STATE OF MICHIGAN
DEPARTMENT OF LABOR AND ECONOMIC GROWTH
MICHIGAN TAX TRIBUNAL

J. C. Penney Company, Inc.,
Petitioner,

MTT Docket No. 301999

v

City of Ann Arbor,
Respondent.

Tribunal Judge Presiding
John S. Gilbreath, Jr.

ORDER GRANTING PETITIONER'S MOTION FOR SUMMARY DISPOSITION

ORDER DENYING RESPONDENT'S MOTION FOR SUMMARY DISPOSITION

INTRODUCTION AND PROCEDURAL HISTORY

Petitioner, J. C. Penney Company, Inc., occupies an anchor department store located at the Briarwood Mall in Ann Arbor, Michigan. In 1969, J.C. Penney Properties, Inc., Petitioner's wholly owned subsidiary, purchased real property, Parcel No. 9-12-08-100-021, which ultimately became part of the Mall. In March 1974, J.C. Penney Properties, Inc. sold the buildings on the subject properties to Pennarbor Associates, Inc. (hereinafter "Pennarbor") for $4,950,000 and also leased the subject parcels (hereinafter "ground lease") to Pennarbor. Simultaneously, Pennarbor leased the buildings (hereinafter "building lease") back to J. C. Penney Properties, Inc., and also subleased the land back to J.C. Penney Properties, Inc. (hereinafter "land sublease"). J. C. Penney Properties assigned its interests as tenant under the building lease and land sublease to Petitioner. The length of the leases nearly mirror each other, as the ground lease and the building lease run concurrently from March 13, 1974 to March 31, 2004 with each having various extensions with the potential expirations being April 1, 2049 and

March 31, 2034, respectively. The length of each term under the ground lease runs one day longer than its counterpart under the building lease.

In 2004, Petitioner appeared before Respondent's Board of Review to request a reduction in its assessment. Petitioner argued that the income stream based on the actual rents received pursuant to the building lease, did not support the true cash value used by Respondent to support the assessment on the subject property for *ad valorem* property tax purposes. The Board of Review denied the requested relief and appeal was made to the Tribunal.

Valuation disclosures were filed by both parties and a prehearing was conducted on February 3, 2006. At the pre-hearing, the parties essentially agreed that the decisive issue is whether Respondent improperly valued the subject property by using market rents under the income-capitalization approach rather than the actual rental income received under a long-term, economically disadvantageous lease encumbering the property as the cases of *CAF Investment Co v State Tax Commission*, 392 Mich 442; 221 NW2d 588 (1974) (*CAF I*) and *CAF Investment Co v Township of Saginaw*, 410 Mich 442; 302 NW2d 164 (1981) (*CAF II*) would require. See also *Uniroyal, Inc v Allen* Park, 138 Mich App 156, 360 NW2d 156 (1981). Petitioner argued that Respondent should have used the "actual rental income received under a long-term, economically disadvantageous lease" consistent with the directives found in *CAF I* and *CAF II*. Respondent argued that the lease referred to in the present situation is not a lease when viewed in the context of the other transactions. They argued that the sum of these transactions is the functional equivalent of a mortgage which takes these rents and these transactions outside of the *CAF I* and *CAF II* penumbra, thereby allowing Respondent to use "market rents" when utilizing the income approach in determining the true cash value.

The parties agreed that resolution of this case would be best accomplished through the filing of reciprocal dispositive motions. While they had been unable to agree to a set of stipulated facts, they do not contest the authenticity or relevance of the documentary evidence submitted to support their respective motions and positions. As such, motions with accompanying briefs were filed by each party on February 6, 2006. Responsive pleadings were subsequently filed by both parties. By request of the parties, it was determined that no oral argument was needed. The parties also agree that if Respondent prevails, the assessments will stand, and if Petitioner prevails, the values as propounded in the Petitioner's appraisal will be used for the true cash and assessed values for the years at issue.

At all times, the Petitioner has been represented by Attorney Laura M. Hallahan and Respondent has been represented by Attorney Kristin D. Larcom.

PETITIONER'S CONTENTIONS

As stated, Petitioner contends that the subject property is encumbered by an unfavorable, long-term lease, which when using the income-approach to determine the true cash value of the subject property, requires the capitalization of the actual rents received under the lease.

On March 1, 1974, Petitioner entered into two long-term leases with Pennarbor Associates. Petitioner argues that Petitioner and Pennarbor are unrelated entities. The original term of the building lease ran from March 13, 1974 to March 31, 2004 and includes four five-year extension options and two additional five-year extensions provided "certain investment criteria were met." In April, 2004, Petitioner exercised the first lease option. Pursuant to all lease options, the lease runs through March 31, 2034 and "encumbers the subject property until

that date."[1] Under the terms of the building lease, Petitioner is responsible for the payment of all property taxes on the subject property. Schedule B of the lease set out the rent rate for the lease period including the extensions which are "non-speculative." The rental rates "were at the prevailing market rate based upon conditions which existed at the time the lease agreement was executed."[2] The lease agreement "has **not** been amended or renegotiated since its inception." The lease has been in force since its inception and was in force on tax days for the years at issue.[3]

As to the application of the *CAF* cases, Petitioner first argues that the leasehold is an income-producing property properly valued using the income-capitalization approach. In support of this proposition, Petitioner cites *Uniroyal, Inc v Allen Park*, 138 Mich App 156, 360 NW2d 156 (1981). Because of this characteristic, Petitioner argues that the valuation must be based on the actual rent received under the lease and "not on hypothetical market rent."[4] Petitioner contends that the *CAF* doctrine applies to the valuation of the subject property because the "property is burdened by a long-term lease until March 31, 2034." Specifically, the Supreme Court in *CAF I* determined that "present economic income" of a property, as found in MCL 211.27, subject to a long term lease is comprised of the actual rental income derived under the lease.[5] Petitioner argues the *CAF I* decision "stands for the obvious proposition that a buyer will be unwilling to purchase property based upon current rental rates available in the market where he is unable to realize those rates due to an existing lease." In addition, Petitioner points to the

[1] Petitioner's Brief in Support of Summary Disposition, p. 2.
[2] Petitioner's Brief in Support of Summary Disposition, p. 2.
[3] Petitioner's Brief in Support of Summary Disposition, p. 3.
[4] Petitioner's Brief in Support of Summary Disposition, p. 3.
[5] MCL 211.27 defined "cash value" and within the statute cash value can be determined by using "*present economic income.*" In an obvious attempt to deal with the *CAF* cases, the Legislature later amended MCL 211.27 to distinguish between leases executed before and after January 1, 1984. In essence, those executed after January 1, 1984 are not bound by the *CAF* actual rent mandate. The leases in this case do not fall within this category and the *CAF* doctrine needs to be accounted for.

Court's holding in *CAF* II that the Tax Tribunal erred in failing to use actual income as the basis of valuing the property as directed in *CAF I*. Petitioner cites *Uniroyal*, *supra*, which "extended the *CAF* decision to lessees."[6] Petitioner notes that *Uniroyal* involved a sale-leaseback transaction similar to the one in the present situation. Despite the fact the Court of Appeals did not specifically address the issue of whether the sale-leaseback resulted in a disguised mortgage, Petitioner argues that because *Uniroyal* held that the *CAF* doctrine applied to that transaction, the transaction in the present situation requires the same treatment, *i.e.*, the application of the *CAF* doctrine.

The second argument presented by Petitioner is that the facts of this case do not fall into the limited exceptions of the *CAF* doctrine. These exceptions would allow the use of projected rental income, rather than actual rents, when valuing the property. The exceptions are:

> 1.) where the right to repossession of the land at the end of the lease, and the length of the lease term suggest that the projected income figure should at the least in part be adjusted to reflect current market conditions; 2.) where financing was obtained at a much more favorable rate than the current going rate, and there is a high current rate of capitalization such that the income-earning capacity of the property is greater than consideration of the unfavorable long-term lease rental at current capitalization rates: or 3.) where facts, peculiar to the circumstances under consideration, indicate that the income capitalization approach is too speculative to be a reliable indicator of valuation. 392 Mich at 455-456: see also *CAF II*, 410 Mich at 460-461.[7]

Petitioner concludes that the exceptions have been distilled to two situations, those being where the actual rent is too speculative or where the actual rent does not reflect the property's true cash value. In support of this position, Petitioner cites *Uniroyal, supra*, and *Jelinek v City of Lansing*, 5 MTT 82 (1986).[8]

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[6] Petitioner's Brief in Support of Summary Disposition, pp. 4-5.
[7] Petitioner's Brief in Support of Summary Disposition, p. 7.
[8] Petitioner's Brief in Support of Summary Disposition, pp. 6-7.

As for the application of these exceptions, Petitioner first argues that the actual rent in "the lease" is not speculative. Petitioner states that "[t]he lease clearly and expressly delineates the monthly rent for each twelve-month period of the lease (Exhibit 2, Schedule B, p. 43), providing six separate gradations of rental payment. The rent to be paid under the lease is obvious and apparent, not speculative."[9] As to the second situation, Petitioner argues that "the lease reflects the subject property's true cash value."[10] Petitioner argues that the application of this exception is narrow and the "Tax Tribunal has utilized this exception from the CAF doctrine in only two limited situations – where the long-term lease in question was set to expire or the rental rates were deemed not to have been economically viable at the time the lease was made." In support of this argument, Petitioner cites *Goodyear Tire & Rubber Co v City of Lansing*, 11 MTT 388 (2001); *Jelinek v City of Lansing*, 5 MTT 82 (1986); *Simpson & Moran, PC v City of Cheboygan*, 7 MTT 506 (1991); *Abraham v City of Detroit*, 8 MTT 169 (1994).[11] In its brief, Petitioner factually distinguishes each of the cited cases. Having analyzed these cases, Petitioner has concluded that the second exception does not apply to the current situation.[12] Petitioner states that:

> [T]he actual income from the long-term lease cannot be ignored; it constitutes the appropriate basis for valuation via the income approach to valuation. Market rent does not reflect the true cash value under the present long-term lease, as any potential buyer would consider the restricted cash flow income for the next 30 years. Under the *CAF* doctrine, the subject property should be valued via the income approach based on the actual rent received under the lease agreement."[13]

[9] Petitioner's Brief in Support of Summary Disposition, pp. 8
[10] Petitioner's Brief in Support of Summary Disposition, pp. 8
[11] Petitioner's Brief in Support of Summary Disposition, p. 8.
[12] Petitioner's Brief in Support of Summary Disposition, pp. 9-10.
[13] Petitioner's Brief in Support of Summary Disposition, pp. 10-11.

Petitioner has filed with the Tribunal a valuation disclosure in the form of a limited appraisal in a self-contained format.[14] The appraisal was prepared by David M. Heinowski, MAI, and Robert W. Scherer of the firm Colliers International. The appraisal was prepared for the purposes of this tax appeal and included the determination of true cash values for the 2003 and 2004 tax years. The proposed purpose of the appraisal is listed as "to estimate the true cash value, in terms of cash, of the leased fee estate of the subject property according to the restrictions and dictates required by law under what is commonly referred to as the '*CAF*' doctrine."[15] The end result was a true cash value determination of $6,485,000 for tax year 2003 and $6,545,000 for the 2004 tax year. These values evolved from the capitalization of the actual rental income derived under the terms of the lease.

Petitioner further contends that the building lease is a true lease containing standard provisions negotiated at arms-length, whereby Petitioner and Pennarbor retain the traditional roles as lessor and lessee, respectively. Petitioner points out that its role as attorney-in-fact for Pennarbor is limited to certain situations and that Petitioner is prohibited "from entering any amendments or modifications of, or surrendering, terminating or cancelling any of the agreements, or from taking any action that would impair the rights of the lessor."[16] Petitioner further states that Section 15 of the building lease which describes Petitioner's repurchase options is grossly misrepresented by Respondent, who has stated that the repurchase price under this Section is based on a sliding scale which correlates with the amount remaining on the mortgage held by Principal Mutual Life Insurance Company and effectively vests complete control and ownership of the subject property in Petitioner. Petitioner states that in order to

[14] See Petitioner's Valuation Disclosure, *Appraisal of Real Property Interest, J.C. Penney, Inc., 500 Briarwood Circle, Ann Arbor, Michigan.*
[15] See Petitioner's Valuation Disclosure, p. 2.
[16] Petitioner's Answer in Opposition to Respondent's Motion, p. 3.

repurchase the leased property, it must pay **the greater of**: 1) a predetermined price in accordance with Schedule C of the lease, or 2) the fair market value of the property, as determined by a third party appraiser. Petitioner states that all of the surrounding facts and circumstances dictate that the series of transactions entered into with Pennarbor result in a true, long-term lease which is economically unfavorable requiring the application of the *CAF* doctrine.

Petitioner requests the Tribunal enter an order that the *CAF* doctrine applies to the facts of this case and that the property should "be valued via the income approach to valuation based on the rents received under the 1974 Lease Agreement."[17]

RESPONDENT'S CONTENTIONS

Respondent raises two primary arguments. First, the facts of this case fall within the exceptions delineated by the *CAF* cases. Secondly, the terms of agreements between Petitioner and Pennarbor create, in substance, a financing mechanism akin to a mortgage, distinguishable from the facts in any of the cases utilizing the *CAF* doctrine. Either conclusion requires granting of a summary disposition for Respondent.

To its Motion for Summary Disposition, Respondent attached the following exhibits:

1. A Ground Lease executed between J.C. Penney Associates, as lessor, and Pennarbor Associates, as lessee. The lease is for land only.

2. A Building Lease and agreement executed between Pennarbor Associates, as lessor, and J.C. Penney Associates, lessee, of premises store no. 819 at the Briarwood Mall consisting of real property and improvements.

3. A Sale Leaseback Summary Sheet prepared by Teri Ladwig Cluoser of Petitioner and provided to Respondent as an answer to Interrogatories. The document sets out the various transactions utilized by Petitioner to complete

[17] Petitioner's Brief in Support of Summary Disposition, pp. 10-11.

the development of the subject property including references to the various leases.

4. A page of Petitioner's Appraisal which shows the sales history of the property which references the sale leaseback financing arrangement.

5. Affidavit of David Petrak, City Assessor, who opines that the transactions in sum constitute nothing more than a mortgage.

6. Petitioner's Motion to Bifurcate which admits that the pivot of this case is the Tribunal determination of the impact of *CAF I* and *CAF II* on the facts of this case.

From these exhibits Respondent extrapolated a number of factual conclusions, summarized as follows. Petitioner sold the buildings and leased the land to Pennarbor, who leased the buildings and the land back to Petitioner. The ground lease and the building lease run concurrently from March 13, 1974 to March 31, 2004, with the each having various extensions with the potential expirations being April 1, 2049 and March 31, 2034, respectively. These leases are net leases meaning that Petitioner is responsible for all expenses, maintenance, taxes, etc. Since 1994, Petitioner has had an unrestricted right to repurchase the property. Respondent further contends that the purchase price is predetermined under the lease.

The sum of these facts support the two arguments raised by Respondent. Respondent argues that these facts fit the exception to the strict rule of utilizing actual rents. The Court in *CAF II* stated:

> there may be such facts, peculiar to the circumstances under consideration, as would indicate that the income capitalization approach is too speculative to be a reliable indicator of valuation. In such circumstances the tax assessor may base his assessment upon a more reliable method of valuation.…a projected income figure arrived at by virtue of a capitalization of actual income may not reflect a truly accurate picture of a property's fair market value. *CAF II*, at 461.

Respondent concludes that the distinguishing facts from the CAF cases is that the building lease term gives Petitioner, since at least 1994, an unrestricted right to terminate the

lease and regain ownership. Respondent concludes that, as a result, Petitioner has complete control and effective ownership of the property. Respondent states, "Petitioner completely controls whether or not it pays any rent to the lessor for the buildings because the lease terms gives Petitioner unfettered discretion to choose to terminate paying rent by purchasing the property back from the lessor."[18] The argument continues that this ability to purchase is akin to a mortgage and in this vein, like a mortgage, the purchase price is listed in a schedule appended to the building lease so at a given point in time the parties will know what the remaining balance on the underlying debt is which can be satisfied at any time. Respondent further states that like a mortgage, the arrangement is beneficial to both parties because it allowed Petitioner to obtain cash up front while Pennarbor obtained an agreeable rate of return and consequently, the facts presented are distinguishable from the *CAF* cases.

FINDINGS OF FACT

In March 1974, Petitioner sold the buildings on the subject properties to Pennarbor for $4,950,000 and leased the land to Pennarbor. Simultaneously, Pennarbor leased the buildings back to Petitioner, and also subleased the land back to Petitioner. Petitioner and Pennarbor are separate, unrelated entities. The length of the leases nearly mirror each other, as the ground lease and the building lease run concurrently from March 13, 1974 to March 31, 2004 with each having various extensions with the potential expirations being April 1, 2049 and March 31, 2034, respectively. The length of each term under the ground lease runs one day longer than its counterpart under the building lease. The building lease contains a repurchase option exercisable by Petitioner. The purchase price set forth in the lease is the greater of 1) an amount which coincides with the time remaining on the lease, or 2) the fair market value of the property as

[18] Brief in Support of Respondent's Motion for Summary Disposition, p. 10.

encumbered by the long-term lease, to be determined by three appraisers, one appointed by each party and an independent third party appraiser, at the time the option is exercised.

The transaction entered into by Petitioner and Pennarbor constitutes a valid sale-leaseback. The United States Supreme Court has held that in circumstances such as those presented by these transactions are legitimate real estate transactions for federal income tax purposes so that parties to such a transaction can avail themselves of various deductions, i.e. the use of rent as an expense for income tax purposes. See *Frank Lyon Co v United States*, 435 US 561 (1978).

The building and ground leases have terms consistent with those contained in a traditional lease. The lessor in this instance retains legal title for the term of the lease and possibly longer, if the repurchase option is not exercised or, if the offering price is not accepted. The lessee retains possession and control over the physical property. The lessor has a right to evict the lessee. In sum, while certain aspects of the sale-lease back may coincide with similar provisions contained in a mortgage, the traditional lessee-lessor relationship still exists and consequently, the end result of this transaction or series of transactions is a long-term lease.

CONCLUSIONS OF LAW

It should first be noted that the seminal issue in this case is how to treat a transaction labeled as a long-term lease, which is part of a larger transaction or series of transactions. This argument has not been specifically addressed in the context of the *CAF* doctrine. Therefore, it is incumbent upon the Tribunal to craft an opinion to not only provide immediate relief to the parties in this case, but to provide a format to examine cases of similar type in a manner that complies with the doctrine formed through the *CAF* cases.

A. Motions for Summary Disposition

Under MCR 2.116(C)(10), a motion for summary disposition will be granted if the documentary evidence demonstrates that there is no genuine issue of material fact, and the moving party is entitled to judgment as a matter of law. *Smith v Globe Life Insurance*, 460 Mich 446, 454-455; 597 NW2d 28, 33 (1999). In *Quinto v Cross & Peters Co*, 451 Mich 358, 362-363; 547 NW2d 314, 317 (1996), the Michigan Supreme Court set forth the following standards for reviewing motions for summary disposition brought under MCR 2.116(C)(10):

> In reviewing a motion for summary disposition under MCR 2.116(C)(10), the trial court considers affidavits, pleadings, depositions, admissions, and documentary evidence filed by the parties, MCR 2.116(G)(5), in the light most favorable to the party opposing the motion. A trial court may grant a motion for summary disposition under MCR 2.116(C)(10) if affidavits or other documentary evidence show there is no genuine issue in respect to any material fact, and the moving party is entitled to judgment as a matter of law. MCR 2.116(C)(10), (G)(4).

The dispute in the present appeal hinges on the characterization of the series of transactions entered into by Petitioner with Pennarbor, and the legal significance of those transactions as they relate to ad valorem taxation. The parties essentially agree that there is no dispute as to the evidence presented, but the legal issue of the application of the *CAF* doctrine to the facts remains. As a result, summary disposition is proper.

B. Application of *CAF* Doctrine to Multiparty Transactions

Throughout the arguments and materials presented by both parties, the term sale-leaseback is used to describe the real estate transactions found in this case. The facts in *CAF* are distinguishable from the case at hand in this regard. The *CAF* cases dealt with a conventional lease as opposed to a more complex transaction.

While both the Michigan Court of Appeals and the Michigan Tax Tribunal in *Uniroyal v City of Allen Park* issued opinions in a case involving a sale-leaseback, the issue of whether a

sale-leaseback results in a long-term lease requiring the application of the *CAF* doctrine was never specifically raised and, therefore, never analyzed in that case. Respondent specifically raises the issue in this case and argues that *CAF* should not apply because the sale-leaseback essentially constitutes a mortgage. As such, the Tribunal is compelled to address Respondent's argument to properly dispose of this case. Furthermore, to address this issue will result in some guidance in order to better address other multi-transaction, multiparty transactions in the future.

1. The *CAF* Cases

In *CAF I*, C.A.F. Investment Company ("CAF") challenged the 1971-1975 property tax assessments issued by Saginaw Township. *CAF*, 392 Mich. 442. In an arms-length transaction, CAF entered into a long-term lease with S.S. Kresge Company ("S.S. Kresge") beginning in 1963, whereby CAF leased the disputed parcel to S.S. Kresge. *Id.* At the time of the dispute, the actual rental income derived by CAF under the lease was relatively low in comparison to what a comparable, unencumbered property could generate. *Id.* However, the actual rents accurately reflected fair market value at the time the lease was entered into. *Id.* Saginaw Township assessed the property using the income-capitalization approach, using an income figure which reflected the market rents that an unencumbered, comparable parcel was capable of producing, rather than the actual rents received under the lease. *Id.* By using these "economic rents," the assessed value of the disputed parcel was significantly increased primarily due to the appreciation of real estate during the period from when the lease was entered into until the disputed tax years. *Id.*

CAF protested the assessment(s) to the State Tax Commission, the predecessor to the Michigan Tax Tribunal, arguing that the true cash value of the subject property should be determined solely by capitalizing the actual rental income received. *Id.* CAF argued actual rents

are more indicative of the true cash value of the property due to the fact that any subsequent purchaser would take the property subject to the unfavorable lease. *Id*. However, the State Tax Commission upheld the original assessment. *Id*. The Michigan Supreme Court reversed the State Tax Commission's decision and remanded to the Michigan Tax Tribunal. The Court framed the issue as:

> Whether, under, Michigan Law, the tax commission was entitled to consider and give weight to evidence of valuation based upon a rate of return which comparable, unencumbered property could earn in the present marketplace in the face of an existing unfavorable long-term lease with an actual rate of return which is substantially less than the present "going rate." *Id*. at 447.

The Court held that under the circumstances presented, the Commission was not entitled to consider and give weight to such evidence. *Id*. In doing so, the Court held that "economic income" as used in the General Property Tax Act requires the consideration of actual rental income when using the income capitalization approach to determine the true cash value of real property subject to an unfavorable, long-term lease. *Id.* at 454. The use of "economic rents" without the consideration of actual rental income "does not comport with the constitutional and statutory standard of 'true cash value,'" if the lease, when entered into, was an arms-length transaction and the actual rental income derived from the lease bears a demonstrable relationship to the true cash value of the property. *Id.* at 455. The primary reason relied upon by the Court was the fact that using "economic rents" implied that property was available for rent in the marketplace, when that was not the case. *Id.*

On remand, the Tax Tribunal discussed the actual rental income, but ultimately decided to value the property based on the amount of income the disputed parcel was capable of producing during the disputed tax years, effectively reinstating the original assessment. However, on appeal the Supreme Court stated:

> Properties may have similar physical characteristics, but differences in economic factors will determine the usual selling price of the properties. Properties encumbered by different lease terms, zoning restrictions, or deed restrictions, although physically similar, would not have the same cash value on the open market. See *Kensington Hills Development Co. v Milford Twp*, 10 Mich App 368, 159 NW2d 330 (1968); *Lochmoor Club v. Grosse Pointe Woods*, 10 Mich App 394, 159 NW2d 756 (1968). It would be incongruous, indeed volatile of the rule of uniformity, to assess two properties the same despite the fact that their usual selling prices are different. *CAF Investment Co v Township of Saginaw*, 410 Mich 442; 302 NW2d 164 (1981) (*CAF II*).

Therefore, when using the income-capitalization approach to value real property subject to an unfavorable long-term lease, the actual rents generated under that lease are to be used in the income-capitalization formula as opposed to the rents a comparable, unencumbered property could generate because the actual rents are more indicative of the true cash value of the subject property as encumbered.

In *Uniroyal v City of Allen Park*, 138 Mich App 156; 360 NW2d 156 (1984), the Court of Appeals held that even when the lessee is responsible for payment of the property taxes, the distinction is not sufficient to warrant a treatment different from that announced in *CAF I* and *CAF II*, *supra*. *Uniroyal*, 138 Mich App at 161. In *Uniroyal*, the disputed parcel was an 8.76-acre parcel with an office building and parking area purchased by the petitioner in 1964. The petitioner subsequently entered into a sale-leaseback arrangement as to the office parcel only. *Id.* at 156-7. The terms of the leaseback agreement in *Uniroyal* are similar to those in the present situation. *Id.* at 158. There was a 25-year initial term with several renewal options at the end of the initial term which potentially extended the length of the lease an additional 40 years. *Id.* The quarterly rents under the *Uniroyal* leaseback decreased upon the exercise of each option. The petitioner in *Uniroyal* similarly had repurchase options, the price of which decreased during the term of the leaseback and its options. *Id.* The agreement was a "net lease," meaning that it contained a provision which required the lessee or its assignees to "pay all costs incidental to

ownership, including property taxes." *Id.* at 159. The per curiam opinion issued by the Court of Appeals stated that the leaseback was "negotiated at arm's length by equal parties and on commercially reasonable terms at the time the lease was entered into" and as a result, the result was an encumbrance on the property that required the *CAF* approach to valuation. *Id.* at 161.

2. Characterization of the Transaction in the Present Appeal

The inception of this case begins with the development of a shopping center, the Briarwood Mall. A method was devised that would allow for the development of an anchor store to meet Petitioner's economic, geographic, and spatial needs. Petitioner purchased the property from the Briarwood Mall, developed it to suit its needs and then sold the buildings and leased the land to Pennarbor. Upon sale of the land, Pennarbor simultaneously leased both the land and the buildings back to Petitioner. This sale and simultaneous leaseback potentially had significant residual federal tax benefits to the various parties as well as providing Petitioner a large influx of capital. This series of transactions between Petitioner and Pennarbor Associates is characterized by those parties as a sale-leaseback.

Despite the fact that the series of transactions is labeled by Petitioner as a sale-leaseback, the Tribunal must independently determine how the transactions between Petitioner and Pennarbor Associates should be characterized, *i.e.*, as a lease, mortgage, or sale-leaseback. In making this determination, the substance of the transaction dictates its characterization, not its form. *Kostyu v Dept of Treasury*, 170 Mich App 123, 130. Depending on how the transactions are characterized, the consequences vary greatly. If the end result of the transactions does not result in an encumbrance identical or similar to a true lease, the *CAF* doctrine does not apply and the market rents the parcel is or was capable of generating must be used in the income-capitalization formula.

In a sale-leaseback, as the name suggests, the owner of property sells the property and simultaneously leases it back from the purchaser. There are numerous potential economic and federal tax advantages for both parties involved in a sale-leaseback. For the seller-lessee the advantages include: 1) "the infusion of working capital." This allows the seller-lessee to "invest in more profitable enterprises, and the ability to … retire some preexisting debt"; 2) balance sheet improvement, which improves short-term borrowing power and can decrease long-term debt; and 3) "the availability of a tax deduction for the rental payments made as a result of the subsequent leaseback."[19]

As for the buyer-lessor, the advantages are: 1) "ownership without management." This arrangement allows the buyer-lessor to become the equivalent of a passive investor who receives a fixed income stream"; 2) as long as the seller-lessee is creditworthy, there is increased stability in a secure income stream; 3) "[b]y acquiring title to the property after the expiration of the lease, the buyer-lessor has gained … the appreciation of [the] property value"; and 4)"the buyer-lessor is entitled to tax deductions in the form of interest, depreciation, and business deductions."[20]

The potential for abuse in these types of transactions is readily apparent. The prospective tax deductions provide an enticing opportunity for those parties who were already looking for a financing mechanism. By placing the sale-leaseback moniker on a transaction that is properly labeled as a mortgage, the parties involved attempt to take advantage of the tax benefits associated with the resulting "lease" while the actual interests involved and exchanged do not comport with those of a traditional lease, but those of a mortgage. The problem requires an analysis of the interests involved and which type of transaction they are underneath the purported label.

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[19] Milich, *The Real Estate Sale-Leaseback Transaction: A View Toward the 19s*, vol. 21, no. 1 Real Estate L J 66, 67-69 (Summer 1992).
[20] *Id*. at 69-71.

a. Mortgage

A real estate mortgage is a lien on the encumbered land and a security for the payment of indebtedness or the performance of an obligation. The title to the land and the right of possession, except as permitted by statute, remain in the mortgagor. See MIJUR MORTGAGES §1. Black's Law Dictionary, 7th ed, defines a mortgage as "[a] conveyance of title to property that is given as security for the payment of a debt or the performance of a duty and that will become void upon payment or performance according to the stipulated terms."

Respondent argues that the present situation is similar to a mortgage, where Petitioner is paying the interest on the "mortgage" through disguised "rental payments," and will pay off the remaining balance at the end of the lease, thereby discharging the lien on the property. Although Petitioner can make an offer to purchase the property at several points throughout the lease and is obligated in certain circumstances to make an offer to purchase, the offer must be the greater of the remaining balance on the schedule contained in the lease or the fair market value of the property and Pennarbor is not bound to accept any offer. As a result, Petitioner's rights at the end of the lease term are limited in a manner which is not analogous to a mortgage. Pennarbor is not merely holding the title to the parcels as security for the underlying rental payment obligations, they retain the ability to sell the property to Petitioner or another buyer if Petitioner does not exercise its right of first refusal at the end of the lease terms and make an offer to purchase at a price that is the greater of the amount remaining on the Schedule or the fair market value of the property. In a mortgage, after the performance of the required duty or satisfaction of the underlying debt, the mortgagor is entitled to full and equitable title. That is not the case in the present situation. As a result, the series of transactions in the present case do not result in a simple mortgage.

b. Lease

A lease is a conveyance by the owner of an estate or a portion of the interest therein to another for a term less than his own for a valuable consideration. *Minnis* v *Newbro-Gallogly Co,* 174 Mich 635, 639, 140 NW 980 (1913). See also *Dep't of Natural Resources* v *Westminster Church,* 114 Mich App 99, 104, 318 NW2d 830 (1982). A lease gives the tenant the possession of the property leased and exclusive use or occupation of it for all purposes not prohibited by the terms of the lease. *Macke Laundry Service Co* v *Overgaard,* 173 Mich App 250, 253, 433 NW2d 813 (1988). Under the Building Lease in the present situation, Pennarbor has conveyed only a portion of its interest in the subject property to Petitioner for a term less than its own for a valuable consideration. Petitioner has possession of this property and exclusive use or occupation of it for all purposes not prohibited by the terms of the agreement, which indicates that the end result is, in fact, a lease.

c. Federal Case Law Regarding Sale-Leaseback

Because the validity of a sale-leaseback has not been specifically addressed by Michigan courts in the context of the *CAF* doctrine, we will examine how federal courts treat these transactions for guidance. A transaction that is entered into solely for the purpose of reducing taxes and which is not supported by any economic or commercial objective is a sham and without effect for federal income tax purposes. *Frank Lyon Co* v *United States,* 435 US 561, 583-584 (1978); *Knetsch* v *United States*, 364 US 361, 365-366 (1960); *Rice's Toyota World, Inc* v *Commissioner,* 81 TC at 195-196. Because of the potential for abuse in sale-leaseback transactions, the Internal Revenue Service has attacked some of these sale-leaseback transactions, attempting to characterize them as financing agreements or disguised mortgages. This argument is analogous to the one presented by Respondent. Federal courts have utilized the

substance over form doctrine when analyzing the validity of sale-leasebacks. *Commissioner v Court Holding Co*, 324 US 331; *Helvering v F & R Lazarus & Co*, 308 US 252, 255; *Bowers v Kerbaugh-Empire Co*, 271 US 170, 174; 462 *Weiss v Stearn*, 265 US 242, 254; *US v Phellis*, 257 US 156, 168. At first, Federal courts looked to the subjective intent of the parties, but this gradually gave way to an objective economic realities test. In *Frank Lyon Co v United States*, 435 US 561, 98 SCt 1291 (1978), the Supreme Court stated:

> In applying this doctrine of substance over form, the Court has looked to the objective economic realities of a transaction rather than to the particular form the parties employed. The Court has never regarded 'the simple expedient of drawing up papers,' *Commissioner of Internal Revenue v. Tower*, 327 U.S. 280, 291, 66 S.Ct. 532, 538, 90 L.Ed. 670 (1946), as controlling for tax purposes when the objective economic realities are to the contrary. 'In the field of taxation, administrators of the laws and the courts are concerned with substance and realities, and formal written documents are not rigidly binding.' *Helvering v. Lazarus & Co.*, 308 U.S., at 255, 60 S.Ct., at 210. See also *Commissioner of Internal Revenue v. P. G. Lake, Inc.*, 356 U.S. 260, 266-267, 78 S.Ct. 691, 2 L.Ed.2d 743 (1958); *Commissioner of Internal Revenue v. Court Holding Co.*, 324 U.S. 331, 334, 65 S.Ct. 707, 89 L.Ed. 981 (1945). Nor is the parties' desire to achieve a particular tax result necessarily relevant. *Commissioner of Internal Revenue v. Duberstein*, 363 U.S. 278, 286, 80 S.Ct. 1190, 4 L.Ed.2d 1218(1960).

In *Lyon*, the seller-lessee, who was a bank, was unable to obtain traditional mortgage financing to construct a building on its property because of federal regulations. In an arms-length transaction, the seller-lessee sold the property and simultaneously leased it back from the buyer. This allowed the seller-lessee to obtain financing which it would have otherwise been unable to do under Federal law and it guaranteed the buyer-lessor a return on its investment with a calculated amount of risk. The sale-leaseback required the seller-lessee to make monthly payments roughly equal to the buyer-lessor's mortgage payment on the property. The leaseback contained a repurchase option for $500,000 plus the remaining balance on the outstanding mortgage owed by the buyer-lessor, which could be exercised by the seller-lessee at various times during the course of the lease, which effectively fixed the return that the buyer-lessor

would receive. In this respect, the transaction in *Lyon* was similar to a financing arrangement because the plaintiff in *Lyon* was likely to exercise the option at some point in the future because it was effectively building equity in the property through its monthly rental payments and the buyer-lessor had a relatively certain return on its investment, provided the property did not substantially depreciate in value and the seller-lessee did not default on the lease. Despite this repurchase option which made it highly likely that the seller-lessee would eventually become the owner again, the buyer-lessor retained significant attributes of the traditional lessor role at the time of the transaction and would continue to do so until the repurchase option was exercised, if it was at all. *Id.* Furthermore, the Supreme Court focused on the fact that the transaction was surrounded by tax-independent considerations:

> [W]here, as here, 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 that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties. Expressed another way, so long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction governs for tax purposes. What those attributes are in any particular case will necessarily depend upon its facts. It suffices to say that, as here, a sale-and-leaseback, in and of itself, does not necessarily operate to deny a taxpayer's claim for deductions. 435 US 561, at 583–84.

Therefore, the Court in *Lyon* held that as long as there is a 1) multi-party transaction with 2) economic substance compelled by tax-independent business and economic motives, and 3) the lessor retains significant and genuine attributes of the traditional lessor status, the characterization of the transaction given by the parties governs for federal tax purposes. In other words, by analyzing the motives and results of the transaction, a court can determine whether the series of transactions is more akin to a lease or a mortgage. Consequently, if a transaction characterized as a sale-leaseback satisfies the test set forth in *Lyon*, the transaction will result in a

long-term lease because the characteristics of the transaction are more akin to a long-term lease than a mortgage.

In the present case, Respondent takes a position similar to the Federal Government's position in *Lyon*. Respondent maintains that the sale-leaseback transaction was a disguised mortgage and Petitioner's characterization of the transaction should be disregarded because the transaction effectively lacks economic substance. Respondent argues that the transaction was merely a financing arrangement whereby Petitioner used Pennarbor as an instrument to forward mortgage payments on to the bank in exchange for guaranteeing Pennarbor a return on its investment. Consequently, Respondent contends that Pennarbor did not acquire the benefits and burdens of ownership in the subject property which does not comport with the traditional lessor role and makes the transaction a mortgage, not a lease. Respondent maintains that Petitioner retained sufficient incidents of ownership through the provisions of the net lease, which placed numerous benefits, burdens, and risks on Petitioner and gave Petitioner control over ownership of the property.

The Tribunal concludes that an analysis similar to the test adopted in *Frank Lyon* is the best way to determine whether the transaction is a lease or a mortgage. If there is: 1) a multi-party transaction with 2) economic substance compelled by tax-independent business and economic motives, and 3) the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction governs for tax purposes. If this test is met, the agreement between the parties shall be viewed as a valid sale-leaseback and will fall within the purview of *CAF* because the end result is a long-term encumbrance on the property similar or identical to a lease. If the sale-lease back is valid, the actual rents shall be used when following the income-approach for purposes of valuation. If the transaction fails the test, the form of the

transaction will be invalidated and the *CAF* doctrine will not apply, thereby requiring the use of market rents when following the income-approach.

C. The Applicable Three Part Test in Determining the Substance of a Transaction for *CAF* purposes

1. Is the Transaction a Multi-Party Transaction?

In *Lyon, supra*, the US Supreme Court distinguished between two-party transactions as found in *Lazarus, supra*, and *Sun Oil Co* v *Commissioner of Internal Revenue*, 562 F2d 258 (CA 3 1977) (a two-party case with the added feature that the second party was a tax-exempt pension trust) and multiple party transaction as found in *Lyon.* In so doing, the Court stated that "the [Lazarus] transaction was one involving only two (and not multiple) parties, the taxpayer-department store and the trustee-bank. . . The present case, in contrast, involves three parties, *Worthen*, Lyon, and the finance agency. . . Thus, the presence of the third party, in our view, significantly distinguishes this case from *Lazarus* and removes the latter as controlling authority." *Lyon*, 435 US at 575-6.

As indicated earlier, Petitioner sold the buildings and leased the land to Pennarbor. This "sale" portion of the transaction was financed through a mortgage taken out by Pennarbor which is currently held by Principal Mutual Life Insurance Company. Simultaneously, Pennarbor leased the land and buildings back to Petitioner. It is undisputed that Petitioner, Pennarbor, and Principal Mutual Life Insurance Company are unrelated parties. Therefore, the Tribunal finds that the transaction satisfies the first portion of the test. It should be noted that Court in *Lyon* indicated that if the seller-lessee and buyer-lessor were both liable on the underlying note, the multi-party distinction from *Lazarus* and *Sun Oil* would not exist. *Id.* at 574-6.

2. Is There a Tax-Independent Business or Economic Motives Compelling the Transaction?

In *Lyon*, the Court looked at the business and economic factors apart from the tax consequences of the transaction to determine whether the parties' motivation for engaging in the transaction was compelled by business or economic motives. The Court determined that federal regulations had prevented the seller-lessee from obtaining traditional mortgage financing, and the buyer-lessor was motivated by the opportunity for economic profit. *Id.* at 575.

In the present appeal, Petitioner developed the property to suit its needs, and then sold its ownership interest in the buildings on the property in order to generate an influx of capital needed for business operations. Petitioner simultaneously entered into a lease whereby it guaranteed its ability to use these buildings. Its ability to use the property is guaranteed through the terms of the lease and the option to purchase during the course of the lease. While several aspects of the lease are beneficial to Petitioner, this is not uncommon for a tenant with Petitioner's bargaining power. These are all strong indicators that Petitioner's motivation was business-oriented, which compelled the execution of this transaction. Furthermore, the potential to keep the transaction off its books for accounting purposes was another possible motivating factor in its decision to utilize the sale-leaseback format.

Aside from the tax implications, Pennarbor's business purpose is one of investment, which is evidenced by the fact that even if Petitioner exercises its option to purchase the property, the agreement allows Pennarbor to receive the greater of: 1) the amount under the schedule established in the lease or 2) fair market value of the property as determined by an independent appraiser. This is the primary benefit of ownership vested in Pennarbor. There are risks associated with Pennarbor's investment. There is the risk that the tenant will default on or withdraw from the lease, and there is also the risk that the property will depreciate over the term

of the lease. If this were a mortgage, Pennarbor would have different avenues to pursue a remedy for such a default, which Pennarbor relinquished in this agreement. In exchange for assuming this risk, Pennarbor enjoys the possibility of profit that is likely greater than that of a mortgage. This opportunity for Pennarbor to profit is tantamount to "economic substance." Therefore, the Tribunal finds that the second prong of the test has been satisfied.

3. Does the Buyer-Lessor Retain Significant and Genuine Attributes of Traditional Lessor Status?

In *Lyon,* the Supreme Court discussed the benefits and obligations imposed on the buyer-lessor and whether those attributes comported to that of the traditional lessor. In examining the transaction to determine its validity, the Court found that although the buyer-lessor was motivated by the economic opportunity for profit in a manner similar to that which motivates a traditional mortgage broker, the buyer-lessor had the rights and obligations of a lessor and treated the transaction as such. The Court stated:

> Here, however, and most significantly, it was Lyon alone, and not Worthen, who was liable on the notes, first to City Bank, and then to New York Life. Despite the facts that Worthen had agreed to pay rent and that this rent equaled the amounts due from Lyon to New York Life, should anything go awry in the later years of the lease, Lyon was primarily liable. No matter how the transaction could have been devised otherwise, it remains a fact that as the agreements were placed in final form, the obligation on the notes fell squarely on Lyon. Lyon, an ongoing enterprise, exposed its very business well-being to this real and substantial risk. The effect of this liability on Lyon is not just the abstract possibility that something will go wrong and that Worthen will not be able to make its payments. Lyon has disclosed this liability on its balance sheet for all the world to see. Its financial position was affected substantially by the presence of this long-term debt, despite the offsetting presence of the building as an asset. To the extent that Lyon has used its capital in this transaction, it is less able to obtain financing for other business needs. *Lyon*, 435 US at 576-8.

Furthermore, the dissent in *Lyon* discusses the repurchase price and its relationship to buyer-lessor's status. "A repurchase option based on fair market value, since it acknowledges the lessor's equity interest in the property, is consistent with a lessor-lessee relationship." *Lyon,*

435 US at 586 (n. 2), citing *Breece Veneer & Panel Co* v *Commissioner of Internal Revenue*, 232 F2d 319 (CA 7 1956); *LTV Corp* v *Commissioner*, 63 TC 39, 50 (1974); see generally Comment, Sale and Leaseback Transactions, 52 NYUL Rev 672, 688-689, n 117 (1977). In support of its position, Petitioner points to the option to purchase as the **greater** of that contained in 1) Schedule C of the lease, or 2) the fair market value of the property. Therefore, if the repurchase option is exercised prior to the end of the extended option terms, the purchase price of the property will be fair market value of the property, as encumbered by the long-term lease and its options. Consequently, any purchase price will reflect appreciation in the property, if there is any, and any excess will be directed to Pennarbor. This is a genuine and significant attribute of a party with "traditional lessor status."

Based on the structure of the agreements between Petitioner and Pennarbor, it is apparent that neither is the owner of the parcel in any simple sense, but it is Pennarbor's capital at stake as it is the obligee under the mortgage. Therefore, the Tribunal finds that Pennarbor retains sufficient incidents of the traditional lessor to satisfy the final part of the test.

CONCLUSION

The Tribunal finds that the sale-leaseback entered into by Petitioner and Pennarbor resulted in a long-term, unfavorable lease on the subject property. Furthermore, Respondent has not introduced evidence that the transaction was not at arms length, commercially unreasonable, or that the income capitalization approach is too speculative to be a reliable indicator of value, and therefore, has failed to sufficiently distinguish the present situation from those in *CAF* or *Uniroyal*, which prevents the application of the exceptions enumerated in *CAF I*. In the absence

of evidence that the rent was too speculative or not reflective of the property's true cash value at the time the lease was entered into, the limited exceptions to the *CAF* doctrine do not apply.

The Tribunal holds that when there is a valid sale-leaseback transaction as described above, the final result of such a transaction is an encumbrance on the property similar or identical to a long-term lease, and when valuing such property using the income approach, the actual rents must be used in accordance with the *CAF* doctrine. The final values are those as provided in the appraisal filed by Petitioner. They are as follows:

Parcel Number	Year	TCV	SEV	TV
09-12-08-100-021	2003	$5,100,000	$2,550,000	$2,550,000
09-12-08-100-021	2004	$5,100,000	$2,550,000	$2,550,000

JUDGMENT

IT IS ORDERED that the property's assessed and taxable values for the 2003 and 2004 tax years are those shown on the 27th page of this Opinion and Judgment.

IT IS FURTHER ORDERED that the officer charged with maintaining the assessment rolls for the tax years at issue shall correct or cause the assessment rolls to be corrected to reflect the assessed and taxable values in the amounts as finally shown in the "Conclusions" section of this Opinion and Judgment, subject to the processes of equalization, within 20 days of the entry of this Order. To the extent that the final level of assessment for a given year has not yet been determined and published, the assessment rolls shall be corrected once the final level is published or becomes known.

IT IS FURTHER ORDERED that the officer charged with collecting or refunding the affected taxes shall collect taxes and any applicable interest or issue a refund as required by this Order

within 20 days of the entry of this Order. If a refund is warranted, it shall include a proportionate share of any property tax administration fees paid and of penalty and interest paid on delinquent taxes. The refund shall also separately indicate the amount of the taxes, fees, penalties, and interest being refunded. A sum determined by the Tribunal to have been unlawfully paid shall bear interest from the date of payment to the date of judgment and the judgment shall bear interest to the date of its payment. A sum determined by the Tribunal to have been underpaid shall not bear interest for any time period prior to 28 days after the issuance of this Order. As provided by 1994 PA 254 and 1995 PA 232, being MCL 205.737, as amended, interest shall accrue for periods (i) after December 31, 2002 at the rate of 2.78% for calendar year 2003; (ii) after December 31, 2003, at the rate of 2.16% for calendar year 2004; (iii) after December 31, 2004, at a rate of 2.07% for the calendar year 2005; and after December 31, 2005, at a rate of 3.66% for the calendar year 2006.

This Order resolves all pending claims in this matter and closes this case.

MICHIGAN TAX TRIBUNAL

Entered: August 30, 2006

By: John S. Gilbreath, Jr.