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THE SUPREME COURT IN THE *LYON'S* DEN: A FAILURE OF JUDICIAL PROCESS*

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On average, the Supreme Court has heard fewer than four civil tax cases a year in the last decade.[1] Its decision to consider a tax case represents a commitment of scarce and valuable resources to the resolution of issues of statutory construction that are usually difficult, intricate, and important. Hardly an enclave of tax experts, the Supreme Court relies for illumination and protection on the validity of a basic assumption of the adversary process: that strong and effective advocates bring the issues into focus and marshal the strongest arguments for each side, thus educating the Court and helping it reach the best result. And the stakes are high, for each case not only affects the immediate fortunes of the litigating taxpayer and the Treasury, but it also has potentially widespread repercussions as lawyers structure future transactions with the new judicial guideposts in mind.[2]

Frank Lyon Co. v. United States,[3] the Court's most recent attempt to deal with the problem of allocating depreciation deductions in real estate financing transactions, illustrates the point. In the three years since the case was decided, it has had a pervasive impact on real estate arrangements. Lawyers now tailor transactions to take advantage of the tax sheltering opportunities created by the *Frank Lyon* opinion. But the example of *Frank Lyon* does not reflect well on the Court or the adversary process. The Court's decision and opinion manifest an understanding that is questionable at best. The poor outcome, dis-

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[1] *The Supreme Court, 1970 Term through 1979 Term*, 85-94 HARV. L. REV., November, Table III. *See also* B. WOLFMAN, J. SILVER, & M. SILVER, DISSENT WITHOUT OPINION, THE BEHAVIOR OF JUSTICE WILLIAM O. DOUGLAS IN FEDERAL TAX CASES 141-66 (1975) (earlier version at 122 U. PA. L. REV. 235, 331-56 (1973)).

[2] Frank Lyon Co. v. United States, 435 U.S. 561, 580 (1978) ("We cannot ignore the reality that the tax laws affect the shape of nearly every business transaction."); Commissioner v. Brown, 380 U.S. 563, 579-80 (1965) (Harlan, J., concurring) ("[T]he tax laws exist as an economic reality in the businessman's world, much like the existence of a competitor. Businessmen plan their affairs around both, and a tax dollar is just as real as one derived from any other source.").

[3] 435 U.S. 561 (1978).

turbing as it is, may nevertheless be the least objectionable aspect of the case, for even the best of process will occasionally produce a flawed opinion and a wrong result. It would be comforting to think of *Frank Lyon* as such an aberration, but the story of this case casts some doubt on the adversary system itself as a reliable vehicle for attaining justice in tax disputes and for producing sound and authoritative interpretation of the Internal Revenue Code. The weakness of government counsel was no match for the strength of taxpayer counsel who moved the Court to consider a tax case in which the grant of certiorari was misguided[4] and to decide it on the basis of a misperception of some of the facts.[5] The tale of *Frank Lyon* is one of process gone awry. If it comes to typify dispute resolution in the Supreme Court, it will be necessary for us to give serious reconsideration to the process itself as well as its assumptions.

I

THE TRANSACTION

Frank Lyon involved a fairly mundane financing transaction. Worthen, a bank in Little Rock, planned a new office building to replace its existing structure. Because a local competitor was in the process of constructing a new office building at about the same time, early completion of the Worthen building became important as the two banks competed for tenants and prestige.[6] Initially, Worthen planned to build and finance the new structure and to retain title itself, but state and federal banking regulators required that Worthen neither borrow the building funds directly nor carry the bank premises, subject to a long-term mortgage, as a balance sheet asset.[7] Conse-

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[4] *See* text accompanying notes 97-104 *infra.*

[5] *See* text accompanying notes 95-96, 105-23 *infra.*

[6] This account is detailed in order to convey the full flavor of the transaction; many of the details were important to the Court in its disposition of the case. *See* text accompanying notes 61-77 *infra.*

[7] Worthen was a state-chartered bank, subject to regulation by both the Arkansas State Bank Commissioner and the Federal Reserve Board. *See* 12 U.S.C. §§ 321-339 (1976); Appendix to the Record, vol. 1, at 131, Frank Lyon Co. v. United States, 435 U.S. 561 (1978) (testimony of Edward Penick, chairman and chief executive officer of Worthen) [hereinafter referred to as Appendix; all subsequent references to briefs, records, and transcripts refer to the *Lyon* case]. During the construction of the building, Worthen became a national bank. 435 U.S. at 564 n.1.

The Arkansas usury law imposed a six percent ceiling on interest rates; Worthen could not effectively market debentures at such a low rate. In addition, Worthen's investment in bank premises could not exceed the amount of its capital stock without Federal Reserve Board quently, Worthen developed a plan under which it would select an "investor" for whom it would negotiate the construction contract and arrange for permanent financing. This investor would take title to the building and lease it to Worthen for a twenty-five year term, with Worthen having an option to acquire title[8] or to extend the lease. Worthen would acquire and own the land, parking deck, and leasehold improvements. The regulators approved this plan.[9]

Worthen accordingly acquired the site and, because of the race for completion, commenced construction of the building before selecting an investor.[10] Worthen was the initial owner of the building because, as a national bank, it could purchase construction materials free of state sales tax.[11] The sale of the building to the investor, brick by brick, would be a sale of real estate, not subject to sales tax.[12]

As construction began, Worthen searched for a suitable third-party investor. The Frank Lyon Company, like Eastman Dillon, Union Securities & Company, Goldman, Sachs & Company, and Stephens, Incorporated, submitted a proposal.[13] Several of the would-be investors suggested that Worthen retain ownership of the land in order to simplify calculation of option prices. Worthen accepted this suggestion, integrated the most favorable terms from each proposal into a new counterproposal, and offered it to several of the bidders. One of these was the Frank Lyon Company, a distributor of household electronic products and a Worthen customer whose major shareholder sat on Worthen's board of directors, and which had employed common counsel with the bank.[14] Because Lyon had accu-

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approval, and Worthen was told that this approval would not be granted. Appendix, *supra*, vol. 1, at 301-02 (unreported district court opinion, finding of fact).

[8] The repurchase option was required by the Federal Reserve Board. Appendix, *supra* note 7, vol. 2, at 326 (letter from Federal Reserve Bank to Worthen).

[9] Appendix, *supra* note 7, vol. 2, at 326-27 (letter from Federal Reserve Bank to Worthen), 336-37 (letter from Arkansas State Bank Department to Worthen).

[10] Appendix, *supra* note 7, vol. 1, at 302 (unreported district court opinion, finding of fact).

[11] This peculiar form of the transaction can be explained by Worthen's having become a national bank by the time construction began. As such, it was exempt from Arkansas sales tax on its purchases. ARK. STAT. ANN. § 84-1904(1) (1960); *see* First Agricultural Nat'l Bank v. Tax Comm'n, 392 U.S. 339 (1968). The sale from Worthen to Lyon qualified for the real estate exemption from the Arkansas sales tax. ARK. STAT. ANN. § 84-1902(c) (Supp. 1979).

[12] Absent the quirk in state law, the investor would have contracted for construction and simply leased the building to Worthen, the landowner.

[13] *See* Appendix, *supra* note 7, vol. 2, at 346-47 (Lyon proposal), 601-08 (Eastman Dillon proposal), 340-43 (Goldman, Sachs proposal), 344-45 (Stephens proposal).

[14] Both Lyon and Worthen had been represented by the law firm of Rose, Nash, Williamson, Carroll, Clay & Giroir until the instant transaction was negotiated. J. Gaston Williamson, a senior partner in the firm, remained as counsel to Frank Lyon Company throughout the

mulated earnings to such an extent that it needed to diversify in order to avoid the imposition of a penalty tax under section 531 of the Internal Revenue Code, it was particularly interested in the Worthen proposal. When Lyon not only accepted the counterproposal but bettered it by offering Worthen a $21,000 annual reduction in the rent during the first five years of the lease, Worthen selected Lyon to serve as the third-party investor.[15]

Under Worthen's counterproposal, the investor was to use the rent during the initial lease term of twenty-five years to repay New York Life Insurance Company's $7,140,000 mortgage loan. The quarterly rent charged Worthen was set at precisely the amount necessary to make the quarterly payments to retire the New York Life obligation. Lyon thus was to have a zero cash flow during the entire primary term of the lease. Because the building was expected to cost $7,640,000, Worthen required Lyon to supply an equity of $500,000. Worthen was given the right to repurchase the building after eleven, fifteen, twenty, and twenty-five years; the repurchase prices were set exactly at the then outstanding New York Life debt, plus the investor's $500,000 with six percent interest compounded annually from the date of the investment.[16] Worthen was also responsible for all taxes and other building-related expenses, and the agreements allocated to Worthen the investment tax credit.[17] In the event of condemnation or destruction before December 1, 1980, proceeds in excess of the amount due on the New York Life mortgage and Lyon's $500,000 would go to Lyon; after that date, the excess would be Worthen's.[18]

Worthen was given the right to extend the lease eight times, each for a five year term, at an annual rent of $300,000. This rent, however, would be offset by a land rent that Lyon would owe

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transaction and during the tax litigation. He also continued to serve as a member of Worthen's board of directors along with Frank Lyon. *See* Letter from Bernard Wolfman to Erwin N. Griswold (May 2, 1977) (on file at *Cornell Law Review*); MOODY'S BANK & FINANCE MANUAL (1968-1975).

[15] *See* Appendix, *supra* note 7, vol. 2, at 349-51 (Worthen's specification), 352-54 (Lyon's acceptance); *id.*, vol. 1, at 108 (testimony of Lyon's vice-president).

[16] 435 U.S. at 565-68.

[17] *Id.* at 572 n.11. It is freely allocable between lessor and lessee. The credit is therefore not linked to the taxpayer's status as owner (or investor) as depreciation deductions are. *See* note 79 and accompanying text *infra*.

[18] This statement accepts the taxpayer's assertion. *See* 435 U.S. at 571 n.7. The Eighth Circuit's opinion states that the excess went to Worthen in all events. Frank Lyon Co. v. United States, 536 F.2d 746, 749 (8th Cir. 1976). *See also* Letter from Lyon's trial counsel, J. Gaston Williamson, to Bernard Wolfman (July 6, 1978) (on file at *Cornell Law Review*).

Worthen. For the first option period, the land rent totaled $500,000, and it increased by $50,000 with each extension until it reached a maximum of $250,000 per year. In short, Worthen's net obligation during the renewal periods would start at $200,000 annually, and would drop to $50,000 for the last period.[19] In the aggregate, these rents would approach, although they would not yield precisely, the amount of Lyon's investment plus interest.[20]

Lyon's lease of the land from Worthen ran unconditionally for seventy-five years from the construction of the building,[21] and, for the last ten years of this term, the rent would be $10,000 per year. Worthen had no contractual right to occupy the building during this period. The potential renegotiation of the lease or use of the building in some alternative enterprise presented Lyon with the possibility, sixty-five to seventy-five years hence, of recouping the balance of its $500,000 investment, or perhaps something more.[22]

Worthen added the land and parking deck to the security given to New York Life and agreed to pay the annual rent without asserting any set-off or counterclaim against Lyon. Lyon, in turn, assigned the lease obligation to New York Life. Because the rental payments were equal to the loan repayments, the assignment insured that New York Life would be paid as long as Worthen remained solvent. Although only Lyon was liable on the note, the agreements effectively made Worthen primarily liable for repayment and placed Lyon in the role of surety.[23]

Despite the fact that Lyon's bid had been successful because of its offer to accept $21,000 less rent for each of the first five years, the final lease agreement did not provide for the rent reduction—this, because New York Life, assignee of the lease, insisted that Worthen's obligation equal the mortgage debt to the penny.[24] Worthen instead agreed

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[19] *See* Appendix, *supra* note 7, vol. 2, at 355 (rental schedule).

[20] 536 F.2d at 749; Brief for the United States at 14.

[21] The lease actually ran for 76 years and seven months, the extra 19 months representing the estimated construction time. 435 U.S. at 565.

[22] *See id.* at 579. Assuming a constant six percent annual rate of interest, the present value of the right to receive $1 in 65 years is less than three cents; at 10%, it is less than one-half cent.

[23] *See* 536 F.2d at 754. Justice Blackmun wrote that "[i]t may well be that the remedies available to New York Life against Lyon would be far greater than any remedy available to it against Worthen. . . ." 435 U.S. at 577 n.13. Because Worthen had an absolute obligation to pay the yearly rent throughout the 25 year period during which New York Life was to be repaid, Appendix, *supra* note 7, vol. 2, at 380-81 (building lease), and because these rents were assigned and the building, land, and parking deck were mortgaged to New York Life as security for the loan, *id.* at 490-91, 495, the mortgage obligation lay primarily upon Worthen.

[24] 536 F.2d at 748 n.1.

to pay the full amount of the original rent directly to New York Life, while Lyon agreed to pay a compensating, higher-than-market interest rate on an "unrelated" $500,000 bank loan.[25] Accordingly, Lyon received no cash from its tenant.

The substance of the transaction can be summarized as follows:

> (1) For the first twenty-five years, Worthen had the benefits and burdens normally associated with ownership, but did not have legal title;
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> (2) Worthen could repurchase the building after eleven years or more by paying the then outstanding portion of the mortgage debt and the $500,000 "equity" plus interest. As a result, Worthen, not Lyon, was entitled to the appreciation in the value of the building that might result from market factors or inflation;
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> (3) Lyon bore the remote risk, to the extent of its $500,000 investment, that the building would depreciate so substantially that Worthen would abandon its more than $7,000,000 investment by not exercising either its option to purchase for $500,000 plus interest at the end of twenty-five years or its options to renew the lease after the initial twenty-five year term;[26]
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> (4) Worthen could extend the lease for up to forty years beyond the initial period on terms even more favorable than the repurchase option;[27]
>
> (5) For the first twenty-five years, Lyon would receive no cash flow and no pre-tax gain from the transaction; and
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> (6) Lyon's legal title to the building could not be disturbed for eleven years.

II

The Litigation

Both the Frank Lyon Company and Worthen treated the transaction on their tax returns just as they had characterized it in the

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[25] *Id.* Ironically, the record reveals that Lyon had not paid completely the additional interest by the time of the trial because it would have resulted in a rate in excess of that permitted under the Arkansas usury statute. Appendix, *supra* note 7, vol. 1, at 192-94. The existence of this loan suggests a question never adequately considered in the tax litigation: Did Lyon have anything at stake? In an "independent" transaction, it borrowed the full amount of its "equity investment" from Worthen.

[26] *See* text accompanying notes 19-20 *supra*. Apparently, Lyon never argued that Worthen would not renew; it claimed only that the purchase option would never be exercised because the renewal option was so favorable. *See* Appendix, *supra* note 7, vol. 1, at 170 (testimony of Worthen officer).

[27] Appendix, *supra* note 7, vol. 1, at 170 (testimony of Worthen officer).

documents. Worthen took rental deductions for the payments required under the lease; Lyon recognized ordinary income in the amount of the rental payments, and it deducted the interest payments made to New York Life. As nominal owner of the building, Lyon took accelerated depreciation deductions on the building and its components, based on useful lives of fifteen to forty years. Lyon's first interest payments were made, and depreciation deductions claimed, in December 1969.[28] Lyon's 1969 return and Worthen's 1969 and 1970 returns were audited.[29] In both instances, the Internal Revenue Service recharacterized the transaction. The government disallowed Worthen's rental deduction but treated Worthen as the building's owner, giving it deductions for interest and accelerated depreciation based on a forty-five year composite life for the new facility.[30] The government also disallowed Lyon's interest and depreciation deductions while excluding from its income the rental it had accrued. Lyon paid the income tax deficiency asserted against it and sued for refund in the United States District Court for the Eastern District of Arkansas.

Lyon urged that the transaction be characterized as the documents between the parties described it. It argued that the arrangement was not motivated purely by a desire to avoid taxation.[31] Indeed, the government conceded that more than mere tax avoidance was behind the form of the transaction, for Worthen had brought in a third-party investor only after the banking regulators denied it permission to finance the construction by direct dealing with the mortgagee.[32] Because the expected tax consequences form a major part of virtually all substantial business transactions, the taxpayer contended that its expectations should not be disappointed "unless there is some substantial reason based in tax policy" requiring it.[33] Lyon asserted

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[28] Although only one-twelfth of a year's depreciation was involved in December 1969, and only one month's interest owing to New York Life was accruable, December was the month in which Lyon claimed the deduction for interest on the temporary construction loan that Worthen had arranged, and this item alone totaled almost $404,000. *See* 75-2 U.S. Tax Cas. ¶ 9545 (E.D. Ark. 1975).

[29] Letter from Lyon's trial counsel, J. Gaston Williamson, to Bernard Wolfman (May 20, 1977) (on file at *Cornell Law Review*).

[30] *Id.*

[31] Lyon acknowledged that "a party should not be allowed to use purely formal labels or maneuvers to frustrate the intent of tax provisions" and that "economic decisions should not be distorted by attempts to achieve tax benefits which present no economic benefit." Brief for the Petitioner at 16. Lyon argued, however, that "the parties have substantial non-tax motives for the transaction . . . ." *Id.* at 17.

[32] *See* Reply Brief for the Petitioner at 11.

[33] Brief for the Petitioner at 15. Because the government agreed that the transaction was not tax-motivated in its entirety, *see* text accompanying notes 31 & 32 *supra*, Lyon was helped in

that no such reason existed in this case. On the contrary, Lyon contended, there was a strong reason not to upset its expectations because private arrangements that may be fair given one set of tax consequences may become completely unreasonable with a different set; to permit the Internal Revenue Service to redetermine honestly estimated tax consequences of a transaction is to render business more precarious and expensive than otherwise.

The government maintained that the labels applied by the parties should not control.[34] It urged that because the purchase option prices were far below fair market value, Worthen would be economically compelled to purchase the building.[35] The government also asserted that the agreements gave Lyon little more than bare legal title to the building. No single aspect of the sale-leaseback would be fatal to Lyon's claim for depreciation, but the government insisted that the real benefits and burdens allocated to Lyon in the transaction, taken as a group, simply were too insubstantial to warrant allocating to Lyon the tax attributes that are associated with ownership. The government argued that the transaction should instead be viewed as the construction of a building by Worthen, with a first mortgage loan in the amount of $7,140,000 from New York Life, and a second mortgage loan in the amount of $500,000 from Lyon. Repayment of the second mortgage would await exercise of the repurchase option.[36]

Lyon responded with testimony that the rents and purchase prices were reasonable and reflected a fair estimate of expected future values. Lyon also showed that Worthen would not be economically compelled to repurchase the building, but only because the lease renewal terms were so favorable that Worthen would do better to rent than to buy.[37] Finally, Lyon claimed that it bore the risk of depreciation, for if the building substantially declined in value, Worthen could abandon the premises after twenty-five years, leaving Lyon as the owner with an additional fifty years of liability on its ground lease.

Lyon denied that it was merely a conduit between Worthen and New York Life, explaining the equality between rental payments and

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distinguishing the familiar "form over substance" cases involving complex legal mechanics animated solely by a desire to sidestep taxation. Brief for the Petitioner at 16. The government quoted, ineffectually, from Commissioner v. Duberstein, 363 U.S. 278, 286 (1960): "[T]he parties' expectations or hopes as to the tax treatment of their conduct in themselves have nothing to do with the matter." Brief for the United States at 27-28.

34 Brief for the United States at 26-27.

35 *See* Appendix, *supra* note 7, vol. 1, at 291-92, 297-98, 308. *Cf.* Addendum *infra,* at 1101.

36 Brief for the United States at 30-32; *cf.* 435 U.S. at 584-88 (dissenting opinion of Justice Stevens).

37 Brief for the United States at 30-32; *id.* at 13 nn.12 & 20.

loan repayments as ordinary business caution: All landlords use rental proceeds to satisfy their construction loans, and Lyon had simply assured itself that its rental income would be sufficient to meet its loan obligations.[38] As the sole party directly liable on the loan to New York Life, Lyon insisted that it should be treated as owner.[39]

The district court entered judgment for Lyon.[40] In holding that the sale and leaseback were bona fide and that Lyon should be treated as the owner of the Worthen Bank building, the court relied primarily on the terminology used in the transaction documents, on the unwillingness of the banking regulators to approve Worthen's acquisition of the building in a form that would designate Worthen as owner-debtor, on the "arm's length" negotiations between Worthen and Lyon,[41] and on the reasonableness of the purchase price and the rents. The trial judge found that the parties intended a sale-leaseback with an option to repurchase, and that this was the substance of the transaction.

The government appealed to the Eighth Circuit. There Lyon contended that the government was asking the appellate court to reevaluate the district court's findings of fact, findings that should be binding on an appellate court unless clearly erroneous. But the court, in an opinion by Judge Bright, disagreed and reversed, treating the issue as one of law, not fact.[42] Judge Bright observed that the intent of the parties is relevant insofar as it may help to establish the state law consequences of the parties' arrangements *inter sese.* He accepted the government's view of property as a bundle of sticks, each stick representing "an interest in the underlying *res* which is the object of property."[43] The intent of the parties was relevant in determining which party possessed which sticks, but once the actual allocation of the various interests was determined, it was for the court to determine as a matter of federal law whether a given package of sticks was sufficient to justify the allocation of the depreciation deduction.[44]

The court proceeded to analyze the allocation of rights and obligations assigned by the agreements to Worthen and Lyon, concluding

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[38] Brief for the Petitioner at 37 n.20.

[39] Brief for the Petitioner at 37-40; *cf.* 435 U.S. at 576 ("[I]t was Lyon alone . . . who was liable on the notes . . . .").

[40] 75-2 U.S. Tax Cas. ¶ 9545 (E.D. Ark. 1975), *reprinted in* Appendix, *supra* note 7, vol. 1, at 301, 311, *rev'd,* 536 F.2d 746 (8th Cir. 1976), *rev'd,* 435 U.S. 561 (1978).

[41] Appendix, *supra* note 7, vol. 1, at 302 (proposed finding of fact).

[42] Frank Lyon Co. v. United States, 536 F.2d 746 (8th Cir. 1976), *rev'd,* 435 U.S. 561 (1978).

[43] 536 F.2d at 751.

[44] *Id.* at 750.

that Worthen had all the rights and responsibilities of ownership, while Lyon had nothing but legal title and the claim to a tax shelter provided by depreciation and interest deductions. As the Eighth Circuit saw the transaction, Worthen received the investment tax credit[45] and the deduction for sales tax on construction materials;[46] it bore responsibility for maintenance and insurance; it received any proceeds attributable to appreciation on destruction or condemnation;[47] its purchase option price was calculated to pay off Lyon's investment with six percent interest, and the rents during the extensions of the initial lease term closely approximated this result. Thus, Worthen would derive the benefit of any appreciation and would control the ultimate disposition of the building through its options and its ownership of the site.[48] Lyon, on the other hand, appeared to the court as nothing more than a conduit for payments from Worthen to New York Life.[49] Consequently, although the court was careful to note that no single aspect of the transaction precluded a depreciation deduction for the mortgagor-lessor, "all of these features . . . employed in the same transaction . . . [have] the cumulative effect of depriving the taxpayer of any significant ownership interest."[50] Given that there is but one owner for tax purposes and that the depreciation deduction accrues to it, Lyon was not the taxpayer entitled to that deduction.

Lyon then added new counsel[51] and petitioned the Supreme Court for certiorari, asserting that Judge Bright's opinion was "fundamentally in conflict"[52] with the approach of the Fourth Circuit in *American Realty Trust v. United States*[53] and the approach of the Ninth Circuit in *Cubic Corp. v. United States*.[54] The Court granted certiorari because of "an indicated conflict" with *American Realty Trust*.[55]

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[45] *See* note 79 and accompanying text *infra*.

[46] The Eighth Circuit apparently was mistaken on this count. Worthen purchased the construction materials because, as a national bank, it was not subject to sales tax, and the sale to Lyon of the building, as a sale of real estate, was not subject to sales tax. *See* note 11 *supra*.

[47] *But see* text accompanying note 58 *infra*.

[48] 536 F.2d at 752-53.

[49] *Id.* at 753-54.

[50] *Id.* at 754.

[51] Lyon retained Erwin N. Griswold as "Counsel for the Petitioner" in the Supreme Court. Mr. Griswold appeared as such on all documents filed with the Court, and he presented the taxpayer's oral argument on the merits. J. Gaston Williamson, Lyon's counsel below, served "Of Counsel" in the Supreme Court. Mr. Williamson continues to serve on Worthen's board of directors, and he is counsel to both Worthen and Lyon generally.

[52] Petition for Certiorari at 8-9.

[53] 498 F.2d 1194 (4th Cir. 1974).

[54] 541 F.2d 829 (9th Cir. 1976).

[55] 435 U.S. at 572.

In a seven to two decision rendered by Justice Blackmun, the Court reversed the Eighth Circuit.[56] The majority perceived "superficial appeal"[57] in the position of the government and the reasoning of the Eighth Circuit because of the relationship of Lyon and its president and principal shareholder with Worthen, the peculiarity of the venture for Lyon, the identity of mortgage and rental payments, the provisions relating to condemnation and destruction, the options, and the tax benefits,[58] but it concluded that "Lyon has far the better of the case."[59] In reaching this conclusion, the Court relied on twenty-six factors.[60]

The Court first distinguished prior sale-leaseback cases in which depreciation had not followed nominal ownership.[61] Noting that these cases (including its own decision in *Lazarus*)[62] had involved only two parties,[63] the Court observed that the Worthen-Lyon-New York Life transaction involved three, which "significantly distinguishes this case."[64]

After disposing of these prior cases, the Court focused on the Lyon transaction, finding important the fact that Lyon alone was liable on the note to New York Life. That liability, the Court stated, exposed Lyon's business to a "real and substantial risk."[65] In addition, if Worthen should fail to exercise its purchase option, Lyon would not be guaranteed a six percent return; thus, the Court stated, Lyon gambled that the rental value during the last ten years of the ground lease would be sufficient, when added to the rent received

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[56] Justice White, dissenting, would have affirmed on the basis of the Eighth Circuit's opinion. 435 U.S. at 584. Justice Stevens filed a separate dissenting opinion. *Id.* at 584-88; *see* text accompanying notes 85-88 *infra*.

[57] 435 U.S. at 581.

[58] *See id.* at 581-82.

[59] *Id.* at 583.

[60] *See id.* at 582-83.

[61] *See, e.g.,* Sun Oil Co. v. Commissioner, 562 F.2d 258 (3d Cir. 1977), *cert. denied*, 436 U.S. 944 (1978).

[62] In Helvering v. Lazarus & Co., 308 U.S. 252 (1939), a taxpayer-department store had transferred title to its buildings to a bank as trustee for land-trust certificate holders. The bank-trustee leased back the buildings to the department store for 99 years with an option to renew. Arguing that the right to depreciation deductions followed legal title, the government denied the deductions to the department store. The Court sustained the taxpayer, holding that the transaction was in essence a mortgage loan. In *Frank Lyon*, the government argued, *inter alia*, that the basis on which it lost in *Lazarus* required that it now prevail—that the depreciation (and interest) deductions belong to the party financed (Worthen) and not to the financing party (Frank Lyon).

[63] 435 U.S. at 575-76.

[64] *Id.* at 576.

[65] *Id.* at 577.

during the renewal terms, to enable it to recoup its investment and enjoy a reasonable return.[66] Because Lyon's capital was at stake, the depreciation deduction was properly allocable to it. In support of this conclusion, the Court echoed an argument offered by Lyon's new Supreme Court counsel. The Worthen-Lyon-New York Life transaction did not create any deductions;[67] on the contrary, the only question was which of two taxpayers would be permitted to take them.[68] Because Lyon asserted (unchallenged by the government) that both taxpayers were subject to taxation at the same rates[69] and that neither was in a special tax circumstance, the Court perceived no real effect on government revenue[70] and no reason to upset the expectations of the taxpayers in the absence of such an effect.

Justice Blackmun then recited the twenty-six factors which, in the view of the majority, established that the government's characterization of Lyon as a lender did not accord with economic reality.[71] Among them, in addition to those already noted, were the role of the state and federal regulators in limiting Worthen's alternatives for structuring the transaction, the competitive situation between the two local banks, the competitive bidding among potential investors, and the findings of the reasonableness of the option prices and renewal rentals.[72]

One of these factors deserves special comment. There was, indeed, competitive bidding among the potential investors.[73] But the Court's opinion ignores just what it was the investors were bidding for. Any appreciation accruing to the investor on the bank building was at least sixty-five years away, because Worthen's repurchase option and lease renewal options limited the investor to a six percent return. The present value of such a distant return is negligible.[74] The would-be investors bid for something else. They sought to garner the

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[66] *Id.* at 579.

[67] *Id.* at 580.

[68] *Id.* at 583.

[69] *Id.*

[70] *Id.* at 580. In this regard, Justice Blackmun found it reassuring that the transaction was "nonfamily and nonprivate" in nature, suggesting that this aspect of the case implied that Worthen and Lyon were not cooperating to decrease government revenue. *Id.* at 583. Surely it only establishes that Worthen would demand some share of the tax savings in return for the depreciation deductions and not give them away, and Worthen did indeed sell to the highest bidder.

[71] *Id.* at 582-83.

[72] *Id.* at 583.

[73] Appendix, *supra* note 7, vol. 1, at 302 (district court finding of fact).

[74] *See* note 22 *supra*.

income tax benefits of ownership: the early interest and accelerated depreciation deductions to shelter their high-bracket income from other sources. Lyon estimated that these benefits would save it approximately $1.5 million in the first eleven years of ownership.[75] The rental income would thereafter exceed the deduction for interest and depreciation, resulting in taxable income that would eventually offset the earlier tax losses. But the taxpayer would have enjoyed the benefits of deferral, equivalent to an interest-free loan in the amount of the tax deferred, often equivalent to a tax-free return on actual investment.[76] If this is the benefit for which the bidders were competing, it is difficult to see how the competitiveness of the bidding establishes the economic reality necessary to buttress the nominal ownership. If mere bidding for a non-assignable depreciation deduction creates economic reality, one wonders why the Court said "sham" in *Knetsch*.[77]

Although the competitive bidding is perhaps the most perverse of the factors specified by the Court, the other factors are hardly more compelling. In distinguishing prior sale-leaseback cases, the Court accepted Lyon's notion that a three-party transaction is inherently different from a two-party transaction. Although the numbers are different absolutely, the significance of this difference is beyond grasp. If Lyon had had available cash of $7,640,000, not just $500,000, it could have invested the full building cost without the intervention of New York Life. Would that have made the case a *harder* one for Lyon? The Court seems to say so.

Or suppose New York Life, desiring the depreciation deductions, had purchased the building and leased it back to Worthen. Would it fail to qualify as owner under the *Frank Lyon* rationale just because it had not brought another financing party into the transaction to make three? Again, the Court seems to say so.[78] This aspect of the Court's

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[75] Appendix, *supra* note 7, vol. 1, at 54 (testimony of Lyon officer); *see* Frank Lyon Co. v. United States, 536 F.2d 746, 749 (8th Cir. 1976), *rev'd*, 435 U.S. 561 (1978). *But see* Fuller, *Sales and Leasebacks and the* Frank Lyon *Case*, 48 GEO. WASH. L. REV. 60, 75 n.132 (1979). After accounting for the tax on Lyon's potential capital gain, when the building would be resold to Worthen after 11 years, the government computed the net tax saving to Lyon as $615,000, not $1,500,000 (Appendix, *supra* note 7, vol. 2, at 696 (D.Ex.6)), and the cash flow after tax as $650,000 (*id.* at 692 (D.Ex.2)).

[76] *See* E. GRISWOLD AND M. GRAETZ, FEDERAL INCOME TAXATION 335-38, 1045-51, esp. 1049, Note (A) (1976).

[77] In Knetsch v. United States, 364 U.S. 361 (1960), the Court disallowed a claimed interest deduction, calling the alleged indebtedness which underlay the claim a "sham" because the transaction, legally valid under state law, would not likely have been entered absent the anticipated federal income tax benefits. Would Frank Lyon Company or any of the other bidders have had any interest in the Worthen proposal or the bank building without the anticipated tax benefits?

[78] *See, e.g.*, 435 U.S. at 576.

opinion does nothing but signal tax lawyers that clients seeking tax shelter should never travel in pairs.

It is also disturbing that the Court found support for its decision in the presumed absence of any potential revenue loss in this case. The Court seemed to believe that the government's loss in tax from Lyon would be equal to the revenue gained from Worthen. That factor, if true, might cause an observer to wonder why the government would bother to litigate this particular case. Would the government with nothing immediately at stake press a case like this only to establish a precedent for cases in which there was a tax differential, or just to establish a principle? Perhaps. For surely one would not expect the Court to enunciate a rule applicable only to pairs of taxpayers in the same tax bracket. Some tax benefits are freely allocable by the parties to a transaction,[79] while most, like depreciation deductions, are not. But *none* are allocable by the parties only in the absence of a significant tax differential. Presumably, then, the precedent of *Frank Lyon* binds all taxpayers, and tax planners will structure transactions in the form approved by *Frank Lyon.* In many of these cases, the government will have a great deal at stake. The Court, therefore, should not have allowed its perception of factors peculiar to *Lyon* to influence it when formulating a principle for future cases in which these factors would not be involved.

As a final illustration of the difficulties with the Court's litany of factors, let us consider the rivalry between Worthen and its local bank competitor and the reasonableness of the prices and rentals. Certainly these factors were present in the case; yet it is difficult to see how they bear on ownership. Surely, Worthen would not be considered owner just because it was the only or most successful bank in town. Nor does the reasonableness of rental payments prevent their characterization as loan repayments. The list of factors recited by the Court seems only to describe the evidence adduced in this case; it does not elucidate a rationale for the holding.

Almost entirely absent from the Court's litany are those factors that go to a comparison of the risk and benefit possibilities that distinguished Worthen from Lyon, or, more generally, to the characteristics that distinguish the investment of an owner from that of a lender. This distinction should have been the focus of the Court's analysis.

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[79] Consider, for example, alimony payments. I.R.C. §§ 71, 215; *see* Commissioner v. Lester, 366 U.S. 299 (1961). Consider also the investment tax credit. I.R.C. §§ 38, 46-48, esp. § 48(d). In August 1981 Congress enacted new, liberal rules for the allocation of depreciation deductions in connection with leases of "qualified leased property" entered into after December 31, 1980. I.R.C. § 168(f)(8). "Qualified leased property" does not include buildings.

In theory, a taxpayer may deduct the amount of his investment by way of annual depreciation deductions taken over the life of the investment, but only if the investment has a limited and estimable useful life, one whose value can be expected to decrease over time. An investment in land or in the capital stock of a corporation, unlike one in machinery or a factory, is not depreciable. When a businessman borrows $10,000 from a bank and purchases a $10,000 machine for use in his business, he may depreciate his investment over the expected life of the machine on a straight-line or accelerated basis. Although his funds come from the bank, the depreciable investment is treated as his because he must repay the loan in full even though in time the machine will be worthless. The bank, however, recovers its capital tax-free only as the principal of its investment, the loan, is repaid. Its amortization is typically decelerated, with substantial interest income up-front. The borrower gets a compensating interest deduction up-front. Lenders, in effect, amortize their loans for tax purposes on a sinking fund theory of capital recovery, one that comports with economic reality.[80] The taxable income of a lender is therefore grossly distorted if he is treated as an owner for purposes of the depreciation deduction.

Who, Worthen or Lyon, is more like the owner of a depreciable asset, and who is more like a financing party? The Eighth Circuit, although it may have been inaccurate in characterizing Lyon's position as completely free from risk,[81] quite properly attempted to answer this question by examining the property rights held by each party to the transaction. Was it not correct to credit the importance of Worthen's right to the appreciation on the investment? Lyon was virtually assured of recovering its investment and six percent interest, subject only to the risk of Worthen's insolvency, the same risk that every lender assumes, or to the wholly improbable possibility that (1) Worthen would not exercise its purchase option, (2) Worthen would not renew the lease,[82] and (3) Lyon would be left with a building worth less than $500,000.[83] The only ownership-type risk that Lyon might be said to have borne was that a $7,640,000 building might drop in value to less than $500,000 plus interest.[84] In analyzing whether such a risk warrants the tax consequences of ownership,

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[80] *See* M. Chirelstein, Federal Income Taxation 135 (2d ed. 1979).

[81] 536 F.2d at 752-53.

[82] It is true, of course, that the lease renewals would not assure a full six percent return.

[83] 435 U.S. at 586 n.4.

[84] Acknowledged lenders take the same kind of risk, particularly when they grant nonrecourse mortgage loans.

Justice Stevens's dissenting opinion is illuminating.[85] He observed that Worthen bore the risk of any economic depreciation to the extent of the difference between the value of the building and Lyon's guaranteed return, for that decrease in value would render the exercise of the purchase option less profitable.[86] Similarly, although not remarked in Justice Stevens's opinion, that first increment of depreciation would render the lease renewal options less profitable if the taxpayer's prediction proved correct and Worthen chose to exercise those options rather than the repurchase option. The price set in the repurchase option assured Lyon a return of its investment with six percent interest. Justice Stevens therefore viewed Worthen as the owner with an option to "put" the building to Lyon if it dropped in value below $500,000 plus interest.[87] Should Worthen choose not to exercise the repurchase option, effectively it would be exercising its put, and "perhaps it would *then* be appropriate to characterize [Lyon] as the owner and Worthen as the lessee."[88] Justice Stevens reasoned, however, that speculation as to events twenty-five years hence should not affect current depreciation deductions.

The economics of the transaction determined that Worthen suffer the burden of any initial decline in value and, if Worthen failed to exercise its options, Lyon would bear the more remote and highly contingent subsequent declines. The tax consequences should follow the economics as long as there is adherence to the principle that the depreciation deduction is for the taxpayer who suffers the economic risk of a decline in value of the investment. According to this principle, Worthen would be entitled to the depreciation deductions unless and until the risk shifted, until Worthen actually "put" the building to Lyon.

III

What Went Wrong?

The Court's opinion in *Frank Lyon* simply fails to deal adequately with the problem presented. Its analysis reflects a limited understanding of the issues, and part of the blame for this rests squarely with the Court. But the adversary system presumes that the parties to a contro-

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[85] *See* 435 U.S. at 584-88.
[86] *Id.* at 586 n.4.
[87] *Id.* at 587 n.7.
[88] *Id.* at 587.

versy will take initial responsibility for helping the Court comprehend and analyze the issues it is being asked to resolve. In *Lyon,* the parties failed to discharge this responsibility.

From the beginning, the government mismanaged the case. Revenue agents operating under common supervision in the same office undertook audits of Lyon and Worthen.[89] They were consistent in that Worthen was denied the rental deduction and given interest and depreciation deductions, while Lyon's interest and depreciation deductions were disallowed and the rental income was excluded.[90] At this point, however, the agents parted ways. The agent handling the Worthen audit set up a depreciation schedule based on a forty-five year composite life for the facility.[91] Lyon, on the other hand, had depreciated elements of the building separately, based on lives ranging from fifteen to forty years. During the Lyon audit, the government disallowed depreciation altogether but never challenged the rates. This failure meant that once Lyon prevailed in court on its right to a depreciation deduction, the government probably was foreclosed from thereafter challenging the rate of depreciation.[92] In spite of an initial determination by the only agent who considered the issue that forty-five years reflected the proper life, Lyon has continued to use shorter lives and has never had to defend its estimates.

A second shortcoming in the government's conduct of the case has had even more serious repercussions. The agents challenged Lyon's depreciation and interest deductions for the month of December 1969, and, at the same time, allowed such deductions to Worthen, one month's depreciation in 1969 and the balance in 1970, increasing its net operating loss for that year by $141,000. The government did not hold Worthen's returns in suspense pending resolution of the *Lyon* case.[93] As a result, during the course of the *Lyon* litigation, the statute of limitations ran against the government's right to reverse its grant of depreciation and interest deductions to Worthen. The net result was

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[89] *See* Letter from Lyon's trial counsel, J. Gaston Williamson, to Bernard Wolfman (July 6, 1978) (on file at *Cornell Law Review*).

[90] *Id.*

[91] *Id.*

[92] Res judicata doctrine probably precludes the government from now challenging the rate of depreciation because it could have challenged the rate during the *Lyon* litigation but did not do so. *See generally* Letter from Lyon's trial counsel, J. Gaston Williamson, to Bernard Wolfman (July 18, 1978) (on file at *Cornell Law Review*).

[93] The IRS could have deferred crediting Worthen's 1967 income with the 1970 net operating loss until *Frank Lyon* was decided, and it could have awaited final resolution of *Lyon* before reducing Worthen's 1969 income by $20,297.81 (depreciation for December 1969). *See* Letter from J. Gaston Williamson to Bernard Wolfman (November 3, 1981) (on file at *Cornell Law Review*).

that in a case in which taxpayer's counsel advised the Court that no deductions were "created,"[94] two taxpayers were irrevocably granted depreciation deductions with respect to the same property for 1969 and 1970.

The irony of the double deduction becomes more poignant and less tolerable on review of the transcript of oral argument before the Court. The Worthen returns and revenue agent reports were not part of the trial record. The Court was therefore unaware that Worthen had been given the depreciation deduction.[95] During questioning from the Bench, however, one of the Justices sought and received assurance from the Assistant Solicitor General that, if the government were to prevail against Lyon, Worthen would receive the benefit of the disputed deductions, and that the statute of limitations would not be a bar to Worthen's claim.[96] Neither government counsel nor taxpayer counsel disclosed that a victory for Lyon would assure a double deduction, $20,300 in 1969 and $141,000 in 1970, for both Lyon and Worthen.

The double deduction was, of course, irrelevant to the substantive question in *Frank Lyon,* and clearly the government should not be able to rely on its failure to protect its claim against Worthen to support its case against Lyon. What is most notable is the inadequacy of the government's advocacy. Government counsel seemed to be unaware of the double deduction prospect, and he made no effort to explain to the concerned Justice that Worthen's failure to file a protective claim for refund or the government's failure to hold the Worthen return in suspense were entirely irrelevant to the question whether Lyon was entitled to depreciation deductions. Counsel for Lyon did not clarify this point. No one disclosed to the Court that the Justice's worry was for naught because Worthen had already been given the deductions in question, and that it was only the government that could lose on this score.

But this is getting ahead of the story, for between the time of the IRS audit and the Court's decision, the process failed at another critical point—the grant of certiorari. Lyon's petition for certiorari alleged a conflict with two cases in other circuits,[97] and the Court based its grant of the writ on an "indicated conflict" with one of these cases, the Fourth Circuit's decision in *American Realty Trust v. United States.*[98] *American Realty Trust* involved a sale-leaseback, and, unlike

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[94] Petition for Certiorari at 10-11.

[95] Transcript of oral argument at 24-25; Appendix, *supra* note 7, vol. 1, at 201-02.

[96] Transcript of oral argument at 24-25.

[97] Petition for Certiorari at 8-9.

[98] 498 F.2d 1194 (4th Cir. 1974); *see* 435 U.S. at 572.

Lyon, the owner-lessor won its appeal in the circuit court. This alone would not imply a conflict, however, for as Lyon's counsel noted, "all cases in this area have their own facts, and so any decision may be distinguished on one ground or another."[99] The gravamen of Lyon's petition was that the *approaches* of the Fourth and Eighth Circuits were inconsistent. Review would have been appropriate if the tensions in *Frank Lyon* were akin to those in *American Realty Trust*, but they were not. A fact in *American Realty Trust* that was absent in *Frank Lyon*—one that could be present in only a handful of special cases—foretold the result in the Fourth Circuit.

In opposition to certiorari, the government pointed to some differences in the facts underlying the two transactions.[100] In *American Realty Trust*, for instance, the rental payments were not equal to the required mortgage payments,[101] condemnation proceeds were divided between landlord and tenant, and the tenant, unlike Worthen, could cancel its lease obligation before the mortgage was satisfied. Perhaps distinctions such as these should not have been persuasive, although it is a bit surprising that they were not, in light of the Court's general reluctance to review civil tax cases absent the clearest of pressing conflicts. But there is another distinction that makes *American Realty Trust* quite special—a distinction that the government did not bring to the attention of the Court. The depreciation deductions claimed in *American Realty Trust* and disallowed by the government amounted to only $19,000. Yet the deficiency in corporate income tax resulting from this disallowance totaled almost $280,000. The taxpayer was not an ordinary business corporation; it was a real estate investment trust not subject to corporate tax on its distributed income if it distributed ninety percent or more of its net income as dividends to its shareholders.[102] Having distributed dividends equal to ninety percent of its reported net income, the taxpayer paid no corporate tax. With the disallowance of its depreciation deduction, however, its net income was retroactively increased by $19,000. Because less than ninety percent of its recalculated net income had been distributed, the trust was now taxable on *all* of its income, both the distributed and the undistributed, leaving a tax liability of nearly $280,000 even though most of the taxpayer's income had already been distributed to its shareholders as dividends taxable to them. This case arose under a section of the

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[99] Petition for Certiorari at 10.

[100] *See* Brief for the United States in Opposition at 10-12; Brief for the United States at 68-70.

[101] Brief for the United States in Opposition at 11.

[102] *See* I.R.C. § 857(a)(1); American Realty Trust v. United States, 498 F.2d 1194, 1195 nn.2-4 (1974).

Code that has since been amended to provide less harsh treatment for real estate investment trusts that have attempted to distribute at least ninety percent of their income; moreover, the amendment was before Congress when the Fourth Circuit considered the case.[103] But because the former provision applied to this taxpayer, it is not surprising that the Fourth Circuit struggled mightily to allow the depreciation deduction that the taxpayer had computed and claimed in good faith. With the facts indicating that some of the property appreciation could accrue to the benefit of the buyer-lessor, and with the seller-lessee not bound absolutely to the lease and thus to the long-term loan, the Fourth Circuit found it possible to treat the taxpayer as owner. The Fourth Circuit was determined to relieve the "plight"[104] in which the taxpayer found itself in *American Realty Trust.* Government counsel in *Frank Lyon* never called attention to this crucial aspect of *American Realty Trust* in opposing certiorari, and the Court did not find it on its own.

The poor substantive result in *Frank Lyon* presents a strong argument for hesitance on the part of the Court to grant certiorari in a civil tax case unless it is certain that a square conflict divides the circuits. Only then is there a clear need for unifying resolution by the Court, and it will have had the benefit of full deliberation given the same issue by two circuits. The chances of irrelevant or unworthy considerations surviving the scrutiny of two circuit courts *and* the Supreme Court are certainly diminished; the very existence of a real conflict suggests that one of the courts may have noted the irrelevancy. The theory works, of course, only if the cases alleged to conflict present the same issue. This simply was not the situation in *Frank Lyon,* a case mishandled by the government from the beginning and one that the Court probably should not have taken. And while before the Court on the merits, this benighted case suffered yet another failure of process.

Taxpayer's counsel repeatedly asserted to the Court, without challenge by the government, that Worthen and Lyon were "subject to identical tax rates,"[105] that there was "no differential in tax rate,"[106] "no effort to take advantage of a tax differential,"[107] and no "special tax circumstance."[108] On the basis of such assertions, the

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[103] 498 F.2d at 1195 n.4. *See* I.R.C. § 859.

[104] 498 F.2d at 1195 n.4.

[105] Petition for Certiorari at 10 n.7; Brief for the Petitioner at 17 n.8.

[106] Brief for the Petitioner at 17. *See also* Transcript of oral argument at 21 ("There is no need to take the [interest] deduction away from Lyon in order to protect the revenue.").

[107] Petition for Certiorari at 10 n.7; Brief for the Petitioner at 17 n.8.

[108] Brief for the Petitioner at 17.

Court concluded that there was no net revenue at stake.[109] The record does show that, for Lyon, the deductions offset income taxable at forty-eight percent,[110] but it contained no information as to Worthen's tax returns or bracket. As it turned out, Worthen was also able to use the depreciation deductions of 1969 and 1970 to offset income taxable at forty-eight percent, but Worthen was a taxpayer in a very "special tax circumstance," one whose marginal tax bracket comes close to being elective.

In 1970, the first full year for which it would have been entitled to interest and depreciation deductions, Worthen was not subject to federal income tax because it had no taxable income.[111] The deductions foisted on it by the government increased a 1970 net operating loss by $141,000, one that Worthen carried back as a deduction against its 1967 income. Accordingly, the government reduced a tax deficiency proposed against Worthen that arose from unrelated issues.[112] Although the 1970 deductions would offset income taxable to both Lyon and Worthen at forty-eight percent, in challenging the tax effect of the Worthen-Lyon arrangement the government was not as academic as Lyon's Supreme Court counsel had the court believe.[113]

One might say that Worthen and Lyon were in the same tax circumstances because both corporations were subject to the same schedule of tax rates under Section 11 of the Internal Revenue Code. But that would be misleading. Worthen was in a "special tax circumstance" because it was a commercial bank.[114] Commercial banks

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[109] 435 U.S. at 550 n.15.

[110] Appendix, *supra* note 7, vol. 2, at 589.

[111] *See* Letters from Lyon's trial counsel, J. Gaston Williamson, to Bernard Wolfman (July 6, 1978, October 19, 1981, and November 2, 1981) (on file at *Cornell Law Review*).

[112] *Id. See* note 122 *infra.*

[113] *See* Letters from Lyon's Supreme Court counsel, Erwin N. Griswold, to Bernard Wolfman (September 25, 1978 and September 30, 1981), and from Lyon's trial counsel, J. Gaston Williamson, to Bernard Wolfman (October 19, 1981 and November 3, 1981) (on file at *Cornell Law Review*).

Government counsel did nothing to relieve the impression of a mere academic exercise created by Lyon's oral and written presentations. He just urged the Court not to be concerned with the absence of a tax differential in *Lyon* since future cases might involve net deficiencies in tax. *See* Brief for the United States in Opposition at 10 n.10; Brief for the United States at 64-65. Stuart A. Smith, the Assistant Solicitor General principally responsible for the Government's brief on the merits, presented the Government's oral argument. *See* notes 116-22 *infra.*

[114] Commercial banks have been a mainstay in the tax-exempt bond market. *See* Note, *The Municipal Bond Market: An Analysis and Suggested Reform,* 16 HARV. J. LEGIS. 211 (1979). Although individual investors replaced commercial banks as the largest group of tax-exempt bondholders during the 1950s, commercial banks reestablished their dominance during the 1960s. *Id.* at 221. During the first half of the 1970s, commercial banks held approximately

comprise the only class of taxpayers permitted to deduct the interest expenses incurred in holding state and local bonds that yield tax-exempt interest income.[115] Studies show that, as a class, commercial banks pay an effective rate of federal income tax of only nine percent, largely because of their substantial holdings of tax-exempt bonds.[116] It is, of course, true that by itself the average effective income tax rate of commercial banks tells us nothing specific about their marginal rate of tax. It does not explain why commercial banks would not need accelerated depreciation deductions to offset income taxable at forty-eight percent, or why they would put such deductions up for bid to taxpayers like Lyon or to the clients of Goldman, Sachs. The explanation lies in the fact that within limits commercial banks like Worthen can predict their taxable income, and they can alter it by shifting their mix of taxable and tax-exempt investments, while Lyon and other ordinary business corporations are less free to do so. Commercial banks can keep their taxable income below the level at which the maximum statutory rate (forty-eight percent at the time of the Lyon-Worthen transaction) becomes applicable by carefully managing their investment portfolios. After seeing a draft of this article, the attorney for Worthen and Lyon put the matter thus:

> You are of course correct in stating in your article that commercial banks can alter their taxable income by shifting their mix of taxable and nontaxable investments. . . . Worthen Bank has always sought to be taxed in the maximum tax bracket . . . . As the record in *Lyon* demonstrated, Worthen Bank initially planned to own the building. . . . You may be sure that had Worthen Bank owned the building, it would have varied its investment mix to ensure that the resulting interest and depreciation deductions would have been against income otherwise taxable at 48%. Anything else would have been considered a waste of the deductions.[117]

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one-half of all outstanding state and local government bonds. BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, DIVISION OF RESEARCH AND STATISTICS, December 1977. *See also* H.R. REP. No. 1016, 94th Cong., 2d Sess. 10 (1976).

[115] *See* I.R.C. § 265(2); Rev. Rul. 70-10, 1970-2 C.B. 499; Rev. Proc. 72-18, 1972-1 C.B. 740; Rev. Proc. 81-16, 1981-17 I.R.B. 33, revoking Rev. Proc. 80-55, 1980-2 C.B. 849. *Cf.* Rev. Rul. 81-200, 1981-33 I.R.B. 5.

[116] Because they hold large amounts of tax-exempt bonds, commercial banks enjoy an effective tax rate far below the statutory corporate tax rate. For the 20 largest commercial banks, the effective United States tax rate on worldwide income (using a weighted industry average) was 3% and 9.3% in 1979 and 1978 respectively. Further, only one of the 20 largest banks had an effective United States tax rate on worldwide income as high as 18% in 1979 or 22% in 1978. *See* TAX NOTES, July 7, 1980, at 39, and February 18, 1980, at 235.

[117] *See* Letter from J. Gaston Williamson to Bernard Wolfman (October 19, 1981) (on file at *Cornell Law Review*).

There is no explanation given for Worthen's voluntary decision "to be taxed in the maximum tax bracket." It may be an expression of *noblesse oblige,* because as a commercial bank Worthen is in an elite tax circumstance that enables it to maintain an extraordinarily low effective rate of federal income tax. Or perhaps, like tax-exempt universities that make payments "in lieu of taxes" in order to fend off a political onslaught from the mass of taxable property owners, a commercial bank like Worthen elects to fly a forty-eight percent flag just high enough not to be noticed as special.

Although the yield on tax-exempt bonds is less than that on corporate bonds, the sacrifice in the investment return (the "implicit tax") is typically less than the federal income tax savings. In 1968, for example, when Worthen and Lyon were negotiating, a corporation with income taxable at forty-eight percent would be indifferent to the status (whether tax-exempt or taxable) of the interest paid on two otherwise equivalent bonds as long as the yield on the tax-exempt bond was fifty-two percent of the yield on the taxable bond. The "implicit tax" of forty-eight percent would exactly equal the federal income tax. But in 1968 tax-exempt municipal bond yields were almost eighty percent of corporate bond yields, reducing the "implicit tax" on federally tax-exempt interest to only twenty percent.[118] The question, then, is why in such circumstances *all* highly profitable corporate taxpayers (like Lyon) do not find municipal bonds the obvious shelter to limit the amount of their income taxable at rates above that of the "implicit tax." There are two main reasons: One is that investment in marketable securities makes ordinary business corporations prey to a penalty tax on "unreasonable accumulations" of income under section 531 (as Lyon already was).[119] Second, ordinary business corporations are subject to significant constraints under section 265(2), and commercial banks are not.[120] Since commercial banks can deduct from their gross taxable income the interest they pay on borrowed funds used to purchase or maintain municipals, they can, if they wish, keep their net taxable income below the "surtax exemption" limit (the erstwhile term used to designate the income level above which the maximum statutory tax rate is applicable). Indeed, a commercial bank that might have more taxable income than it wants above the surtax exemption limit (or income above the

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[118] *See* H.R. REP. No. 1016, 94th Cong., 2d Sess. 8, esp. Chart 1, (1976). It shows that from 1947 to 1975 the ratio of municipal to corporate bond yields varied from a low of 63% to a high of 80%. Short term municipal debt, however, purchased almost exclusively by commercial banks, tended to yield a return equal to (just above) the reciprocal of the maximum statutory corporate tax rate, *i.e.*, 52% when the tax rate was 48%. *Id.* at 10.

[119] *See, e.g.*, Treas. Reg. 1.533-1(a)(2)(ii).

[120] *See* note 115 *supra*.

"implicit tax" rate on municipals, its "effective marginal rate")[121] would be free to sell deductions like accelerated depreciation to shelter-seeking taxpayers like Lyon, this because the bank could borrow funds to generate an interest expense sufficient to offset the income that otherwise would be taxed at the maximum statutory rate. The fact is that Worthen and Lyon were very different kinds of taxpayers in very different circumstances. It is not credible that Worthen and Lyon, while sharing the same tax lawyer, with both Mr. Lyon and the lawyer sitting on the Worthen board, were unaware of their differing tax needs and the way each might be helpful to the other at the expense of only the United States Treasury.[122]

None of this, of course, should have made the slightest difference to the Court. If Lyon is entitled to depreciate the building, it is entitled to do so regardless of how valuable the depreciation deduction is to it and how relatively unimportant it is to Worthen. But if the Court believed that the absence of a special tax circumstance mattered, it should have remanded for findings on the issue, or dismissed the writ of certiorari as improvidently granted, or required Lyon's counsel to support his assertion that neither party to the Worthen-Lyon transaction was in a special tax circumstance. Government counsel failed in not challenging the assertion and not explaining to the Court that commercial banks have a special, if not unique, tax status. Although the assumed absence of a special tax circumstance should not have been important to the Court in reaching its decision, the Court, as good advocates know, better appreciates the tension between tax collector and taxpayer when one exists.[123]

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[121] By "effective marginal rate" I mean the *lower* of the rate of "implicit tax" or the highest rate of federal income tax applicable to a taxpayer's taxable income. I am indebted to my colleague, William D. Andrews, for the term "effective marginal rate."

[122] During the period in question, Worthen enjoyed an "effective marginal tax rate" well below the maximum statutory rate of 48%, although it chose to pay federal tax on some of its income at 48%. *See* Letters from Lyon's counsel, J. Gaston Williamson, to Bernard Wolfman (July 6, 1978, October 19, 1981, and November 2, 1981) (on file at *Cornell Law Review*). *See also* note 113 *supra.*

Public records show that First Arkansas Bankstock Corporation, which acquired 99% of Worthen's stock in 1969, had an average effective tax rate of only 11% during the period 1971-1975 inclusive. *See* ANNUAL REPORT OF FIRST ARKANSAS BANKSTOCK CORPORATION TO SECURITIES AND EXCHANGE COMMISSION 28 (1975). It is clear from the Report that Worthen's holdings of municipal bonds were primarily responsible for Worthen's low rate of federal income tax throughout the period. Although the precise data are not available for each year, it appears that Worthen, like other commercial banks, generally was able to determine how much, if any, of its income was to be taxed at 48%, the rate at which the bulk of Lyon's income was taxed.

[123] It is apparent from the Court's opinion in *Frank Lyon*, 435 U.S. at 561 n.18, that it accepted the government's successful reallocation of the depreciation deduction in Sun Oil Co. v. Commissioner, 562 F.2d 258 (3d Cir. 1977), *cert. denied*, 436 U.S. 944 (1978), largely because it knew that one of the parties involved in that sale-leaseback was tax-exempt. What if

At trial, government counsel should have made it clear to the district court that this controversy involved the allocation of deductions between a taxpayer unlikely to be subject to much tax at high marginal rates, except at its pleasure, and a taxpayer with so much taxable income that it feared imposition of a section 531 penalty. Only with that type of record could the government be confident that the courts would not view the question as largely academic, one for which it was not worth upsetting businessmen's expectations.

IV

THE FUTURE OF *Frank Lyon* AND THE ADVERSARY PROCESS

The full scope of *Frank Lyon* is unclear.[124] The Court concluded its opinion on a relatively broad note, stating:

> [W]e hold that where . . . there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features . . . [the lessor retains significant and genuine attributes of the traditional lessor status,] the form of the transaction adopted by the parties governs for tax purposes.[125]

But the Court also relied on twenty-six factors peculiar to this transaction, leading one commentator to observe, "[D]espite [*Lyon*'s] favorable outcome for the taxpayer, it may actually only benefit the Commissioner, who will be able to show that few, if any, future cases are ones where all the *Lyon* factors are present."[126]

Frank Lyon did not have to happen. The elucidation of principle in tax cases should not depend on irrelevant or legalistic distinctions. A Supreme Court opinion ought not become the basis for tax lawyers to make a laughingstock of the Court as they now do when quite routinely they add unnecessary third parties to financing transactions

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the Court had known that Worthen, like all commercial banks, was in a very special tax circumstance?

[124] *See* Fuller, *Sales and Leasebacks and the* Frank Lyon *Case*, 48 GEO. WASH. L. REV. 60 (1979).

[125] 435 U.S. at 583-84.

[126] Zarrow & Gordon, *Supreme Court's Sale-Leaseback Decision in* Lyon *Lists Multiple Criteria*, 49 J. TAX. 42, 47 (1978). In Davis v. Commissioner, 585 F.2d 807, 814-15 (6th Cir. 1978), *cert. denied*, 440 U.S. 981 (1979), the court compared the facts in the case before it with those present in *Lyon*; in Belz Inv. Co. v. Commissioner, 72 T.C. 1209, 1226 (1979), the court stated, "[I]t is difficult to pinpoint a general legal proposition for which [*Lyon*] stands." *But cf.* Hilton v. Commissioner, 74 T.C. 305, 346 (1980) ("[I]mplicit in the [*Lyon*] Court's opinion is the acceptance of the proposition . . . that the seller-lessee's financing requirements may be a valid business purpose to support a sale-leaseback transaction for tax purposes.").

in order to qualify for the shelter of *Frank Lyon*.[127] Until the time comes when the Court can undo the mischief of *Frank Lyon*, one hopes that the Service and lower courts will see it as a case whose precedential significance is impaired substantially by the flawed process from which it emerged.

It is too much, if not wrong, to expect the Court to develop an enduring and sophisticated tax jurisprudence. In an environment of infinitely diverse and complex transactions governed by an arcane Code, the Court cannot devote the time necessary to become expert. Except in the most unusual circumstances, therefore, it is necessary for the Court to protect itself from cases that have not produced sharply conflicting decisions below. The Court should satisfy itself that an asserted conflict is real and not just rhetorical or superficial, that the tensions in the allegedly conflicting cases are the same.[128] The Court in this instance should have seen the difference between *American Realty Trust* and *Frank Lyon* on its own, even without the wonted help of the Solicitor General. The Court, moreover, has a duty to ascertain whether it is actually deciding the case it thinks it is. If relevant facts are not evident from the record, the Court should either remand the case or dismiss the writ of certiorari. The Court must exercise such restraint if the process is to function and if its decisions are to be accepted as precedents worthy of respect and deference.

Nor is it too much to ask that counsel help the Court. The Solicitor General's role is special in this respect because the Court has long looked to him for assurance that the analysis is complete, the research exhaustive, and the shoddy and irrelevant exposed. Moreover, the Court has a right to expect that all counsel will look critically at the contentions and assertions of their adversaries and that none

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[127] *See* Fuller, *Sales and Leasebacks and the* Frank Lyon *Case*, 48 GEO. WASH. L. REV. 60, 81 (1979) (recommending that tax lawyers always include third parties in sale-leasebacks, without suggesting any function for third parties, and citing *Frank Lyon*).

[128] In Singleton v. Commissioner, 439 U.S. 940 (1978), Justice Blackmun, dissenting from the Court's denial of certiorari, urged quite reasonably that even in the absence of a conflict below, review of a tax case is justifiable when the issue has "importance in the administration of the tax laws" as long as it is not "too fact-specific or incapable of precedential effect." Justice Stevens, also quite reasonably, supported the Court's denial of the writ, stating that "the absence of any conflict among the Circuits is plainly a sufficient reason for denying certiorari." It is ironic that in *Frank Lyon*, where the Court assumed a square conflict below, it decides the case in a way that confounds administration of the tax law by emphasizing 26 fact-specific criteria as its ground for decision.

There can be cases in the absence of an asserted conflict that will justify Supreme Court review on the conditions Justice Blackmun indicated. *See, e.g.*, United States v. Cannelton Sewer Pipe Co., 364 U.S. 76 (1960). But those conditions may be more apparent than real, and as *Frank Lyon* indicates, even when conflicts are asserted there may be more illusion than reality.

will ever make assertions that lack a basis in the record. Such an environment and a diligent Court is needed if we are to shed some of our skepticism about the integrity of the adversary process, allay our suspicion that the case as described by the Court may be partially hypothetical, and come to respect the decisions of the Court as worthy precedent. The Court and its Bar must bring us to believe that the process that produces the ultimate interpretation of federal law is dependable and whole.

ADDENDUM

The author has learned that early in 1981 Worthen repurchased the bank building from Lyon in exchange for cash of $500,000 and Worthen's seven percent cumulative preferred stock of an aggregate par value of $14,000,000 and that twenty years hence Lyon can put the stock to Worthen for cash redemption at par plus accrued dividends.[129]

Under the terms of the Worthen-Lyon sale-leaseback, Worthen was granted an option to repurchase the building first exercisable after the eleventh year of the lease, on November 30, 1980, at a price of $6,325,169.85 (the amount of the unpaid New York Life note plus Lyon's $500,000 "equity" with six percent compound interest).[130]

For the first eleven years of the lease, Lyon's depreciation and interest deductions exceeded its rental income, providing substantial shelter for its other income.[131] Thereafter, beginning in 1981, if it remained the "owner" Lyon's rental income from Worthen would exceed the deductions, producing taxable income.[132]

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[129] *See* Letter from J. Gaston Williamson to Bernard Wolfman (October 19, 1981) (on file at *Cornell Law Review*). If Worthen chooses, it may pay for its preferred stock upon redemption in 20 years with $14,000,000 worth of the stock of its parent holding company, First Arkansas Bankstock Corporation. Lyon will pay off the outstanding balance on the New York Life note in accordance with its orginal terms. *See* Letter from Bernard Wolfman to J. Gaston Williamson (November 16, 1981) (on file at *Cornell Law Review*).

[130] Appendix, *supra* note 7, vol. 1, at 303 (district court finding of fact). See note 16 and accompanying text *supra*. A 20 year bond with a face value of $14,000,000, paying semi-annual interest of 7% and discounted to yield an annual return of 17.69%, would have a present value of approximately $5,825,170. That sum, plus the $500,000 cash payment, equals the option price. A discount rate of 17.69% apears reasonable for early 1981. According to the attorney for Worthen and Lyon, "Because of Worthen's need to increase its capital, this was a better buy for Worthen than exercising its option on November 30, 1980 to purchase the building for $6,325,170 in cash." Letter from J. Gaston Williamson to Bernard Wolfman (October 19, 1981) (on file at *Cornell Law Review*). As the government foresaw from the beginning, as the Eighth Circuit and the dissenting Justices would understand, Lyon has received only the repayment of its $500,000 with interest at six percent.

[131] Appendix, *supra* note 7, vol. 2, at 595 (P.Ex.36); notes 75-76 and accompanying text *supra*.

[132] *Id.*

The Government had projected the repurchase as an almost inevitable event. It urged this strong probability as an important reason for treating Worthen as owner of the building from the beginning. But Lyon persuaded the district court to find:

> Because of Worthen's future capital requirements, the very substantial amounts of the option prices, the reasonableness of the net rents Worthen will be required to pay . . . , it is most unlikely that Worthen will exercise its options to purchase at the end of the first eleven years of the lease . . . .[133]

The Supreme Court said that it could not "indulge in . . . speculation" to the contrary in light of this "clear finding."[134]

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[133] Appendix, *supra* note 7, vol. 1, at 304 (district court finding of fact).

[134] 435 U.S. at 581. For an outcome very different from that in *Frank Lyon*, in another context, see *A Gnat Challenges a Lyon* in L'Estrange, FABLES OF AESOP 13 (Harrison of Paris ed. 1931).