AT RISK DETERMINATIONS IN CIRCULAR LEASING TRANSACTIONS

BY THOMAS A. PLISKIN

Recent decisions by the Tax Court and by federal district courts affect the Section 465 at risk rules that affect leasing transactions. These decisions significantly impact funding for equipment leasing purchases and, as such, impact those who invest in and market transactions that raise capital for equipment leasing purchases.

The issue of whether a taxpayer is prohibited by the at risk rules from deducting losses usually surfaces in sale-leaseback equipment leasing situations involving a circular chain of payments. The fact pattern typically involves the following entities and relationships:

1. A seller-lessee who sells equipment to another entity (conduit purchaser)
2. The conduit purchaser takes a note in return
3. The conduit purchaser, at the same time, sells the equipment for a note to an investor (usually a partnership)
4. The investor who simultaneously leases the equipment back to the seller-lessee
5. Installment payments on both notes and leases that are equal and therefore offsetting

BACKGROUND

The at risk rules of Section 465 of the Internal Revenue Code represent one of three sets of limitations that operate to prohibit or reduce the deduction of losses by a partner or by a member of a partnership or limited liability company. The other two limitations are the basis rules and the passive loss rules. A partner may acquire basis from partnership non-recourse liabilities against which to deduct a loss, but the partner may not be at risk for his or her share of those liabilities. For instance, partners are not at risk for non-recourse financing except where the borrowing secured by the partnership's real estate is from a "qualified person" such as an institutional lender having no other relationship with the taxpayer or the partnership or its property, and is not convertible debt.[1] If a partner is protected against loss by an agreement with a non-partner, this partner will not be at risk for the partner's share of the partnership's liability even though the partner has basis for the share of that liability.[2]

As a result, the partner is prohibited from taking a tax deduction for losses generated by an activity. The entity usually is a partnership in which the partner is an investor.

CURRENT LEASEBACK LITIGATION

Since 1995, a number of cases addressed whether a taxpayer, by virtue of various agreements, is protected against suffering an economic loss. The cases are significantly fewer than those brought in the late 1980s and early 1990s. The following are current litigation involving leaseback situations:

1. Two Tax Court cases appealable to the Sixth Circuit, *William Kingston v. Commissioner*[3] and *Pledger v. United States of America*[4]
2. One Tax Court case appealable to the Third Circuit, *Kimmich v. Commissioner*[5]
3. Two cases appealable to the Ninth Circuit, *Whitmire v. Commissioner*[6] and *Sacks v. Commissioner*[7]

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The Economic Reality Test

The economic reality test applies in most circuits in determining whether a taxpayer is at risk. In the economic reality test, a taxpayer will not be at risk if the taxpayer's chance of suffering economic loss is only a mere theoretical possibility.[8] The Sixth Circuit, however, does not apply the economic reality test.

The Sixth Circuit's test is whether, in a worst-case scenario, the taxpayer will suffer any personal out-of-pocket expense.[9] In applying this worst-case scenario test, the insolvency of the seller-lessee and conduit purchaser is assumed. The seller-lessee and conduit purchaser are two of the three parties to the circular transaction. The third party is the investor. Under the worst-case scenario, the investor will be at risk if the investor has no right of recourse against anyone.

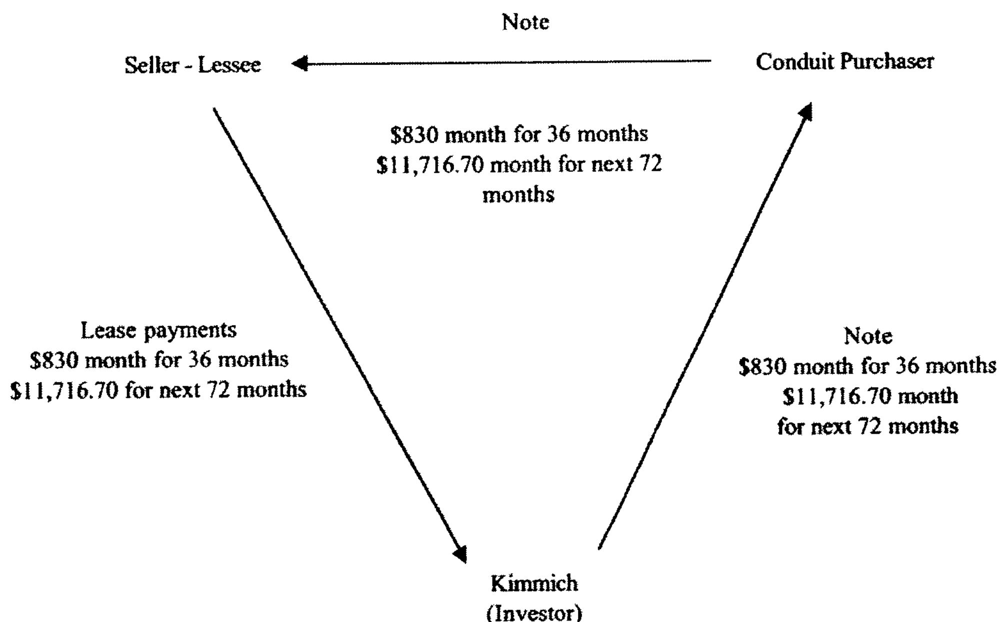
Kingston and *Kimmich* Cases

The cases of *William Kingston v. Commissioner*[10] and *Kimmich v. Commissioner*,[11] both decided by the Tax Court, have similar facts but have opposite results. These disparate results occur because *Kingston* was appealable to the Sixth Court, where the worst-case scenario test applied, while *Kimmich* was appealable to the Third Circuit, which employs the economic reality test as its analytical tool.

In both *Kingston* and *Kimmich*, a seller-lessee sold equipment to a conduit purchaser, taking back notes. The conduit purchaser then sold the equipment to an investor. In *Kimmich* the investor was an individual. In *Kingston* the investor was a limited partnership. The investor in turn leased the equipment to the seller-lessee, who agreed to make lease payments that were equal to the note payments being made by the investor to the conduit purchaser, and by the conduit purchaser to the leasing company. Diagram 1 illustrates the note and lease payments in *Kimmich*.

In *Kimmich*, these circular payments were made by bookkeeping entries at one particular bank. The seller-lessee had given an indemnity in both cases, further protecting the investor against loss. There was no evidence of a creditor outside the circular transaction having the right to enforce the investor's obligation. Based on these facts, the Tax Court in *Kimmich* found that the investor, an

Diagram No. 1



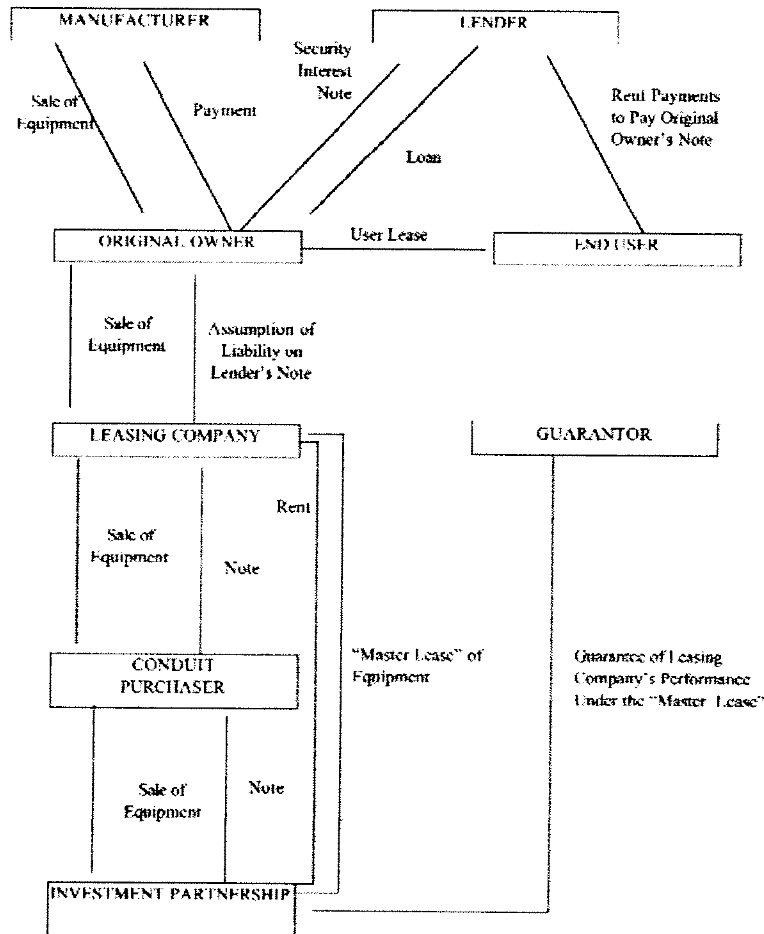
individual, was not at risk, as the investor was effectively immunized from any realistic possibility of suffering economic loss. The Tax Court reached this result in *Kimmich* without caring or deciding whether the investor's note was recourse.

The court in *Kingston* recited the fact that the investment partnership gave up any right to setoff it had against its lessee, the leasing company. The court applied the worst-case scenario test, assuming the insolvency of the seller-lessee. The court in *Kingston* therefore held that the partners of the investor (a limited partnership), who were liable for their pro rata share of the limited partnership note to the conduit purchaser, would have to pay and thus were at risk because they bore the ultimate responsibility.

Whitmire v. Commissioner

Whitmire v. Commissioner[12] has slightly different facts than the first two cases. At its core is the same circular arrangement between a leasing company, a conduit purchaser, and an investment partnership. In that case, the leasing company previously purchased the equipment from an original owner subject to a lease with an end user that the original owner had made. The original owner who borrowed funds to pay for its purchase of the equipment was personally liable on its note to the bank. The original owner provided collateral to the bank, which included the investor's note initially given to the conduit purchaser. The investor lent money in order to facilitate the purchase of the equipment by the original owner. These relationships are illustrated by Diagram 2.

Diagram No. 2



The Tax Court in *Whitmire* employed the economic reality test, but first determined that under the worst-case scenario test the investor bore the ultimate liability. The Tax Court then recited all the defaults that had to occur in order for the investor to pay. The Tax Court determined that the end user, the leasing company, the guarantor of the leasing company's obligation, and the conduit purchaser all would have to have defaulted, and the equipment had to be worth less than the amount due on the leasing company's note to the bank.

The investor in *Whitmire* was liable on recourse notes held by a creditor outside the circular transaction where the investor had no disincentive to sue on the investor's note. Nevertheless, the Tax Court found that there was only a theoretical possibility that such a lawsuit would be brought, and therefore the investment partnership and its partners were not at risk.

Sacks v. Commissioner

Sacks v. Commissioner provides further evidence that the Ninth Circuit will grapple with the issue of whether there is a realistic possibility that an investor in a sale-leaseback transaction has more than a mere theoretical possibility of suffering economic loss.[13] In that case an investor, who was a lawyer to and friendly with the person creating the investment, purchased ten solar heating units from BFS Solar for cash and negotiable notes for a price that he had the ability to pay. The investor in turn leased back the equipment to BFS. The lease payments were less than the amounts due on the notes, but the investment was projected to be profitable on an after-tax basis, apparently because of tax credits and accelerated depreciation.

The Tax Court held that the transaction was a sham and the taxpayer not at risk on the taxpayer's recourse notes. The Tax Court based its judgment on findings that:

1. The cash flow from the investment was insufficient to pay debt service;
2. Even though the notes were recourse, the notes were not held by an independent third party, but by an essential party to the sale-leaseback arrangement; and
3. The taxpayer and the principal of BFS were close friends and had a lawyer-client relationship.

The Ninth Circuit reversed the *Sacks* decision, saying that the taxpayer was at risk because the notes were recourse. Even though those notes were not negotiated, the notes were negotiable. The fact that the investment was not profitable on a pre-tax basis did not make the arrangement a sham because the investor would be making a profit on an after-tax basis. Further, based on testimony at trial, there was no basis in the record for inferring an unwritten agreement not to collect money due on the notes.

The Ninth Circuit, in applying the economic reality test, will seek to determine if the note is recourse or non-recourse. This result is in contrast to the Third Circuit. There, if the facts disclose a circular transaction with offsetting payments, the investor will not be at risk under the economic reality test, and therefore, it becomes irrelevant whether the note is recourse or non-recourse. If the note is recourse, and negotiable, the Ninth Circuit would find its maker at risk so long as there are not many layers of protection for the note's maker or guarantor, or evidence of an agreement not to sue.

Pledger v. Commissioner

Pledger v. Commissioner,[14] the Sixth Circuit decided in the Federal District Court of Ohio, has factual differences with the circular transaction pattern. Integrated Equipment Leasing Corp. (IELC) was a wholly owned subsidiary of Integrated Resources, Inc. (Integrated) and purchased certain equipment. IELC sold equipment to Investors Credit Corp. (ICC), another wholly owned subsidiary of Integrated. ICC leased back the equipment to IELC and created a grantor trust. The trust sold beneficial interests in it to investors, including the taxpayer, who was assigned a share of the rents to be paid by IELC to ICC. IELC's rent obligation was guaranteed by its parent, Integrated. The investor paid cash and gave

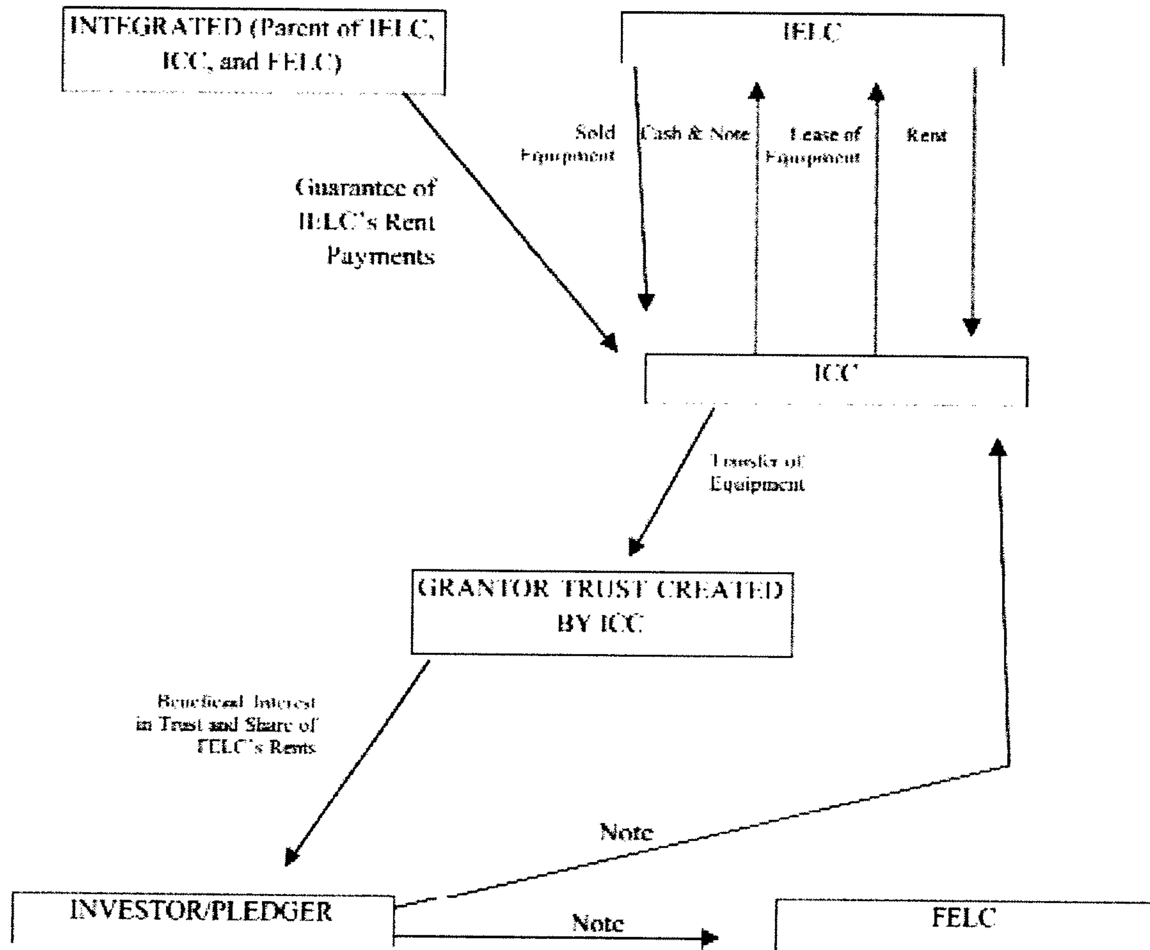
recourse notes for his trust interest to ICC and FELC (another wholly owned subsidiary of Integrated) who continued to hold the notes. The essential facts are diagramed in Diagram 3.

The offering memorandum given to the investor stated that Integrated and its subsidiary, ICC, did not deal at arm's length. Many of the investor's note payments were actually made to Integrated, the guarantor of the rent payments due from IELC to ICC, Integrated's subsidiary. The court determined that ICC was a dummy for Integrated. Therefore, Integrated was both the obligee on the investor's note and the guarantor of payment on that note through its guarantee of lease payments. Therefore, if Integrated failed to honor its guarantee of lease payments after IELC defaulted on the lease, the investor's obligation on the note would be set off by Integrated's guarantee of lease payments. Therefore, the investor was not the payor of last resort, and was not at risk.

FURTHER ANALYSIS

The Second, Third, Eighth, Ninth, and Eleventh Circuits, being suspicious of contrived related transactions, apply the economic reality test in a setting of a circular transaction, with offsetting payments and no outside creditor holding the investor's obligation. On these facts these circuits will not look to see if the obligation is recourse, and thus investors will not be at risk.[15]

Diagram No. 3



Even if an outside creditor exists, the investor may not be at risk if the investor has too many layers of protection or there is some other device that would protect the investor in all but the worst cases.

Distinctions between circuits are significant. In the Sixth Circuit, the court in the circular transaction situation would find that the investor is at risk, assuming the investor is the payor of last resort, if there is a recourse obligation and the investor does not have a right to setoff either by contract or implied by law.

The *Pledger* case is a reminder that courts will examine facts to determine that an investor is not the payor of last resort. If that is the case, no court will find the investor at risk. If payments in a sale-leaseback transaction are not equal, the Ninth Circuit has examined additional evidence before ruling on the at risk issue. One may ask whether in circuits other than the Sixth, further facts should be looked at where there are circular offsetting payments to see if there is a realistic possibility that an investor will be sued on a recourse obligation, especially given an unsettling economy.

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1. I.R.C. § 465(b)(2) and (6).
2. I.R.C. Reg. 1.752-2(b)(5).
3. T.C. Memo 937-512.
4. 99-2 USTC ¶50, 835.
5. T.C. Memo 1999-349.
6. 178 F.3d 1050 (9th Cir. 1999).
7. 69 F.3d 982 (9th Cir. 1995).
8. Whitmire v. Commissioner, 178 F.3d 1050, 1056 (9th Cir. 1999).
9. Pledger v. United States of America, 236 F.3d, 315, 319 (6th Cir. 2000); Emershaw v. Commissioner, 949 F. 2nd 41(6th Cir. 1991).
10. T.C. Memo 1997-512.
11. T.C. Memo 1999-349.
12. 178 F.3d 1050 (9th Cir. 1999).
13. T.C. Memo 1992-596; *rev'd* F. 2d 982 (9th Cir. 1995).
14. Pledger v. United States of America, 236 F. 3d 315 (6 th Cir. 2000).
15. Whitmire v. Commissioner, 178 F.3d 1050, 1057 (9th Cir. 1999).

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