

Chapter 16 p. 921

Leverage & Leasing

Consider the “tax sheltering” effects of:

- 1) **Rapid income tax depreciation deductions.**
- 2) **Leveraging (with non-recourse debt) to have a high tax basis and limited actual cash investment. (Remember Tufts case).**

Consider the use of these deductions to offset income from other sources.

Estate of Franklin

p.921

Ltd. partnership acquires the Thunderbird motel in Arizona for \$1,224,000. Prepaid interest but then deferral over ten years for large principal payments & balloon payment due after 10 year period. Nonrecourse debt.

Warranty deed is placed in escrow. Leaseback with net lease payments approximating the P&I payments on the debt. No potential for equity growth for taxpayer?

continued

Estate of Franklin, continued

p.921

Tax Court: Transaction was an option and not a sale. Deed never recorded and “benefits and burdens of property” still with “seller.”

Court of Appeals: Transaction can be a genuine sale and with genuine indebtedness.

But, must demonstrate that the purchase price is real, i.e., approximately equal to the fair market value of the property. Here FMV of the property could not be proved (fn.4). No real potential for creating an equity for the buyer.

Pleasant Summit Land Corp. p.926

Another example of

- 1) Nonrecourse financing (i.e., purchase price?), exceeding**
- 2) Fair market value of property.**

Should depreciation be disallowed only to the extent of the nonrecourse debt in excess of the fair market value of the property? This is holding in Pleasant Summit.

Correct? Providing an incentive for tax gamble?

Problem, p. 929

Building constructed for \$2 million.

1.8 mil. nonrecourse construction financing (where is the \$200,000) and no loan reduction.

\$600,000 claimed depreciation (and adjusted basis of \$1.4 million).

Transfer of property subject to the \$1.8 million mortgage.

Tax results? If basis treated as not including debt, then no debt realized on disposition.

The “At-Risk” Limitation Provision p. 929

No deduction for investment if taxpayer is not “at risk.”

However, exception for real estate for “qualified non-recourse debt. See §465(b)(6).

Leasing, p. 933

Frank Lyon case, noted on p. 934.

Sale-leaseback of Worthen Bank & Trust building in Little Rock.

Bank leased land to Lyon and then leaseback for 25 year primary term and eight five year option terms. Net lease.

Rent paid equaled the debt amortization requirements.

Held: Frank Lyon was the owner of the property.

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p. 937