. 1984) (Ninth Circuit evaluated economic reality and business purpose of gift leaseback transaction to determine whether sham existed); *Boynton v. Commissioner*, 649 F.2d 1168, 1172 (5th Cir. 1981) (Fifth Circuit analyzed economic effect of partnership profit allocation to determine whether sham existed), *cert. denied*, 454 U.S. 1146 (1982); *Hagist Ranch, Inc. v. Commissioner*, 295 F.2d 351, 354 (7th Cir. 1961) (Seventh Circuit evaluated business purpose of corporate taxpayer to determine whether corporation was sham to avoid tax liability rather than entity to effectuate liquidation of bankrupt estate); see also EXAMINATION TAX SHELTER HANDBOOK, *supra* note 9, at 831 (Commissioner's method of evaluating equipment leasing tax shelters). The Commissioner evaluates the validity of equipment leasing tax shelters based on the taxpayer's intent to earn a profit by entering the transaction, and the objective factors that indicate whether a realistic opportunity for economic profit justifies the form of the transaction. *Id.* The Commissioner focuses primarily on the transaction's potential to earn a profit in deciding whether the transaction is legitimate for tax purposes. *Id.* at 832. In measuring a transaction's potential to earn a profit, the Commissioner performs quantitative tests such as a present value test and a rate of return test. *Id.* at 872-73.

51. 585 F.2d 807 (6th Cir. 1978), *cert. denied*, 440 U.S. 981 (1979).

52. *Id.* at 813.

53. *Id.* at 812. The *Davis* court determined that the taxpayers entered the sale and

*Holman v. United States*,<sup>54</sup> analyzed the economic substance of a trust created to shift income to other family members in order to avoid income taxes.<sup>55</sup> The *Holman* court determined that the trust constituted a sham because the taxpayers' dual status as trustees and beneficiaries of the trust did not alter the taxpayers' economic position.<sup>56</sup> Therefore, in formulating the definition of a sham transaction in *Rice's Toyota*, the Fourth Circuit explicitly combined criteria that courts generally have implemented in determining whether a transaction is a sham.<sup>57</sup>

While focusing on the computer's residual value, the Fourth Circuit correctly determined that *Rice's Toyota* entered the lease transaction with no business purpose.<sup>58</sup> The president of *Rice's Toyota* knew that *Rice's Toyota* would have to realize a substantial residual value from the computer in order to recoup the recourse investment.<sup>59</sup> The failure to make a reasonable analysis of the residual value therefore suggests that tax avoidance purposes, rather than a business purpose, motivated *Rice's Toyota* to enter the sale and leaseback transaction.<sup>60</sup> The Tax Court has suggested that at some point naivete becomes an intentional refusal to analyze an investment's true potential when the investment's tax reduction benefits alone justify the investment.<sup>61</sup> Additionally, by focusing on the computer's residual value, the *Rice's Toyota* court properly determined that the lease transaction objectively lacked economic substance.<sup>62</sup> At the inception of the lease, no reasonable possibility of a profit existed, apart from the tax benefits.<sup>63</sup> With the initial

---

leaseback transaction of several apartment buildings for the sole purpose of acquiring interest and depreciation deductions to shelter other income. *Id.*

54. 728 F.2d 462 (10th Cir. 1984).

55. *Id.* at 465.

56. *Id.*

57. See *supra* notes 49-56 and accompanying text (analysis of factors used by courts to determine whether given transaction constitutes sham).

58. See 752 F.2d at 92 (Fourth Circuit determined that *Rice's Toyota* entered transaction with no business purpose).

59. See *supra* note 34 and accompanying text (several sources informed president of *Rice's Toyota* that computer equipment's residual value must be substantial in order to recognize profit from transaction).

60. See *Brannen v. Commissioner*, 722 F.2d 695, 704 (11th Cir. 1984) (emphasizing that failure to appraise valuable asset prior to purchase indicated that taxpayer did not engage in activity in business like manner for profit); *Fox v. Commissioner*, 80 T.C. 972, 1010 (1983) (considering size of financial investment involved, failure to seek independent appraisal of asset's value indicated that taxpayer did not enter transaction with business purpose other than tax avoidance), *aff'd*, 731 F.2d 230 (4th Cir. 1984).

61. See *Flowers v. Commissioner*, 80 T.C. 914, 940 (1983) (noting that when taxpayer, having very little knowledge of investment, invests substantial amount of funds, without independent appraisal, indicates that taxpayer considered only tax reduction aspects of investment).

62. See 752 F.2d at 95 (*Rice's Toyota* court found that lease transaction lacked economic substance).

63. *Id.*; see *Bridges v. Commissioner*, 325 F.2d 180, 184 (4th Cir. 1963) (courts do not consider transaction sham for tax purposes when reasonable chance for profit exists, based on realistic terms of transaction).

five-year sublease guaranteeing only a \$50,000 return, Rice's Toyota would have to recoup the remaining \$230,000 recourse investment by either selling or re-leasing the computer.<sup>64</sup> The expert testimony produced at trial regarding used computer residual values, supports the contention that, at the expiration of the lease, Rice's Toyota could not realize an overall gain on the transaction from the sale of the computer.<sup>65</sup> Furthermore, the likelihood of Rice's Toyota or Finalco securing a profitable sublease, after the expiration of the initial five-year sublease, to generate an overall profit from the transaction, was remote.<sup>66</sup> Accordingly, the transaction would not prove profitable, apart from the tax benefits.<sup>67</sup>

In supplementing the conclusions based on the computer's residual value, the *Rice's Toyota* court drew valid inferences from the fact that Rice's Toyota used nonrecourse debt to inflate the computer's purchase price.<sup>68</sup> The Fourth Circuit correctly inferred that Rice's Toyota intended to abandon the transaction prior to the realization of taxable income.<sup>69</sup> Because the outstanding balance of the nonrecourse loan exceeded the computer's fair market value, the Fourth Circuit had a sufficient factual predicate reasonably to infer that Rice's Toyota intended to abandon the transaction prior to realizing taxable income.<sup>70</sup> The United States Court of Appeals for the Ninth Circuit's analysis, in *Estate of Franklin v. Commissioner*,<sup>71</sup> supports the Fourth Circuit's abandonment inference.<sup>72</sup> In *Estate of Franklin*, the taxpayer entered a sale and leaseback involving a motel, with a purchase price inflated by the use of nonrecourse debt.<sup>73</sup> The *Estate of Franklin* court stated that,

---

64. 752 F.2d at 94.

65. See 81 T.C. at 205 (summarizing expert testimony from trial regarding computer equipment residual value).

66. See 752 F.2d at 92-94 (*Rice's Toyota* court did not speculate on possibility of recouping investment from re-leasing computer equipment). In order for Rice's Toyota to recoup the \$230,000 net recourse investment outstanding at the end of the five-year sublease by re-leasing the computer equipment, Rice's Toyota would have had to enter comparable lease agreements yielding a \$10,000 cash flow for 23 years. See *id.* (analyzing Rice's Toyota's ability to recoup investment); *supra* note 16 and accompanying text (lease transaction generated \$10,000 annual cash flow to *Rice's Toyota*). Based on the obsolescence of computer equipment, the possibility of re-leasing the computer equipment for 23 more years was remote. See 81 T.C. at 192 (newer systems render most old computers uneconomic to use within 13 years).

67. See *supra* note 66 and accompanying text (analysis of Rice's Toyota's lease transaction's profit potential, apart from tax benefits).

68. See 752 F.2d at 92-94 (*Rice's Toyota* court made inferences from fact that Rice's Toyota used nonrecourse debt to inflate computer's purchase price).

69. See *id.* at 93 (*Rice's Toyota* court inferred that Rice's Toyota intend to abandon lease transaction prior to realizing taxable income).

70. See *id.* at 91 (In *Rice's Toyota*, outstanding balance of nonrecourse loan exceeded computer's fair market value); *infra* note 126 (courts consider objective facts in evaluating taxpayer's intentions).

71. 544 F.2d 1045, 1048 (9th Cir. 1976).

72. See note 74 and accompanying text (explanation of abandonment theory supported by *Estate of Franklin v. Commissioner*).

73. *Estate of Franklin*, 544 F.2d at 1048. In *Estate of Franklin*, a taxpayer invested in the sale and leaseback of a motel. *Id.* at 1046. The investment required a \$75,000 down payment

when the nonrecourse purchase price of an asset exceeds the asset's fair market value, the taxpayer's payments on the asset create no equity and the taxpayer would be prudent to abandon the transaction.<sup>74</sup>

In evaluating whether Rice's Toyota had a business purpose for entering the lease transaction, the Fourth Circuit considered properly Rice's Toyota's willingness to pay an inflated purchase price for the computer.<sup>75</sup> Rice's Toyota negotiated only the terms of the \$280,000 recourse investment and not the computer's purchase price.<sup>76</sup> Similarly, in analyzing the validity of a book manuscript tax shelter, the Fourth Circuit in *Barnard v. Commissioner*,<sup>77</sup> approved the Tax Court's determination that a lack of concern during negotiations for a purchase price, inflated by the use of nonrecourse loans, indicated that a taxpayer contemplated only the tax benefits of the transaction.<sup>78</sup>

Upon determining that the lease transaction lacked a business purpose and that the transaction objectively lacked economic substance, the *Rice's Toyota* court correctly deemed the sale and leaseback a sham.<sup>79</sup> The Fourth Circuit then proceeded to pierce the labels of the lease transaction in order to evaluate the transaction's true substance.<sup>80</sup> In evaluating the lease transaction's true substance, the Fourth Circuit properly focused on the disparity between the computer's fair market value and the nonrecourse debt's outstanding balance, in disallowing the deductions for depreciation and interest expense.<sup>81</sup> In disallowing the depreciation deduction, however, the *Rice's*

---

in the form of prepaid interest and the issuance of a \$1,224,000 nonrecourse note. *Id.* The seller purchased the motel in the year prior to the transaction for \$660,000. *Id.* at 1048 n.4.

74. *Id.* at 1048.

75. See *supra* note 12 and accompanying text (previously having purchased used computer for \$1,297,643, Finalco sold computer to Rice's Toyota for \$1,455,277); see also *Flowers*, 80 T.C. at 937 (disparity between indebtedness and fair market value of property acquired taints indications of profit objective); *Narver v. Commissioner*, 75 T.C. 53, 102 (1980) (possibility exists that taxpayer entered transaction for tax avoidance motives when seller requires small downpayment with remainder of purchase price being satisfied with nonrecourse loans that are not reasonably comparable to fair market value of purchased property) *aff'd per curiam* 670 F.2d 855 (9th Cir. 1982).

76. See Appellee's Brief at 27, *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89 (4th Cir. 1985) (Rice's Toyota negotiated only method of cash payment upon entering lease transaction).

77. 731 F.2d 230 (4th Cir. 1984).

78. *Id.* at 231-32.

79. See *supra* notes 2-4 and accompanying text (when taxpayer enters transaction with no business purpose and transaction lacks economic substance, court considers transaction sham).

80. 752 F.2d at 95; see *supra* note 5 and accompanying text (when court finds transaction is sham, courts look beyond form of transaction and evaluate substance).

81. See 752 F.2d at 95 (Fourth circuit noted disparity between computer's value and nonrecourse loan balance). Several courts have focused on a disparity between an asset's fair market value and related nonrecourse purchase price, as one factor, in disallowing depreciation deductions. See, e.g., *Odend'hal v. Commissioner*, 748 F.2d 908, 912 (4th Cir. 1984) (disallowing depreciation deduction when nonrecourse purchase price exceeded asset's fair market value by \$2,000,000); *Estate of Franklin v. Commissioner*, 544 F.2d 1045, 1048 (9th Cir. 1976) (disallowing depreciation deduction when nonrecourse purchase price exceeded motel's fair market value);

*Toyota* court may have relied hastily on *Estate of Franklin v. Commissioner* without documenting the complete analysis utilized by the *Estate of Franklin* court.<sup>82</sup> The *Rice's Toyota* court implied that, based on *Estate of Franklin*, a court will disallow an entire depreciation deduction when the outstanding balance of a nonrecourse loan exceeds the related asset's fair market value.<sup>83</sup> The Ninth Circuit in *Estate of Franklin*, however, focused on factors in addition to the disparity between the nonrecourse purchase price and the

---

*Narver v. Commissioner*, 75 T.C. 53, 100-01 (1980) (disallowing depreciation deductions when nonrecourse purchase price exceeded asset's fair market value by \$1,400,000) *aff'd per curiam* 670 F.2d 855 (9th Cir. 1982); *see also* REV. RUL. 78-29, 1978-1 C.B. 62 (absent evidence that value of asset equals nonrecourse purchase price, taxpayer cannot include nonrecourse loan balance in asset's depreciable basis); REV. RUL. 77-110, 1977-1 C.B. 58 (taxpayer cannot include balance of nonrecourse loan in asset's depreciable basis when taxpayer cannot show asset's value equals nonrecourse loan balance); EXAMINATION TAX SHELTERS HANDBOOK, *supra* note 9, at 845 (when fair market value disparity exists along with factors indicating lack of profit intent, Commissioner generally disallows entire transaction). *See generally* Bittker, *Tax Shelters, Nonrecourse Debt and the Crane Case*, 33 TAX. L. REV. 277 (1978) (analyzing use of nonrecourse debt in tax shelter transactions); Javaras, *Nonrecourse Debt in Real Estate and Other Investments*, 56 TAXES 801, 819 (1978) (*Estate of Franklin* provides Commissioner with substantial support in attacking investments when nonrecourse purchase price exceeds asset's fair market value); Wangard, *Use of Nonrecourse Loans in Tax Planning: The Possibilities and the Pitfalls*, 39 J. TAX'N 286 (1973) (discussing Commissioner's attack on use of nonrecourse debt in tax shelters).

Various courts also have disallowed deductions for interest expense on nonrecourse loans when the nonrecourse loan balance exceeds the related asset's fair market value. *See, e.g., Odend'hal*, 748 F.2d at 912 (taxpayer cannot deduct interest paid on nonrecourse loans that exceed fair market value of acquired property); *Estate of Franklin*, 544 F.2d at 1049 (taxpayer can deduct interest on nonrecourse debt only when economically reasonable to make underlying investment); *Flowers*, 80 T.C. at 942 (when purchase price and underlying nonrecourse debt exceeds fair market value of purchased property, no genuine indebtedness occurs); *Hager v. Commissioner*, 76 T.C. 759, 775 (1981) (when principal balance of nonrecourse debt unreasonably exceeds value of acquired property, indebtedness is not genuine and taxpayers are not entitled to deduct related interest expense); *Narver*, 75 T.C. at 98 (courts do not allow taxpayers to take interest deductions on nonrecourse debt when nonrecourse purchase price exceeds asset's fair market value); *Beck v. Commissioner*, 74 T.C. 1534, 1552 (1980) (in nonrecourse debt situations, indebtedness is genuine only if the underlying collateral bears reasonable relationship to debt balance), *aff'd* 678 F.2d 818 (8th Cir. 1982).

82. *See* 752 F.2d at 95 (*Rice's Toyota* court relied upon Ninth Circuit's analysis in *Estate of Franklin v. Commissioner* to disallow depreciation deduction); *Estate of Franklin*, 544 F.2d at 1048 (excess of nonrecourse purchase price over asset's fair market value does not represent investment in property upon which taxpayer can support depreciation expense deduction). Congress has codified in the Internal Revenue Code (Code) the principle stated in *Estate of Franklin*, that the depreciable basis of an asset purchased with nonrecourse loans cannot exceed the asset's fair market value. *See* I.R.C. § 1274(b)(3)(A) (West 1985) (in potentially abusive situation, principal amount of debt assumed to purchase property equals asset's fair market value); *id.* § 1274(b)(3)(B)(II) (potentially abusive situation includes purchase of asset using nonrecourse loans); *see also* JOINT COMMITTEE ON TAXATION, 98TH CONG., 2D SESS., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984 119 (Comm. Print 1984) (noting that § 1274 paralleled *Estate of Franklin*).

83. *See* 752 F.2d at 95 (*Rice's Toyota* court implied that when outstanding balance of nonrecourse loan balance exceeds asset's fair market value the court will disallow entire depreciation deduction).

asset's fair market value in disallowing the depreciation deduction.<sup>84</sup> Nevertheless, the Fourth Circuit properly disallowed the depreciation deduction.<sup>85</sup>

Several courts have evaluated sale and leaseback transactions based on economic substance to determine whether the transaction deserves recognition for tax purposes.<sup>86</sup> The Tax Court, in *Dunlap v. Commissioner*,<sup>87</sup> evaluated the economic substance of a sale and leaseback transaction involving a building.<sup>88</sup> In upholding the transaction, the *Dunlap* court relied primarily on the fact that the building's residual value would provide a sufficient return to enable the taxpayer to recognize a gain from the overall transaction.<sup>89</sup> Additionally, the Tax Court noted that the rents from the initial lease term provided sufficient funds to repay the debt used to purchase the building.<sup>90</sup> In contrast, the Rice's Toyota lease involved an asset almost surely to depreciate in value over the lease term, and the leasing revenues provided no opportunity to recoup Rice's Toyota's investment.<sup>91</sup>

The Tax Court also focused on asset residual value in evaluating the economic substance of a sale and leaseback transaction in *Estate of Thomas*

---

84. See 544 F.2d at 1047. In *Estate of Franklin v. Commissioner*, the United States Court of Appeals for the Ninth Circuit evaluated not only the disparity between the asset's fair market value and nonrecourse purchase price, but also the fact that the seller retained the burdens and benefits of ownership in the property. *Id.* The *Estate of Franklin* court noted that a court will not disallow an entire depreciation deduction solely because an asset's nonrecourse purchase price exceeds the asset's fair market value. *Id.* at 1049; see *Narver v. Commissioner*, 75 T.C. 53, 101-02 (1980) (disparity between asset's fair market value and nonrecourse purchase price is merely indication of transaction's validity in context of all circumstances) *aff'd per curiam* 670 F.2d 855 (9th Cir. 1982); see also *Brannen v. Commissioner*, 722 F.2d 695, 701 (11th Cir. 1984) (describing procedure used by court in disallowing depreciation deduction); REV. RUL. 82-224, 1982-2 C.B. 5, 6 (describing procedure used by Commissioner to disallow depreciation deduction).

85. See *supra* note 32 and accompanying text (Fourth Circuit determined that lease transaction contained no business purpose or economic substance).

86. See, e.g., *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978) (evaluating sale and leaseback of bank building to determine whether transaction contained economic substance); *Estate of Thomas v. Commissioner*, 84 T.C. 412 (1985) (analyzing sale and leaseback of computer to determine whether transaction contained economic substance); *Flowers v. Commissioner*, 80 T.C. 914 (1983) (disallowing sale and leaseback of master recordings based on economic substance analysis); *Hager v. Commissioner*, 76 T.C. 759 (1981) (disallowing sale and leaseback of cattle based on economic substance analysis); *Dunlap v. Commissioner*, 74 T.C. 1377 (1980) (upholding validity of sale and leaseback of warehouse when residual value projection showed strong potential for profitability), *rev'd on other grounds*, 670 F.2d 785 (8th Cir. 1982); *Hilton v. Commissioner*, 74 T.C. 305 (1980) (disallowing sale and leaseback of department store based on analysis of transactions economic substance), *aff'd per curiam*, 671 F.2d 316 (9th Cir. 1982) *cert. denied* 459 U.S. 907 (1982); *Narver v. Commissioner*, 75 T.C. 53 (1980) (disallowing sale and leaseback transaction involving rental property, based on economic substance analysis), *aff'd per curiam*, 670 F.2d 855 (5th Cir. 1982).

87. 74 T.C. 1377 (1980), *rev'd on other grounds*, 670 F.2d 785 (8th Cir. 1982).

88. *Id.* at 1431.

89. *Id.* at 1437. In *Dunlap v. Commissioner*, the seller built the leased building in an expanding, industrial location. *Id.* at 1436.

90. *Id.* at 1437.

91. See *supra* note 63 and accompanying text (Rice's Toyota's lease transaction lacked potential to recouperate recourse investment).

v. Commissioner.<sup>92</sup> The *Estate of Thomas* taxpayer invested in a partnership that entered into several sale and leaseback transactions involving computers.<sup>93</sup> The partnership financed the lease transactions with nonrecourse debt.<sup>94</sup> The Tax Court distinguished the *Estate of Thomas* lease transactions from the *Rice's Toyota* lease transaction on the basis that the *Estate of Thomas* computers had sufficient residual values to allow the partnership to break even on the transactions.<sup>95</sup> Additionally, the Tax Court noted that because the computer's fair market value approximated the purchase price, the *Estate of Thomas* partnership most likely did not intend to abandon the lease transactions.<sup>96</sup>

In evaluating the deductibility of the interest expense on the recourse loan, the Fourth Circuit incorrectly determined that Rice's Toyota's recourse loan created a genuine obligation upon which to base a deduction for interest expense.<sup>97</sup> Section 163(a) of the Internal Revenue Code provides for the deduction of interest expense without expressly requiring a taxpayer to show any purpose for the creation and deduction of interest expense.<sup>98</sup> Courts, however, have formed judicial tests to disallow interest deductions on funds borrowed to engage in an activity that has no economic substance, apart from tax avoidance.<sup>99</sup> In the seminal case, *Knetsch v. United States*,<sup>100</sup> the United States Supreme Court utilized a variant of the sham transaction doctrine to deny an interest expense deduction.<sup>101</sup> The *Knetsch* sham test suggests that once a court determines that the underlying transaction is a sham, the court cannot find genuine indebtedness to support an interest

---

92. 84 T.C. 412 (1985).

93. *Id.* at 413.

94. *Id.* at 422. In *Estate of Thomas v. Commissioner*, the partnership purchased the computer equipment paying \$945,673 in cash and issuing nonrecourse notes for \$8,124,561. *Id.*

95. *Id.* at 439.

96. *Id.*

97. See 752 F.2d at 96 (*Rice's Toyota* court allowed Rice's Toyota's deduction for interest expense on recourse loan).

98. See I.R.C. § 163(a) (West 1985) (taxpayer can deduct all interest expense incurred within taxable year on indebtedness). Certain sections of the Code however, limit or exclude the deductibility of interest expense. See, e.g., I.R.C. § 163(d) (West 1985) (limiting interest deduction on investment indebtedness); *id.* § 265(2) (disallowing deduction for interest on indebtedness incurred to purchase tax exempt securities).

99. See *Rothschild v. United States*, 407 F.2d 404, 406-07 (Ct. Cl. 1969) (analyzing various tests used by courts to disallow interest expense deductions); see also *Goldstein v. Commissioner*, 364 F.2d 734, 740 (2d Cir. 1966) (courts should construe § 163(a) of Code to allow deduction for interest on borrowed funds only when taxpayer borrows funds to engage in purposeful activity), *cert. denied*, 385 U.S. 1005 (1967). But see *Wachovia Bank & Trust Co. v. United States*, 499 F. Supp. 615, 621 (M.D. N.C. 1980) (neither legislative history nor express language of § 163(a) of Code import congressional intent to limit interest expense deductions to situations involving purposive activity). See generally *Kanter, Interest Deduction: Use, Ruse, Refuse*, 46 TAXES 794, 821 (1968) (discussing tests used by courts to disallow interest expense deductions); *Packman, How Not to Lose Interest in a Tax Shelter*, 52 TAXES 615, 622 (1974) (analyzing factors considered by courts to determine whether transaction will support interest deduction).

100. 364 U.S. 361 (1960).

101. *Id.* at 369.



deduction.<sup>102</sup> The taxpayer in *Knetsch* engaged in a series of investment transactions designed solely to create an interest deduction.<sup>103</sup> Because the transactions lacked economic substance, apart from tax benefits, the *Knetsch* court determined that the transactions were shams.<sup>104</sup> The Fourth Circuit utilized the *Knetsch* sham test in *Bridges v. Commissioner*.<sup>105</sup> In *Bridges*, the taxpayer also engaged in an investment transaction designed solely to generate an interest deduction.<sup>106</sup> The *Bridges* taxpayer, however, used recourse debt to finance the transaction.<sup>107</sup> Nevertheless, the Fourth Circuit held that, because the transaction contained no chance of appreciably affecting the taxpayer's economic interest, apart from tax reduction, the transaction constituted a sham and could not support an interest expense deduction.<sup>108</sup> Similarly, the *Rice's Toyota* court determined that the Rice's Toyota lease transaction constituted a sham.<sup>109</sup> Accordingly, the Fourth Circuit should not have concluded that the recourse note could support an interest expense deduction. The policy behind the tax laws does not encourage taxpayers to invest in transactions solely to decrease tax liability.<sup>110</sup>

In combining both the subjective business purpose and objective economic substance tests to define what constitutes a sham transaction, the *Rice's Toyota* court apparently attempted to state explicitly the analysis implicitly applied by the United States Supreme Court in *Frank Lyon & Co. v. United States*.<sup>111</sup> In *Frank Lyon*, the Supreme Court, in determining that a sale leaseback transaction did not constitute a sham, held that the Commissioner should honor multiple party transactions containing economic substance, apart from tax benefits, which business or regulatory realities

---

102. *Id.*

103. *Id.* at 363.

104. *Id.* at 369.

105. 325 F.2d 180, 184 (4th Cir. 1963).

106. *Id.* at 181-83. In *Bridges v. Commissioner*, the taxpayer purchased government securities with bank loans. *Id.* at 182. The interest rate on the bank loans exceeded the yield on government securities. *Id.* The taxpayer deducted the interest from the bank loans, on his tax return. *Id.* at 183.

107. *Id.* at 182. The *Rice's Toyota* court placed significant emphasis on the fact that Rice's Toyota was obligated on the \$280,000 recourse loan. 752 F.2d at 96. A commentator has noted that liability alone does not create a genuine obligation upon which a deduction for interest can be supported. See Klein, *Interest Expense Must Meet Several Conditions Before a Taxpayer Will Be Allowed a Deduction*, 14 TAX'N FOR ACCT. 14, 15 (1975) (even if taxpayer is liable for note, courts will not allow interest deduction when no purpose for transactions exists other than creation of tax deduction).

108. 325 F.2d at 185.

109. See 752 F.2d at 95 (*Rice's Toyota* court determined that lease transaction was sham).

110. See *Goldstein v. Commissioner*, 364 F.2d at 742. Courts would frustrate the purpose of § 163(a) of the Code if courts allowed deductions for interest on money to finance activities designed to avoid tax liability. *Id.*

111. See 752 F.2d at 91 (Fourth Circuit in *Rice's Toyota* agreed with Tax Court's conclusion that *Frank Lyon Co. v. United States* implicitly mandates analysis of both business purpose and economic substance tests in determining whether transaction constitutes sham); *Frank Lyon Co. v. United States*, 435 U.S. 561, 583 (1978) (upholding sale and leaseback transaction that contained nontax business purpose and economic substance).

necessitate.<sup>112</sup> In *Frank Lyon*, the taxpayer (Lyon) entered into a sale and leaseback transaction with Worthen Bank (Worthen), involving the construction of Worthen's office building and headquarters.<sup>113</sup> The *Frank Lyon* Court implicitly analyzed the lease transaction's business purpose by focusing on the fact that banking regulations necessitated the transaction's form.<sup>114</sup> In implicitly analyzing the lease transaction's economic substance, the *Frank Lyon* Court noted that the parties had structured the lease to enable Lyon to recoup the total investment and pay off the related debt by the end of the lease term.<sup>115</sup> Additionally, the *Frank Lyon* Court noted that the parties engaged in extensive arm's length negotiations to determine the transaction's terms.<sup>116</sup> Accordingly, the Supreme Court's analysis in *Frank Lyon* formed the genesis for the Fourth Circuit's definition of a sham transaction in *Rice's Toyota*.<sup>117</sup>

A literal interpretation of the Fourth Circuit's sham transaction definition imports an understanding that a court will evaluate separately, both the subjective business purpose and objective economic substance tests before concluding that a transaction constitutes a sham.<sup>118</sup> Accordingly, a taxpayer might infer that, once a court determines a transaction contains a nontax business purpose, a court will honor a transaction regardless of a transaction's economic substance. Similarly, a taxpayer might conclude that a Court will apply an objective analysis to determine whether a transaction contains economic substance before disallowing a transaction that lacks a business purpose. Such a literal interpretation of the Fourth Circuit's two-pronged definition of a sham, however, is illusory.<sup>119</sup> In the context of sale and leaseback transactions, the subjective business purpose and objective economic substance tests are interdependent.<sup>120</sup> Economic substance or profitability, apart from tax benefits, is a fundamental business purpose.<sup>121</sup>

---

112. 435 U.S. at 583.

113. *Id.* at 563.

114. *Id.* at 563-64. In *Frank Lyon Co. v. United States*, state usury laws made issuance of debt securities impracticable because the securities would not be marketable at the maximum legal rate. *Id.* at 563. Additionally, state laws required state approval of all bank expenditures for premises in excess of 40% of the bank's capital accounts. *Id.* at 564. Regulatory authorities indicated that they would not grant the necessary approval. *Id.*

115. *Id.* at 566. In *Frank Lyon*, the lease agreement contained purchase option provisions allowing Worthen to purchase the bank building for a specific price at certain intervals. *Id.* at 567. Additionally, Frank Lyon Co. purchased the property using recourse debt. *Id.* at 577.

116. *Id.* at 564.

117. See *supra* note 111 and accompanying text (*Rice's Toyota* court followed *Frank Lyon* in developing definition of sham transaction).

118. See 752 F.2d at 91 (*Rice's Toyota* court looked to both subjective business purpose and objective economic substance tests in defining sham transaction).

119. See *infra* note 121 and accompanying text (business purpose test and economic substance test are interdependent).

120. See *infra* note 121 and accompanying text (economic substance apart from tax benefits is fundamental business purpose).

121. See *Zmuda v. Commissioner*, 731 F.2d 1417, 1420 (9th Cir. 1984) (no real difference exists between business purpose and economic substance tests); Bittker, *Judicial Doctrines*,

Accordingly, a taxpayer will have a difficult time showing that a business purpose exists, absent economic substance, unless the taxpayer can show some regulatory or independent considerations compelling the initiation of the transaction.<sup>122</sup>

In evaluating the practical consequences of the Fourth Circuit's sham transaction definition, a taxpayer also could misinterpret the effect of the use of the subjective standard of the business purpose test.<sup>123</sup> A taxpayer might infer that, when determining a taxpayer's subjective motivations for entering a particular transaction, a court will look only to a taxpayer's individual perceptions of a particular transaction. Courts, however, when evaluating the subjective mental state of a taxpayer, place more emphasis on the objectives of taxpayers as a group than on the mental state of a particular individual before the court.<sup>124</sup> When a court finds that taxpayers as a group are likely to enter a particular type of transaction to reduce taxes rather than achieve nontax objectives, a court generally will find that the transaction lacks a business purpose.<sup>125</sup> Additionally, because the temptation to reduce taxes is pervasive, when a transaction contains significant tax reduction benefits, a taxpayer will have to produce substantial evidence to show that the taxpayer entered the transaction with a purpose other than tax avoidance.<sup>126</sup>

A taxpayer also could formulate a false sense of security in relying on the Fourth Circuit's use of the objective standard for the economic substance test.<sup>127</sup> In practical application, courts diminish the objectivity of the eco-

*supra* note 5, at 716 (formulation that transaction lacks economic substance is another way of saying transaction lacks business purpose); Rosenberg & Weinstein, *Sale-Leaseback Transactions After Frank Lyon Company*, 2 EVALUATING TAX SHELTERS OFFERINGS 419, 425 (1982) (economic substance or potential to earn profit is business purpose).

122. *Cf.* Frank Lyon Co. v. United States, 435 U.S. at 564 (banking regulations compelled parties to structure transaction in form of sale and leaseback).

123. *See* 752 F.2d at 95 (*Rice's Toyota* court adopted subjective standard for business purpose test).

124. *See* Bittker, *supra* note 5, at 702 (discussing motive and intent in tax cases).

125. *Id.*; *see* Blum, *Motive, Intent and Purpose in Federal Income Taxation*, 34 U. CHI. L. REV. 485, 498 (1967) [hereinafter cited as Blum, *Motive, Intent and Purpose*]. Courts base tests of subjective mental state on inferences drawn from taxpayer's statement and other facts related to a taxpayer's thoughts. *Id.* Courts recognize certain taxpayer characteristics as indicative of a certain mental state when particular taxpayer conduct occurs repeatedly in a specific area of taxation. *Id.* at 504.

126. *See* Blum, *Motive, Intent and Purpose, supra* note 125, at 498. Courts balance the taxpayer's nontax objectives against the tax reduction objectives in determining whether the transaction contains a valid business purpose. *Id.* at 516. The taxpayer has the burden of showing an important nontax goal in order to dispel the conclusion that the tax reduction objectives did not amount to tax avoidance. *Id.* at 498. A factor that the taxpayer must overcome in mitigating the tax benefits of a transaction is the fact that courts can translate tax benefits into dollar terms, while courts often cannot quantify nontax benefits. *Id.* at 522. Accordingly, when a transaction generates large tax benefits, courts can identify more easily a tax reduction purpose. *Id.*

127. *See* 752 F.2d at 95 (*Rice's Toyota* Court adopted objective standard for economic substance test).

conomic substance test by relying on the subjective opinions of expert witnesses, to establish the data underlying the court's objective conclusions.<sup>128</sup> Accordingly, courts can use the hindsight of expert testimony to second-guess the business judgment of taxpayers.<sup>129</sup>

By following the precedence of tax cases factually similar to *Rice's Toyota*, the Fourth Circuit could have disallowed the depreciation and interest expense deductions without defining a sham transaction.<sup>130</sup> The Fourth Circuit, however, probably selected *Rice's Toyota* to express clearly a definition of a sham transaction, in an attempt to offer some precedent of value for taxpayers and tax practitioners.<sup>131</sup> Commentators have noted that sale and leaseback cases generally have provided little precedential value due to the significant emphasis placed on the factual considerations particular to each case.<sup>132</sup> Accordingly, in *Rice's Toyota*, the Fourth Circuit attempted to establish clear guidelines to assist taxpayers in structuring financial transactions.<sup>133</sup>

*Rice's Toyota* carries several additional implications for Fourth Circuit taxpayers. Because of the interdependent nature of the business purpose and economic substance tests taxpayers, generally, will have to show the presence of economic benefits to avoid disallowance of a transaction.<sup>134</sup> Courts have

---

128. See, e.g., *Estate of Thomas v. Commissioner*, 84 T.E. 412 (1985) (evaluating expert testimony in determining adequacy of computer's residual value); *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221, 1239 (1981) (analyzing expert testimony in determining fair market value of investment property); *Hilton*, 74 T.C. at 350 (relying on expert testimony in determining adequacy of building's residual value).

129. See *Wright v. United States*, 249 F. Supp. 508, 513 (D. Nev. 1965) (criticizing use of expert testimony to second guess business judgment of investors in tax cases); see also *Rosenburg & Weinstein*, *supra* note 121, at 430 (because courts and Internal Revenue Service can utilize hindsight of expert testimony to second guess businessmen's judgment on rates of return, businessmen must enter business transactions with caution).

130. See, e.g., *Estate of Franklin*, 544 F.2d at 1049 (disallowing sale and leaseback of motel because transaction lacked economic substance); *Hilton*, 74 T.C. at 361 (disallowing sale and leaseback of department store because transaction lacked economic substance); *Narver*, 75 T.C. at 102 (disallowing sale and leaseback of building because transaction lacked economic substance).

131. See *supra* note 6 and accompanying text (decisions based on some variation of substance over form analysis yield little precedential value).

132. See *Weiss*, *The Crane Case Updated*, 32 TAX LAW. 289, 299 (1979) (*Frank Lyon Co.* offers little precedential value because Supreme court failed to establish broad principle and focused on particular facts of case); cf. *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978); see also *Wolfman*, *The Supreme Court in the Lyon's Den: A Failure of Judicial Process*, 66 CORNELL L. REV. 1075, 1099 (1981) (Supreme Court's holding in *Frank Lyon Co.*, contains little precedential value because Supreme Court relied on 26 factors in deciding case); Comment, *Sale-and-Leaseback: Shelter or Sham*, 8 GOLDEN GATE 219, 227 (1977) (*Estate of Franklin v. Commissioner* offers little precedential value because of court's concentration on case's particular facts); cf. *Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976).

133. See *supra* note 131-33 and accompanying text (previous sale and leaseback cases have provided little precedential value).

134. See *Lefevre*, *The Tax Law of Lease Transactions Revisited*, 53 TAXES 764, 776 (1975) (to avoid application of sham transaction doctrine, taxpayers should structure lease transactions to provide modest cash flow or provide potential profit from residual value). See generally

tended to uphold transactions that offered economic benefits to taxpayers.<sup>135</sup> In evaluating a transaction's economic benefits, courts probably will look primarily to the potential for a return on investment through realization of residual value or cash flow.<sup>136</sup> Another implication of *Rice's Toyota* for Fourth Circuit taxpayers is that, when relying on *Rice's Toyota's* sham definition to structure financial transactions, taxpayers should consider cautiously the prescribed tests. In addition, Fourth Circuit taxpayers should consider the probability that, when a court evaluates a transaction, the court might utilize the subjective opinion of expert testimony to decide whether a transaction is legitimate for tax purposes.<sup>137</sup> Finally, while *Rice's Toyota* dealt specifically with a sale and leaseback transaction, the Fourth Circuit may extend the *Rice's Toyota* sham definition to other types of financial transactions.<sup>138</sup>

DAVID T. POPWELL

---

Rosenburg & Weinstein, *supra* note 121, at 419 (summarizing court decisions involving sale and leaseback transactions subsequent to *Frank Lyon*).

135. See, e.g., *Frank Lyon Co. v. United States*, 435 U.S. at 566 (considering fact that parties structured lease payments to recoup Lyon's investment); *Estate of Thomas v. Commissioner*, 84 T.C. 412 (1985) (evaluating fact that computer's residual value was sufficient to generate overall profit on transaction, in upholding transaction as valid); *Dunlap v. Commissioner*, 74 T.C. at 1431 (in upholding transaction as valid, Tax Court focused primarily on property's potential residual value to generate gain on overall transaction).

136. See *supra* note 135 and accompanying text (analysis of factors considered by courts in upholding sale and leaseback transactions).

137. See *supra* note 128 and accompanying text (courts reduce objectivity of economic substance test through use of subjective expert testimony).

138. See *supra* notes 49-56 and accompanying text (courts have evaluated various types of transactions using either business purpose or economic substance test).