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Recent Developments: Federal Taxation—Taxpayer Held to Have Beneficial Interest and to Qualify for Depreciation Deduction Where He Made Little Investment and Incurred No Liability as Majority Shareholder of a Corporation and Transferee Subsequent to Purchase—Lease Back and Mortgage Agreements. Bolger v. Commissioner, 59 T.c. 760 (1973)

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appear to be particularly applicable in cases where no effort has been made by police officers to secure a warrant or to independently corroborate the information.

In *Thompson* the facts fit the mold of *Spinelli*; therefore, the holding appears to be well founded. However, the *Thompson* variation, while minor, is still one that might lead to a major deprivation of a defendant's fourth amendment rights. Since the reliability of an unnamed criminal informant is at best suspect, if his information is to be used, it should be subjected to the rigid tests dictated by *Aquilar* and *Spinelli.*

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FEDERAL TAXATION—TAXPAYER HELD TO HAVE BENEFICIAL INTEREST AND TO QUALIFY FOR DEPRECIATION DEDUCTION WHERE HE MADE LITTLE INVESTMENT AND INCURRED NO LIABILITY AS MAJORITY SHAREHOLDER OF A CORPORATION AND TRANSFEREE SUBSEQUENT TO PURCHASE—LEASE BACK AND MORTGAGE AGREEMENTS. *BOLGER V. COMMISSIONER*, 59 T.C. 760 (1973).

May a corporation be created to buy industrial property, lease the property back to the seller, mortgage the property using the lease as security and then convey the property to the incorporator thus providing a liability free depreciation deduction to that taxpayer?

The Tax Court answered yes in *Bolger v. Commissioner.*[1] There the court approved a scheme which allowed the taxpayer and his associates to hold commercial property with most of the advantages and few of the headaches. The court considered two basic issues: (1) whether the financing corporation is a separate viable entity or merely a conduit for the property owner; and (2) if the corporate entity is recognized, whether the taxpayer acquires a depreciable interest from it. An affirmative answer was given to both by application of the Internal Revenue Code of 1954 (the "Code"), § 167, allowing depreciation for property used in trade or business to the taxpayer, and § 1011, adjusting the basis by including an unpaid mortgage balance. The Tax Court held that despite the circuitous land transactions divesting the corporation of its sole assets, it engaged in sufficient business activity to be recognized as a viable entity.[2] The taxpayer was entitled to a depreciable interest in the property because he and the other transferees had acquired legal title and the beneficial ownership by virtue of the transfer. The outstanding debt obligation of the mortgage was recognized by the court as

1. 59 T.C. 760 (1973).
2. *Id.* at 766.

the fair market value of the property and accepted as Bolger's basis despite the absence of his personal liability.[3]

David Bolger (the taxpayer) negotiated, in ten similar transactions, with a manufacturing or industrial concern to sell its property to a financing corporation established by him. This corporation was set up to lease the property back to the seller and then sell its own negotiable interest bearing notes in the amount of the purchase price to a commercial lender in a mortgage form.[4] The lease payments were aligned with the mortgage payments which in turn went directly from the lessee to the mortgagor, bypassing the corporation. The corporate shareholders, Bolger always being one, would then have the property conveyed from the corporation to themselves for the nominal sum of one dollar. This process permitted Bolger to: (1) obtain a loan for the purchase price thereby avoiding state usury restrictions on individual borrowers,[5] (2) shield himself from any liability, (3) create transferable fractional interests, (4) increase the marketability of the financing, and (5) deduct the property depreciation in his personal tax return.

Both the majority and minority in *Bolger* accepted the financing corporation as a corporate entity. Judge Tannewald's majority opinion showed little reservation in characterizing the financing corporation as "viable," noting its actions of buying, selling and mortgaging the property as satisfying the business activity test established by *Moline Properties, Inc. v. Commissioners.*[6] In that case the doctrine of corporate entity caused the questionable corporation, established by an individual who conveyed existing mortgages in return for all but the qualifying shares of stock, to be recognized as a "tax identity," because it discharged existing mortgages, and both rented and sold parts of the realty. In *Moline*, the Court saw no reason to disregard the corporate form and to consider it identifiable with the petitioner. On the other

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3. *Id.*
4. Both parties treated all ten transactions as if there were no significant differences, thus all references herein will be made in the singular. The price of each transaction when completed was one dollar.
5. Some states limit the interest rate for which an individual may contract but do not subject a corporation to such restrictions, *e.g.*, N.Y. GEN. OBLIGATIONS LAW § 5-501 (McKinney 1964); N.J. REV. STAT. § 31:1-1 (1973). Maryland law provides no such impediment. Art. 49, § 5 exempts all commercial loans in excess of $5,000 from Maryland usury regulations regardless of the nature of the contracting parties. *Cf.* B.F. Saul Co. v. West End Park, 250 Md. 707, 721, 246 A.2d 591, 600 (1968). Other advantages cited in the text indicate that it may be desirable to form a corporation. The sale-lease back formula being a purchase transaction, also escapes usury restrictions limiting the amount of a loan to a percentage of the appraisal value of the borrower company. Thus, the company can obtain capital equivalent to the price generated by the sale. *E.g.*, N.Y. INSUR. LAW § 87 (McKinney 1964).
6. 319 U.S. 436 (1943). The *Moline* Court stated:

   > The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity.

   Id. at 438-39 (citations omitted).

hand, the taxpayer argued that the facts of *O'Neill v. Commissioner*,[7] where corporations were formed to avoid the need to obtain the wife's signature in land transactions, and *Jackson v. Commission*,[8] where the sole purpose of two corporations was for the wife to hold property free of the husband's creditors, were analogous to the function of the present financing corporation and required the corporate form to be disregarded for tax purposes. The *Bolger* court disagreed and held that the financing corporation engaged in substantial business activity with a function considerably more active than a mere shell holding title to property, as was found to be the case in *O'Neill* and *Jackson*.[9]

In *Bolger* the taxpayer, seeking to establish his right to depreciation over that of the corporation, argued to have it recognized as his agent or nominee. Several exceptions to the doctrine of corporate entity were noted in *Moline*,[10] and the taxpayer relied upon the one established in *Southern Pacific Co. v. Lowe*,[11] which disregarded the corporate form where the corporation was the agent of the owner. The Southern Pacific Company solely owned and controlled the Central Pacific Railroad Company. The latter accumulated a considerable surplus consisting primarily of debits against the former. Central Pacific declared a stock dividend and the Commissioner ruled it to be income to Southern Pacific, which was the sole stockholder. The Supreme Court reversed and held that in reality the two companies were merged and that the dividend was no more than a paper transfer between two funds controlled by Southern Pacific. The rationale of *Southern Pacific* possesses only limited persuasive power for Bolger's case because the Supreme Court held that *Southern Pacific* turned on "its very peculiar facts"[12] and should be distinguished from cases where one seeks to identify his interest with a corporation. In *Bolger* the Tax Court rejected the agency-nominee argument without commenting, but a reading of the cases cited in the decision results in the same conclusion. *National Carbide Corp. v. Commissioner*[13] discussed the fallacy of the agency exception and declined to accept as one a corporation and its subsidiary corporation because an analysis of the facts[14] showed that the subsid-

7. 170 F.2d 596 (2d Cir. 1948).
8. 233 F.2d 289 (2d Cir. 1956).
9. 59 T.C. at 766.
10. 319 U.S. 436, 439 (1943).
11. 247 U.S. 330 (1918).
12. *Id.* at 339. Gulf Oil Corp. v. Lewellyn, 248 U.S. 71 (1918), is cited in *Moline* as disregarding the corporation form in favor of an agency relationship where a dividend was ruled to be mere "bookkeeping." 319 U.S. at 439.
13. 336 U.S. 422 (1949).
14. Subsidiary-owned assets approximated $22 million, net sales of $20 million and earnings approaching $4.5 million. The Court said:

> What we have said does not foreclose a true corporate agent or trustee from handling the property and income of its owner-principal without being taxable therefor. Whether the corporation operates in the name and for the account of the principal, binds the principal by its actions, transmits money received to the principal, and whether receipt of income is attributable to the services of employees of the principal and to assets belonging to the principal are some of the relevant

iary did not perform the duties of an agent. The *Bolger* court observed that in *Taylor v. Commissioner*,[15] where a corporation borrowed money, mortgaged property and entered buy-sell agreements, it had conducted sufficient business activity to forestall the agency exception. Similar reasoning was applied in *Paymar v. Commissioner*[16] where two closely owned property-holding corporations were formed solely to deter creditors. There the court was satisfied that the one securing a $50,000 loan fulfilled the business activity test while the second was ruled a sham, being but a passive dummy which merely held property titles. In order to establish that his transaction came within the agency exception, Bolger had the burden of showing that the sole business purpose of the corporation was the carrying on of the normal duties of an agent.[17]

However, after the corporation transferred the property (being the extent of its assets) to Bolger and his associates, the court still found continuing business activity of a corporate entity because the corporation was required by the lease,[18] mortgage and transfer agreements to remain in existence, acting as a liability shield and preserving its powers under state laws to own property and transact business.[19]

Once the majority concluded that the corporation should be recognized as a viable entity, the court considered whether Bolger was entitled to a deduction for depreciation. The Commissioner argued that Bolger, as transferee, acquired only a reversionary interest in the buildings and thus had no present interest which could be depreciated. The argument was predicated on the view that by the long term leases and financing transactions the corporation had divested itself of everything but bare legal title and thus had no depreciable interest which could be

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> considerations in determining whether a true agency exists. If the corporation is a true agent, its relations with its principal must not be dependent upon the fact that it is owned by the principal, if such is the case. Its business purpose must be the carrying on of the normal duties of an agent. Absence of the factors mentioned above, and the essentiality of ownership of the corporation to the existence of any "agency" relationship in the *Moline Properties, Commonwealth Improvement Co.* and *Southern Pacific* cases indicates the fallacy of the agency argument made in those cases.

Id. at 437-38 (citations omitted). The agency exception was similarly rejected in Harrison Property Management Co., Inc. v. United States, 475 F.2d 623 (Ct. Cl. 1973), because the agent-corporation would not have made oil lease agreements had the so-called principals not been its owners.

15. 445 F.2d 455 (1st Cir. 1971).
16. 150 F.2d 334 (2d Cir. 1945).
17. The Court in *National Carbide* sets out some basic characteristics of a true agency:

> [It] operates in the name and for the account of the principal, binds the principal by its actions, transmits money received to the principal, and whether receipt of income is attributable to the services of employees of the principal and to the assets belonging to the principal . . . .

336 U.S. at 437 (citations omitted).

18. The "net" lease form was used making lessee responsible for maintenance, taxes, repairs and insurance.
19. Subsequent to the transfer, the corporation participated in the refinancing of the San Antonio property thus conducting its on-going business purpose.

transferred to Bolger. The majority rejected this argument and concluded that Bolger had acquired full legal and beneficial ownership. Judge Tannenwald declared the lease to be a beneficial interest belonging to the corporation from the inception of the sale-lease back, saying that the lease served merely as security for the mortgage.[20] In accepting Bolger's right to depreciation, the majority found further support in the Commissioner's contention that the corporation was accountable for the rental income. The court ruled this argument to be logically inconsistent with the Commissioner's contention that the corporation was devoid of a transferable interest, for if the corporation held an interest which produced income it certainly had a depreciable interest which it could transfer.[21]

The possibility of the lessee (the original owner) being entitled to the depreciation was also ruled out by the *Bolger* court. The Commissioner argued that the present transaction was analogous to *World Publishing Co. v. Commissioner*,[22] where the taxpayer having purchased property subject to a lease was denied the depreciation deduction for a building constructed by the lessee because the landlord made no investment in the capital improvement. If adopted here, Bolger would not have a depreciable interest because the lessor-corporation would have had none to transfer. However the court rejected this reasoning saying simply that the parties had stipulated that the lessee was not entitled to the depreciation. Also, the court distinguished *World Publishing Co.* from *Bolger* because in the former the lessee's beneficial interest was clearly evident by his construction of the building being depreciated, whereas in the latter the court held the corporation-lessor had the beneficial ownership.[23]

Having determined that Bolger was subject to tax liability on the rental income and hence entitled to the depreciation deduction, the court next considered what the basis for his depreciation was to be. The unpaid balance of the unassumed mortgage was accepted by the majority as the fair market value of the depreciable property.[24] The question raised then was whether the unpaid balance could properly be considered part of the taxpayer's basis since Bolger had no personal liability on the mortgage. Section 167(G) provides for the depreciation to be determined in accord with the adjustment procedures prescribed for the gain on sale or other disposition of property under Code § 1011. The purchase price is generally accepted as the basis in fixing the gain or loss on the sale of property.[25] The ownership of property does not guarantee a right to depreciation.[26] To gain a deduction for depreciation the taxpayer must establish that he is incurring an economic loss by wear

20. 59 T.C. at 768.
21. *Id.*
22. 229 F.2d 614 (8th Cir. 1962).
23. *Id.* at 769.
24. *Id.*
25. Treas. Reg. § 1.1012-1 (1960).
26. Cogar v. Commissioner, 44 F.2d 554 (6th Cir. 1930); Gladding Dry Goods Co., 2 B.T.A. 336 (1925).

and deterioration of his business property.[27] The court stated that in view of the nominal consideration paid by Bolger and the absence of any liability, Bolger's situation was governed by *Crane v. Commissioner.*[28] In that case, Beulah Crane inherited an apartment building subject to a mortgage. By agreement with the mortgagee, Mrs. Crane continued to collect the rent, to reserve part for tax payments and to direct the net to the mortgagee, without assuming any liability on the mortgage. When the mortgagee threatened to foreclose, Crane sold the property subject to the mortgage. The *Crane* court determined that the taxpayer's basis for establishing the amount realized on the sale was the unpaid balance of the mortgage despite the lack of Mrs. Crane's personal liability for the mortgage payments.[29]

In applying the *Crane* doctine, the Bolger court, having earlier recognized the fair market value of the property to be equal to the remaining principal balance of the mortgage, considered the Commissioner's argument that the liability-free mortgage should only be allowed as Bolger's basis if he had a real economic investment in the property which he would seek to protect should mortgage foreclosure be threatened. The Commissioner argued that Bolger's nominal cash investment acquired no real interest. The majority refuted this reasoning by pointing out that Bolger did have an interest to protect. That interest was represented by Bolger's equity. As the rent payments retired the mortgage debt, Bolger received an ever increasing benefit which could be realized as a gain on the sale on his interest. Also, Bolger had an interest in any appreciation of the fair market value of the property. The Bolger court realized that the effect of this application of *Crane* allows an investor to recoup an investment for which he has laid out no cash and concluded by saying, "petitioner's case should not be treated differently merely because his acquisition of the property is completely financed and because his cash flow is minimal."[30]

Judge Quealy's dissent does not challenge the corporate existence but does assert that it is the corporation which should be held accountable for the income and is entitled to the depreciation. He directly disputes Bolger's beneficial ownership:

> To put the matter simply having transferred its entire interest in the lease-hold to a trustee to collect the rents and pay its indebtedness, I would regard the documents purporting to transfer the property to the petitioner and his associates as carrying no present interest. The petitioner had no present interest in the property which was subject to depreciation.[31]

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27. Commissioner v. Moore, 207 F.2d 265 (9th Cir. 1953).
28. 331 U.S. 1 (1947).
29. The *Crane* doctrine has not been limited to inheritance questions. Commissioner v. Korell, 339 U.S. 619, 628 (1950); First National Industries, Inc. v. Commissioner, 404 F.2d 1182, 1186 (6th Cir. 1968); Harsh Investment Corp. v. United States, 323 F. Supp. 409, 412 (D. Ore. 1970).
30. 59 T.C. at 771.
31. *Id.* at 775.

Had this line of reasoning been adopted by the majority, the *Crane* doctrine would have been inapplicable, since the corporation is the party subject to liability on the mortgage. Judge Quealy relied on *M. Dematteo Construction Co. v. United States.*[32] There the taxpayer purchased property which was subject to a lease and upon which the lessee had constructed a building. The useful life of the building was found to have expired before the taxpayer gained possession, so the purchaser could not acquire a depreciable interest. *Bolger* can be initially distinguished from *DeMatteo* in that the leases of the former will culminate at a time when some useful life of the building remains. *DeMatteo* is in conflict with *World Publishing Co. v. Commissioner*,[33] which held that it was illogical, for purposes of determining depreciable interest, to emphasize an historical fact (*i.e.* whether the lessor or the lessees constructed the building) which was neither participated in nor caused by the purchaser and which was of no economic consequence to him.[34] While *World Publishing* has been criticized[35] and is contrary to some recognized authority,[36] it nevertheless deserves weight equal to *DeMatteo* because the *World Publishing* court reasoned realistically that the taxpayer-purchaser in making the investment was not concerned with whether the lessee or the lessor had the depreciable interest; he was only concerned with acquiring an investment subject to depreciation. The *World Publishing* court concluded that the purchaser had bought a building which was a wasting asset and depreciation was therefore warranted.

Bolger's case is significant in that the Tax Court has recognized the legitimacy of a depreciation deduction as an incentive to the organizer of a sale-lease back transaction. This method of off-balance sheet financing has had a substantial impact on tax revenue to the government because many high income bracket taxpayers have been taking large depreciation deductions such as Bolger succeeded in claiming here. Sale-lease back transactions have become a fashionable financing method because they provide an attractive alternative to raising cash by mortgaging property and because they result in significant tax benefits to both parties. The outright sale of the business property allows the company to obtain more capital than might be otherwise raised through mortgage financing because state usury restrictions often limit the amount of a loan to a percentage of the appraised value of the company.[37] The credit of the company and the property to be acquired are the elements evaluated by the financier in determining the

32. 433 F.2d 1263 (1st Cir. 1970).
33. 299 F.2d 614 (8th Cir. 1962).
34. *Id.* at 622.
35. Comment, *Depreciation of Tenant-Erected Building by Purchaser of Fee*, 23 MD. L. REV. 353 (1963); Note, *Taxation-Depreciation of Tenant-Erected Improvements by Purchaser-Lessor*, 1963 WIS. L. REV. 484; 76 HARV. L. REV. 1303 (1963).
36. 4 MERTEN, LAW OF FEDERAL INCOME TAXATION § 23.90 (1966).
37. Cary, *Corporate Financing through the Sale and Lease-Back of Property: Business, Tax, and Policy Considerations*, 62 HARV. L. REV. 1, 2 (1948).

quality of the investment.[38] The purchaser, usually a land-investment trust or an insurance company, buys the property and then enters into a long term lease with the seller for a rent based on the amortization of the purchase price and an agreed rate of return.[39] The seller-lessee can now claim a deduction for the rental payments. This amount is substantially greater than the deductions available had the property been mortgaged because a borrower can only deduct the interest on the loan payments and the depreciation of the property. The main advantage to the buyer-lessor is the acquisition of a secure investment with a long term fixed return.[40] Of course, the rental payments will be treated as income to the purchaser under § 61 of the Code.

The result of these financing transactions is that Bolger will initially realize a substantial tax saving. The total depreciation and interest rate deductions will, at the outset, exceed the tax on the rental income, thereby resulting in sheltered income. However, the tax shelter advantages of this transaction will diminish once the deductions for interest and depreciation have decreased to an amount that will not cancel out the fixed rental income. Bolger will surely wish to dispose of the property before the tax shelter begins to collapse. This disposition will also result in possible detrimental tax consequences to Bolger in the form of depreciation recapture. However, a discussion of these consequences is beyond the scope of this note.

There is no real paradox present in adjusting Bolger's basis by an amount equal to the mortgage, despite the fact that he did not assume it, thereby allowing depreciation based on the face amount. Likewise the holding that no gain has been realized upon transfer is logical, since the gain is merely postponed until the mortgage is discharged. Bolger will realize a taxable gain either when the rental payments erase the encumbrance or when he sells the property pursuant to his powers under the assumption agreement entered into at the time of the nominal sale.

While perhaps not representing a landmark decision in tax law, the *Bolger* case is significant in its recognition that such sophisticated transactions as involved here are permissible within the present tax scheme.

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38. S. McMichael & P. O'Keefe, Leases; Percentage, Short and Long Term 108 (5th Ed. 1959).
39. *Id.* at 111.
40. *Id.* at 109.