November 2009

Dear ,

This issue of the WKBK&Y newsletter addresses:

1. 2010 Roth IRA Conversion

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3. Economic Substance of Sale / Repurchase Transactions

1. **2010 Roth IRA Conversion**

Introduction

The Roth IRA which was initially introduced in the 1990s provided a unique wealth generation opportunity – the ability to pay tax once and never again! Unfortunately, many taxpayers are prohibited from contributing to a Roth IRA since in 2009 a single taxpayer is phased out at $114,000 ($176,000 for joint filers). Furthermore, taxpayers with a modified AGI over $100,000 are precluded from converting an account into a Roth IRA.

However, for tax years starting after 2009 the $100,000 limit for converting another account into a Roth IRA is removed, allowing accounts such as 401(k)s, 403(b)s, SEP IRAs, profit sharing plans, and traditional IRAs to be converted to a Roth IRA. This article gives a brief overview of the rules and planning considerations regarding Roth IRA conversions.

Discussion

The Tax Increase Prevention and Reconciliation Act of 2005 amended Internal Revenue Code ("Code") section 408A(c)(3) so that starting in 2010 taxpayers will be able to convert their accounts into Roth IRAs. Unlike contributions to IRAs, there is no limit on the amount that can be converted to a Roth IRA.

It is important to note that when a tax-deferred account, such as a traditional IRA, is converted to a Roth IRA, the taxpayer must pay taxes on the taxable portion of the amount converted. The new law also amended Code section 408A(d)(3)(A)(iii) to cushion the tax hit by allowing a taxpayer to include half of the taxes resulting from the conversion in gross income in 2011 and the other half in 2012.

Also, a taxpayer may not choose to convert only the non-deductible the portion of their traditional IRA; instead, a taxpayer is deemed to convert a pro-rata portion of the amount in their

IRA account. For example, if an IRA account consists of $50,000 of non-deductible contributions and $150,000 of deductible contributions, and the taxpayer converted $100,000 into a Roth IRA, the taxpayer would be deemed to have converted $25,000 of non-deductible contributions and $75,000 of deductible contributions.

Perhaps the most taxpayer-friendly portion of the Roth conversion rules is not part of the new law but nonetheless provides a well-received cushion. Code section 408A(d)(6) provides a taxpayer with an option to choose to un-convert (or recharacterize) amounts converted into a Roth IRA. By allowing the taxpayer to undo the Roth conversion, the taxpayer can convert an account into a Roth IRA and then not be bound to pay taxes on the amount converted if the value of the account subsequently depreciates of if the taxpayer's circumstances change. This effectively allows a taxpayer to make conversion decisions using 20/20 hindsight. A taxpayer generally has until the due date of his tax returns including extensions (usually Oct. 15) to recharacterize the Roth conversion. The taxpayer can then convert the account back into a Roth IRA in the later of 30 days or the year after the year in which the conversion occurred.

> <u>Example 1</u>. *On July 15, 2009, a taxpayer converts $100,000 from a traditional IRA into a Roth IRA. During 2010 the balance in the converted Roth IRA depreciates to $50,000. As things stand, the taxpayer will owe taxes based on $100,000. On February 1, 2010, the taxpayer recharacterizes the Roth IRA back to a traditional IRA and avoids paying taxes in connection with the conversion. The taxpayer can then reconvert the traditional IRA into a Roth IRA and pay taxes based on the depreciated account balance.*
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> <u>Example 2</u>. *On January 10, 2010, a taxpayer converts a traditional IRA into a Roth IRA. During 2010 the balance in the converted Roth IRA significantly depreciates. On November 1, 2010, the taxpayer recharacterizes the Roth IRA back to a traditional IRA and avoids paying taxes in connection with the conversion. The taxpayer can then reconvert the traditional IRA into a Roth IRA as early as January 2011 (the later of 30 days or the next tax year after conversion.)*
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> <u>Example 3</u>. *Assume the same facts as Example 2 except the taxpayer does not recharacterize the Roth IRA back to a traditional IRA until October 15, 2011. The taxpayer then reconverts the traditional IRA into a Roth IRA on November 15, 2011 since the taxpayer only have to wait 30 days since 2011 is the next tax year after conversion.*

<u>Advantages</u>

The main advantage of a Roth IRA is that one will generally never need to pay taxes on gains or distributions. Beyond the ramifications regarding the potential to grow and keep wealth, a consideration of future tax rates also plays into the decision of whether to convert to a Roth IRA, especially for those taxpayers who expect to maintain high taxable incomes in the retirement years.

In addition, one's need for cash and estate planning concerns should be considered. A traditional IRA is subject to required minimum distributions starting at age 70½ with substantial penalties if the required minimum distribution is not distributed; however, Roth IRAs are not subject to required minimum distributions during the owner's lifetime. Thus if one does not need the income from a Roth IRA for living expenses, the account can be left alone to grow in value and can later be used to fund specific purchases or even to be passed to a beneficiary at death. The beneficiary will also receive distributions from the Roth IRA tax free which can provide a substantial benefit to the beneficiary if they are either at the height of their earning power and subject to high tax rates or nearing retirement where a lower taxable income will positively effect the taxation of social security benefits and the tax free income from the Roth IRA will provide an extra cushion during the retirement years.

Disadvantages

Potential disadvantages should be considered when contemplating converting an account into a Roth IRA. First, it is important to remember that in the case of a converted Roth IRA, beyond the requirement that the taxpayer be 59½ to receive tax free distributions, the taxpayer must also wait 5 years from the date of conversion he can receive a tax free distribution. Therefore, even if a taxpayer is 65 at the time of conversion tax free distributions will generally not be allowed until the taxpayer is 70.

While a traditional IRA is not taxed until distributions are taken, the tax due on a Roth IRA conversion can be substantial and are incurred at the time of conversion. If a taxpayer does not have funds available to pay the related taxes and must use a portion of their traditional IRA or 401(k) to pay such taxes, the taxpayer may be subject to a 10% early withdrawal penalty in addition to the regular tax due on the distribution. Thus, if a 50 year old taxpayer in a high marginal tax bracket plans to convert a traditional IRA with a balance of $100,000 into a Roth IRA, approximately half of the account balance could go taxes and the early withdrawal penalty, with only $50,000 actually being converted to the Roth IRA.

Given the high balances that many taxpayers have in retirement accounts, such as one's 401(k), the tax liability in connection with converting an account into a Roth IRA could exceed the taxpayer's current year income. While the special rules for 2010 cushion the impact by allowing the taxes in connection with a Roth conversion to be paid over 2 years, paying the tax liability is an important consideration especially as personal income is expected to be depressed in the short-term. However, it is important to note that the full balance in an account need not be converted, and a taxpayer does have the option to convert only a portion of an account.

Finally, a taxpayer's marginal tax bracket should be considered. If a taxpayer is in the top tax brackets, only a few years away from retirement and expects to draw upon their retirement accounts in early retirement a Roth conversion may not make sense even if the taxpayer is expected to drop multiple tax brackets and tax rates do go up. In addition, many taxpayers retire to states that have a lower or no tax on income.

WKBKY Takeaway

Roth IRAs provide an unprecedented opportunity for wealth growth and the elimination of the income limitation for Roth IRA conversions provides a wonderful opportunity for higher income taxpayers. However, Roth conversions are not for everyone and those who do decide to go forward with a Roth conversion need to fully understand the rules so as to minimize taxation and protect their investments and, in many cases, their retirements.

RIA has published the following as a sample letter to clients who may be affected by the change.

Dear Client:

I am writing to tell you of an interesting new rollover opportunity that's coming up in a few months. After 2009, you will be able to roll over amounts in qualified employer sponsored retirement plan accounts, such as 401(k)s and profit sharing plans, and regular IRAs, into Roth IRAs, regardless of your adjusted gross income (AGI). Currently, individuals with more than $100,000 of adjusted gross income as specially modified are barred from making such rollovers.

What's so attractive about a Roth IRA? Here's a summary:

- Earnings within the account are tax-sheltered (as they are with a regular qualified employer plan or IRA).
- Unlike a regular qualified employer plan or IRA, withdrawals from a Roth IRA aren't taxed if some relatively liberal conditions are satisfied.
- A Roth IRA owner does not have to commence lifetime required minimum distributions (RMDs) after he or she reaches age 70 1/2 as is generally the case with regular qualified employer plans or IRAs. (For 2009, there's a moratorium on RMDs.)
- Beneficiaries of Roth IRAs also enjoy tax-sheltered earnings (as with a regular qualified employer plan or IRA) and tax-free withdrawals (unlike with a regular qualified employer plan or IRA). They do, however, have to commence regular withdrawals from a Roth IRA after the account owner dies.
- The catch, and it's a big one, is that the rollover will be fully taxed, assuming the rollover is being made with pre-tax dollars (money that was deductible when contributed to an IRA, or money that wasn't taxed to an employee when contributed to the qualified employer sponsored retirement plan) and the earnings on those pre-tax dollars. For example, if you are in the 28% federal tax bracket and roll over $100,000 from a regular IRA funded entirely with deductible dollars to a Roth IRA, you'll owe $28,000 of tax. So you'll be paying tax now for the future privilege of tax-free withdrawals, and freedom from the RMD rules.

Should you consider making the rollover to a Roth IRA? The answer may be “yes” if:

- You can pay the tax hit on the rollover with non-retirement-plan funds. Keep in mind that if you use retirement plan funds to pay the tax on the rollover, you'll have less money building up tax-free within the account.
- You anticipate paying taxes at a higher tax rate in the future than you are paying now. Many observers believe that tax rates for upper middle income and high income individuals will trend higher in future years.
- You have a number of years to go before you might have to tap into the Roth IRA. This will give you a chance to recoup (via tax-deferred earnings and potentially tax-free payouts) the tax hit you absorb on the rollover. In other words, the future potentially tax-free withdrawals can more than offset the tax paid up front.
- You are willing to pay a tax price now for the opportunity to pass on a source of tax-free income to your beneficiaries.

You also should know that Roth rollovers made in 2010 represent a novel tax deferral opportunity and a novel choice. If you make a rollover to a Roth IRA in 2010, the tax that you'll owe as a result of the rollover will be payable half in 2011 and half in 2012, unless you elect to pay the entire tax bill in 2010.

Why on earth would you choose to pay a tax bill in 2010 instead of deferring it to 2011 and 2012? Keep in mind that absent Congressional action, after 2010 the tax brackets above the 15% bracket will revert to their higher pre-2001 levels. That means the top four brackets will be 39.6%, 36%, 31%, and 28%, instead of the current top four brackets of 35%, 33%, 28%, and 25%. The Administration has proposed to increase taxes only for those making $250,000, but it is difficult to predict who will get hit by higher rates. What's more, there's a health reform proposal before the House of Representatives right now that would help finance healthcare reform with a surtax on higher-income individuals.

So if you believe there's a strong chance your tax rates will go up after 2010, you may want to consider paying the tax on the Roth rollover in 2010.

Here are some ways individuals can prepare now for next year's rollover opportunity.

(1) Non-high-income individuals who are able to make deductible IRA contributions this year should do so. They'll reduce their 2009 tax bill and, if they make the conversion to Roth IRA next year, they won't have to pay back the tax savings until 2011 and 2012.

(2) Individuals who have never opened a traditional IRA because they weren't able to make deductible contributions (and who never rolled over pre-tax dollars to a regular IRA) should consider opening such an IRA this year and making the biggest allowable nondeductible contribution they can afford. If they convert the traditional IRA to a Roth IRA next year they will have to include in gross income only that part of the amount converted that is attributable to income earned after the IRA was opened, presumably a small amount. In 2010 and later years, they could continue to make nondeductible contributions to a traditional IRA and then roll the contributed amount over into a Roth IRA. However, note that if an individual previously made deductible IRA contributions, or rolled over qualified plan funds to an IRA, complex rules determine the taxable amount.

(3) Some high-income individuals may plan to make large conversions in 2010 but to opt out of the deferral of tax until 2011 and 2012 because they fear they will be in a higher tax bracket in those years than in 2010. These individuals should avoid the standard year-end-planning wisdom of accelerating deductions and deferring income but should, rather, do the reverse in an effort to avoid being pushed into the highest brackets by a large IRA-to-Roth-IRA conversion in 2010. These individuals should be considering ways to defer deductions to 2010, and accelerate income from next year into 2009.

We should discuss your and your family's entire financial situation before you plan for a large rollover to a Roth IRA after 2009. There also are many details that we should go over, such as whether the amounts you are thinking of switching to a Roth IRA are eligible for the rollover (technically, they are called “eligible rollover distributions”), whether you can make rollovers from your employer sponsored plan (for example, there are restrictions on rollovers from 401(k) plans), and the tax impact of rolling over amounts that represent nondeductible as well as deductible contributions.

I'm looking forward to your call.

2. Potential Modifications to Proposition 13

Introduction

Two new initiatives were recently filed for Title and Summary with the California Attorney General’s Office to modify Proposition 13. The Education and Taxpayer Fairness Act and the Protect Homeowners (ETFA) and Close Corporate Tax Loopholes Act (CTLA).

Discussion

Generally, these initiatives propose to remove commercial real estate from the Proposition 13 property tax protection, but leave current Proposition 13 property tax law protections in place for all residential housing, including apartments. ETFA proposes to increase the property tax rate to 1.55% for nonresidential property beginning January 1, 2011 (previously 1%). CLTA proposes to allow nonresidential real property to be reassessed every three years, beginning January 1, 2012 (previously there was no reassessment without a change of ownership).

While the initiatives appear to correct the all or none reassessment ambiguity with multi-family units and mixed use properties from a similar initiative four years ago, the current initiatives still leave several uncertainties. In particular, reference to nonresidential property as including any real property, unless exempted wherein exemption includes a single family or multi-family dwelling unit or any portion for residential use, mixed use properties remain an issue as to how Proposition 13 will continue to apply. For bed and breakfasts, personal mixed use lofts/warehouse districts, i.e., Artists Quarters, commercial/business use of personal residences and for multifamily units, areas used for laundry/vender rooms, offices and leased retail space, guidance will be needed as to whether there will be systems of apportionment between uses and whether annual filings/proof will be required as residential usage can/will change from year-to-year. Also, a third petition has been filed that would reduce from approx. 66.6 to 55 percent the local voter approval necessary to increase local property taxes and parcel taxes on all real property.

There is no prediction as to whether adequate signatures will be obtained or whether these initiatives will pass. In past discussions with Jonathan Coupal, president of Howard Jarvis Taxpayers Association, with regards to the previous initiative process, they were able to convince the author to withdraw the initiative (despite adequate signatures) due to defects in the legislative language. It is unclear that this approach will again be taken or will cause the initiatives to be dropped. A major concern for the commercial property owners is the effect of passage on their properties wherein increased property taxes may destabilize properties already experiencing negative cash flow on their gross leases and increasing the number of defaulting tenants due to their choice to default rather than pay the increased property taxes.

Finally, to encourage voter support, the initiatives propose an increase in homeowners' property tax exemption from $7,000 to $14,000 saving a small $70 in property taxes, an increase in the personal property tax exemption to $1 million in business assets, and a promise to double the current renters credit to $240 or $120, depending on taxpayer's gross income ($0 over $50,000).

WKBKY Takeaway

WKBKY will continue to monitor the initiatives as the potential impact may not only be substantial in the current environment in which commercial business are very much struggling but also seem to set the stage for further changes in the property tax laws.

3. Economic Substance of Sale / Repurchase Transactions

Introduction

This article discusses the law with respect to a sale / repurchase transaction ("sale/repo") and whether and when the form of such a transaction is respected under tax law. A number of cases have held that the circumstances surrounding certain sale/repos economically resemble a financing arrangement more than a sale and repurchase.

With the economic conditions as they are, many clients may see a sale/repo of real property as a way of both meeting short-term finance needs while allowing for a potential tax loss (perhaps freeing additional capital) and retaining the potential to reacquire the old property should economic conditions sweeten. If a sale/repo is recast as a financing transaction, a taxpayer with a built-in loss would be prevented from recognizing that loss in the year in which the "sale" occurred, and the transaction will be treated as a mortgage, giving the client a small fraction of the tax benefit through an interest deduction.[1] Depending on the facts and a client's goals, this result can likely be avoided (or planned around) under existing legal authority.

History of the Economic Substance Doctrine

A great deal of case law exists in analyzing whether a transaction formed as a sale would be recast as a loan in substance and thus treated as such for tax purposes. For example, in American Realty Trust v. U.S.,[2] the taxpayer transferred real property to the transferee and leased it back with a voluntary option to repurchase. The IRS argued that the sale-leaseback did not effect a transfer of true ownership of the real property and recast the transaction as a loan. In affirming the district court, the Fourth Circuit focused on the intent of the parties to the transaction. The court concluded that the intent of the parties, acting in good faith, was to enter into the sale-leaseback and not a loan.

The approach adopted by the Supreme Court in Lazarus & Co. and the Fourth Circuit in American Realty Trust was to focus on the intent of the parties in entering into the transaction. Both courts were primarily concerned with whether the parties themselves viewed the transactions as a sale-leaseback or a loan. In Frank Lyon Co. v. U.S.,[3] the Eighth Circuit chose instead to examine the respective ownership rights held by the parties. Analogizing property rights to a "bundle of sticks," the court determined which party had the larger bundle. In Frank Lyon, a transferor transferred real property to the taxpayer and leased it back from the taxpayer with a voluntary option to purchase. The Supreme Court held the transaction was a valid sale-leaseback. Although the Court reversed the Eighth Circuit, it adopted the Circuit's approach focusing on the economic realities of the transaction, as opposed to merely inquiring into the subjective intent of the parties in entering the transaction, which had been the approach before the Eighth Circuit's opinion in Frank Lyon.

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[1] Of course, a loss could be recognized at the time of "foreclosure".

[2] 498 F.2d 1194 (4th Cir. 1974).

[3] 536 F.2d 746 (8th Cir. 1976), rev'd, 435 U.S. 561 (1978), 1978-1 C.B. 46.

The Sale/Repo Analysis in General

The Tax Court has noted that where "[a] deed [is] absolute on its face the transaction must be considered a sale unless it can be shown by clear and convincing evidence that it was intended to be a mortgage or security transaction. Peugh v. Davis, 96 U.S. 332 [(1878)]; Johnson v. National Bank of Commerce, 65 Wash. 261 … [(1911)]."[4] Perhaps in search of this type of evidence, the tax court, circuit courts and IRS have analyzed a number of objective factors (consistent with Frank Lyon) to determine the economic consequences of a sale/repo to determine whether the form of the transaction would be respected for tax purposes; where the facts suggest a transaction in the nature of a mortgage, tax law will calculate the tax ramifications as such. For instance, the law is settled that whether a sale has taken place for federal income tax purposes is determined by whether the benefits and burdens of ownership have been transferred.[5] The facts and circumstances of each case are relevant,[6] and implicit in the analysis of the benefits and burdens of ownership is the determination of whether the transaction fairly allocates economic risk considering all the agreements as a whole.[7]

Between five and eight factors have been recognized to apply in determining the economic substance of a sale/repo:

1. whether legal title passes;
2. how the parties treat the transaction;
3. whether an equity was acquired in the property;
4. whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments;
5. whether the right of possession is vested in purchaser;
6. which party pays property taxes;
7. which party bears the risk of loss or damage to the property; and
8. which party receives the profits from the operation and sale of the property.[8]

A similar analysis is captured in the IRS' five-factor approach in Rev. Rul. 74-27 (the "74-27 Factors"):

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[4] Vickers v. Comm'r, TC Memo 1977-90.

[5] See, e.g., Franklin Est. v. Comm'r, 544 F.2d 1045 (9th Cir. 1976); Swift Dodge v. Comm'r, 692 F.2d 651 (9th Cir. 1982); Union Planters Nat'l Bank of Memphis v. U.S., 426 F.2d 115 (6th Cir.

[6] Citizens Nat. Bank of Waco v. U.S., 551 F.2d 832 (Ct. Cl. 1977).

[7] See Alex Raskolnikov, "Contextual Analysis of Tax Ownership," 85 B.U. L. Rev. 431, 499-501 (2005) (synthesizing the case law on the issue).

[8] See Alex Raskolnikov, "Contextual Analysis of Tax Ownership," 85 B.U. L. Rev. 431 (2005), citing factors listed in Grodt & McKay Realty, Inc. v. Comm'r, 77 TC 122 (1981).

1. whether the identical securities which are "sold" to the bank are required to be held by it for repurchase by the customer;
2. whether upon the customer's failure to repurchase the securities and to make payment therefor as stipulated, the bank may sell the securities, apply the proceeds to the repurchase price, and either credit the dealer with the excess or hold him liable for a deficiency;
3. whether the dealer is legally bound both to repurchase the securities and to pay a deficiency remaining unpaid after application of the proceeds of a sale (the customer not having a mere option to repurchase);
4. whether the customer agrees to pay interest at a stipulated rate upon the amount advanced by the bank; and
5. whether the value of the securities bears a reasonable relationship to the amount advanced by the bank.

Sale/Repos – Tax-Exempt Bonds

The typical sale/repo of tax-exempt bonds illustrates the analysis. In this situation, a securities dealer "sells" tax-exempt bonds to a bank, and through a combination of put and /or call options, through a tacit understanding with the dealer, or by a history of conduct, the dealer will repurchase the bonds at par value plus accrued interest. While the bank "owns" the property, the dealer finds a purchaser for the bonds, and once he does, the dealer repurchases the bonds from the bank at par for sale to the customer. The banks attempted to claim that the interest earned during their "ownership" of the bonds was tax-exempt under applicable tax law. Most of the courts addressing these cases found that in fact the transaction was not a true sale of the securities to the bank but was in substance a loan collateralized by a pledge of the bonds, focusing heavily on the benefits and burdens of ownership, the allocation of risk among the parties, and the frequency with which such transactions were entered into.

For example Union Planters,[9] the court held that no sale had occurred because the structure of the transaction bore more resemblance to a financing transaction than it did to a sale. In Union Planters, the bank purchased the bonds plus a put option to force the dealer to resell at the bank's option. The puts were never exercised because the bank would simply approve a repurchase whenever a dealer requested one, even though the bank was not required to do so; the court found it significant that the bank approved the repurchases as a matter of course. Moreover, the repurchase price matched exactly the original sales price, which, combined with the bank's put right, protected the bank from taking any risk of market fluctuations in the price of the bonds. The bank further protected its risk by requiring the dealer to post additional money sufficient to protect an asset's decline in value (which the court analogized as the posting of additional collateral). The court held that the transaction did not economically resemble a sale because the dealers, through their sales efforts, essentially treated the bonds as their own and because the bank was fully protected from decline in the asset's value. The court held the

[9] 426 F.2d 115 (6th Cir. 1970).

transaction was in substance pledge of the bonds as security for a loan from the bank.[10] The court cogently identified and summarized the risk allocation element of its analysis: "In contrast [to the transaction that occurred in this case,] in a transaction that could be characterized as a sale for tax purposes, we would expect the Bank, rather than the dealer, to assume the risk of fluctuations in the market value of the bonds."[11]

Similarly, Rev. Rul. 74-27 involved the characterization of a transaction wherein all five 74-27 Factors were found to be against the taxpayer's favor. On these facts, the IRS held that the transaction was in substance a loan even though in the form of a sale/repo. The IRS only found the first three 74-27 Factors to be relevant in Rev. Rul. 82-144 in finding in the taxpayer's favor. In Rev. Rul. 82-144, the taxpayer was a Massachusetts business trust, taxed as a corporation, which engaged in sale/repos as the purchaser of tax-exempt bonds. Concurrent with the purchase, the trust also purchased puts (for an economically reasonable price) that would require the original seller to repurchase the bonds if exercised; these puts were for terms substantially less than the life of the obligations to which they applied, were nonassignable, and terminated if the trust disposed of the bond to which the put related. The IRS noted the lack of a call option by the dealer and the lack of any transfer restrictions imposed on the trust. On these facts, the IRS reasoned that the sale to the trusts were recognized for tax purposes because the puts were in place to increase the trust's liquidity rather than to insulate it from loss and because the trust paid an arm's length price for the puts.[12]

The principle of risk-allocation is demonstrated in Citizens National Bank of Waco v. U.S.,[13] the one case that has given tax effect to the form of a sale/repo. In Citizens Bank, the Court of Claims recognized a number of factual and economic distinctions that led to a result divergent from that reached in Union Planters and related cases. Just as in Union Planters, the dealer gave the taxpayer a put option with respect to the bonds, the puts were never exercised, and the taxpayer instead agreed to repurchase the bonds whenever the dealer made such a request. The repurchase price matched the sales price; however, the court specifically identified the purpose of the put giving the bank the ability to fulfill its legal liquidity obligations. Significantly, however, the taxpayer had the legal right to sell the bonds while it owned them, even though such a sale never occurred. Also lacking from the fact pattern was a requirement that the dealer compensate the taxpayer for any drop in the value of the property at issue (as was

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[10] See also First Amer. Nat. Bank of Nashville v. U.S., 327 F. Supp. 675 (6th Cir. 1972); Amer. Nat. Bank of Austin v. U.S., 421 F.2d 442 (5th Cir. 1970).

[11] This language alone seems to suggest that the allocation of risk to the "owner" of the property is an essential fact—presumably, were the facts of Union Planters to include a *call* rather than *put* option, the risk would instead fall on the bank, and the analysis would ostensibly fall upon whether the price paid for the call was economically reasonable *ab initio*.

[12] "First, unlike the facts in Rev. Rul. 74-27 … or *Union Planters* … , the taxpayer paid an arm's length price for the 'puts'. The price paid for the 'puts' represented the taxpayer's and [the dealer's] estimation of the value of the risk that [the dealer] was assuming under the 'puts', independent of the taxpayer's acquisition of the obligations. Secondly, the primary purpose of the 'puts' was to increase the liquidity of the taxpayer's portfolio of obligations rather than to shift the risk of loss. Third, unlike the facts in Rev. Rul. 74-27 … and *Union Planters* … where the risk of loss was transferred for the entire period the securities were held, the shifting of risk under the facts described herein was for a definite period that was for substantially less than the life of the obligations." (Rev. Rul. 82-144.)

[13] 551 F.2d 832 (Ct. Cl. 1977).

the case in Union Planters). Stating the government's position that the sale/repos were in substance loans was largely speculative, the court listed 23 objective facts that led to its conclusion that the form of the transaction should be respected.

Sale/Repos – Real Property

Vickers and PLR 9217010 are two authorities that deal with the sale/repo issue in the context of real property. In Vickers, the court found the sale/repo to be in substance a financing transaction ostensibly using the Frank Lyon "bundle of sticks" approach. The taxpayers executed a sale/repo of their property to finance a corporation they owned. The taxpayers could not exercise their option prior to expiration of the option term. The taxpayers claimed that the transaction, though in the form of a sale, was intended to be a security transaction, culminating in a loss of the property to the mortgagee. The IRS argued that the taxpayers sold the property to the third party. The court held that the transaction was a security transaction in the form of a deed coupled with agreement to reconvey the property. The court found that the taxpayers always intended for the transaction to be a loan, even though the third party viewed the transaction as a sale. In making its determination, the court focused on the fact that the taxpayers paid the taxes, utilities and other expenses during the "buyer's" ownership period. Fatally (to the IRS' position), the IRS allowed taxpayer to claim deductions on the property in prior year(s). The court recast the sale/repo as a loan based on its finding of the taxpayer's intent, the taxpayer's practice, and the IRS' history of accepting the taxpayer's characterization.

PLR 9217010 distinguished Vickers on the basis of the IRS' implicit acceptance of the treatment of the transaction as a loan and subsequent change in position as a basis for the distinction, suggesting that the facts of Vickers may not be particularly relevant in analyzing other cases.[14] This PLR again presents facts wherein the taxpayer (rather than the IRS) attempted to disregard the form of the sale. The taxpayer entered into four separate purchase agreements for four different parcels of real property. Subsequently, but prior to closing on the properties, the taxpayer executed an agreement to sell the properties to a joint venture specifically organized for the purchase and development of the parcels. To fund its original purchase, taxpayer subsequently executed a repurchase agreement with the joint venture. The transaction was structured such that the taxpayer could not simultaneously close on the four purchases and sell them to the joint venture. The joint venture took title to the properties for approximately 120 days, with two of the properties being transferred directly from the original owner to the joint venture.

The taxpayer wished to treat the transaction as a financing arrangement and disregard the sale/repo form. The IRS analyzed the transaction largely by reference to the "benefits and burdens" of ownership, addressing several factors discussed herein. First, the IRS noted the exorbitant profit that the joint venture made on the sale, suggesting that the joint venture indeed

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[14] In fact, in an unpublished opinion, the Ninth Circuit has explicitly rejected the precedential value of Vickers, stating that neither it nor the Tax Court finds a Tax Court Memorandum Opinion to be binding, but acknowledging that even under Vickers, the ultimate question is one of intent. (U.S. v. Bontrager, 1995 U.S. App. LEXIS 23776 (9th Cir. 1995), footnote 2, citing Inverworld, Ltd. v. Comm'r, 979 F.2d 868, 878 n.9 (D.C. Cir. 1992) and Nico v. Comm'r, 67 T.C. 647, 654 (1977) ("We consider neither revenue rulings nor Memorandum Opinions of this Court to be controlling precedent.").)

owned an equity interest in the properties. Second, the joint venture had full rights to enter onto and possess the properties. The taxpayer was credited for real property taxes owing and not paid by the joint venture in the repurchase, suggesting that the joint venture was legally liable for these taxes during its 120-day ownership period. The risk of loss or damage seemed to fall more on the taxpayer's side, as the taxpayer's obligation and price to repurchase the properties was unequivocal (rather than an option to repurchase); the joint venture's profit was certain unlike the case of a call option, where the "owner" bears some risk of market fluctuations. The IRS dismissed Vickers as a special case of the IRS taking inconsistent positions and found it inapplicable to the facts presented. Reviewing the facts in the light of the relevant factors, in particular the joint venture's 50% profit for a 120-day investment, the IRS held that the form of the transaction (as a sale/repo to the joint venture) would be respected for tax purposes.

WKBKY Takeaway

While some tax-recharacterization risk may be inherent in any sale/repo, much of this risk can be mitigated. The two elements at the heart of this multi-factor analysis under the law cited are (1) whether the agreements represent a reasonable allocation of risk for the parties; and (2) upon whom are the benefits and burdens of ownership allocated. By using reasonable terms for the component agreements, and by ensuring that the parties' actions post-sale are consistent with the buyer's ownership of the property, a client should be able to avoid a Union Planters result.

The law is inconsistent on a pure factual comparison basis—the same facts will lead to differing conclusions under different circumstances. To understand the disparity is to understand that the key is in economic reality. This translates roughly to appropriate risk and cost allocation. To be a true owner means to bear the burdens of ownership and to bear the risk of value fluctuations. The buyer in the sale/repo can hedge this risk by using options, but those option terms have to be reasonable.

In sum, the validity of a sale/repo's form will depend entirely on its own facts and circumstances. While the majority of cases addressing this issue tend to side with loan treatment, the contrary authority offers excellent insight into the types of terms that will minimize the risk that the form will not be respected. By recognizing the key elements of risk and the benefits and burdens of ownership, a client may, through proper planning (if otherwise consistent with his economic goals), be able achieve a tax loss on a sale/repo.

We hope that you find these items of interest to you. If you need further information or would like to discuss a particular issue, feel free to call any one of the lawyers listed below. We will get you to the right person.

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