DESCRIPTION OF H.R. 3110

RELATING TO

TAX TREATMENT OF PROPERTY USED BY NONTAXABLE ENTITIES

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS

ON JUNE 8, 1983

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The House Committee on Ways and Means has scheduled a public hearing on June 8, 1983, on H.R. 3110 (introduced by Messrs. Pickle, Rangel, Vander Jagt, Frenzel, Stark, Gradison, Duncan, Pease, Dorgan, and Martin of North Carolina). The bill relates to the tax treatment of property used by nontaxable entities. This pamphlet, prepared in connection with the hearing, provides a description of the bill and present law and related issues.

The first part of the pamphlet is a summary. The second part is a description of present law. The third part is a discussion of tax policy issues. Part four is a summary of the report and recommendations of the Ways and Means Subcommittee on Oversight, and part five is a description of the provisions of the bill.

I. SUMMARY

Present law

The Federal income tax benefits of ownership of property include accelerated cost recovery (ACRS) deductions and investment tax credits. Essentially, the law is that the economic substance of a transaction, not its form, determines who is entitled to the tax benefits associated with ownership. Thus, in a lease or similar arrangement, the person claiming ownership for Federal income tax purposes must show that he has sufficient economic indicia of ownership.

The tax benefits of ownership are generally allowed only for property used for a business or income-producing purpose. They are not available for property that is owned by governmental units and tax-exempt organizations. Property that is used by (though not owned by) a tax-exempt organization or a domestic governmental unit qualifies for ACRS deductions, but generally does not qualify for investment credits. For example, property used under a lease by one of these entities is ineligible for investment credits. A statutory exception to this investment credit limitation is that rehabilitation expenditures for a building leased to a tax-exempt organization or a governmental unit can qualify for the rehabilitation tax credit. Also, one court has held, and the Internal Revenue Service has ruled, that investment credits can be claimed where a governmental unit essentially contracts not for the use of property itself, but rather for a service to be provided by the owner of the property.

The investment credit limitation does not apply to property used by any possession of the United States, any foreign government, or any foreign person. However, if property is used predominantly outside the United States, ACRS deductions are reduced and generally no investment credit is allowed.

Present law rules relating to the ownership of property (in the context of leases or similar arrangements), the investment credit limitation, and the tax treatment of property used predominantly outside the United States are described in part II.

Issues

The recent increase in leasing and similar transactions by tax-exempt entities raises a number of tax policy issues. These issues include: (a) the extent to which the benefits of ACRS deductions, investment credits and deductions for interest expenses should be made available to tax-exempt entities that engage in leasing; (b) the efficiency of leasing for providing assistance to tax-exempt lessees; (c) the Federal revenue loss; (d) the impact of governmental leasing on public budgeting processes; and (e) the possibly adverse effect on public perceptions about the fairness of the income tax system. Many of these topics were addressed during a public hearing held by the Subcommittee on Oversight of the Committee on Ways and Means on February 28, 1983.

These issues are addressed in part III. The subcommittee's principal findings and recommendations, presented in its report to the committee, are summarized in part IV.

Description of the bill

In general, H.R. 3110 would reduce the tax benefits that would otherwise be available for property which is used by tax-exempt entities.

The bill would clarify that the investment tax credit limitation applies in cases where a service contract is more properly treated as a lease of property by a tax-exempt entity. The investment credit limitation would be extended to apply to property used by any international organization, foreign government, possession of the United States, and any foreign person not subject to U.S. tax on income from the property. The rehabilitation tax credit would not be allowed where the rehabilitation expenditure or building has been financed by a tax-exempt industrial development bond.

In general, the bill would require that ACRS deductions for property used by tax-exempt entities be computed using the straight-line method over extended recovery periods. In the case of 15-year real property, this provision would apply to the extent of the use by a tax-exempt entity, but only if more than 20 percent of the property is used under conditions specified in the bill. ACRS deductions for mass commuting vehicles that are eligible for safe-harbor leasing under present law would not be affected by the bill.

The bill would generally apply to property placed in service by the taxpayer after May 23, 1983. However, it would not apply to property used pursuant to written binding contracts that meet certain requirements.

The bill is described in detail in part V.

II. PRESENT LAW

A. Overview

Under present law, the rules for determining who is entitled to the tax benefits associated with the ownership of property generally are not written in the Internal Revenue Code; rather, they are embodied in a series of court cases and revenue rulings and revenue procedures issued by the Internal Revenue Service (IRS). Essentially, these rules focus on the economic substance of a transaction, not its form, for determining who (if anyone) is entitled to the tax benefits of ownership of property. Thus, in a lease or similar arrangement, the person claiming ownership for Federal income tax purposes must show that he has sufficient economic indicia of ownership.

In general, the tax benefits of ownership of property include depreciation or accelerated cost recovery (ACRS) deductions and investment tax credits. Generally, ACRS deductions and investment credits are allowed only for property used for a business or income-producing purpose.

As a general rule, governmental units and tax-exempt organizations are not entitled to ACRS deductions or investment tax credits for property owned by them. Moreover, no investment tax credit is allowed for property used (even though not owned) by a tax-exempt organization in its exempt function or by a governmental unit (nontaxable use restriction). This nontaxable use restriction does not affect the allowance of ACRS deductions and certain other tax benefits.

Property used by a foreign government or person is not subject to the nontaxable use restriction. However, if the property is used predominantly outside the United States (foreign-use property), ACRS deductions are reduced and generally no investment credit is allowed.

The traditional reasons for leasing stem from tax, accounting, and a variety of business considerations.[1] Tax-exempt organizations and governmental units have leased equipment for many of the same reasons as taxable entities. The recent increase in leasing and similar arrangements is due, in part, to budgetary limitations on the purchase of equipment and, in the case of some State and local governments, limitations on the ability to issue tax-exempt bonds. From a tax perspective, leasing allows certain tax benefits (such as ACRS deductions) to flow through (in the form of reduced rents) to nontaxable entities that are not eligible for such benefits on their own account. The reasons for arranging a transaction with a nontaxable entity as a service contract in some cases stem from

[1] These considerations are discussed in the pamphlet, "Analysis of Safe Harbor Leasing" (JCS-23-82), published in 1982 by the staff of the Joint Committee on Taxation.

the desire to avoid the nontaxable use restriction on the investment credit.[2]

What follows is a description of the present law rules governing the determination of ownership of property for Federal income tax purposes, in the context of leases or similar arrangements, and a description of the nontaxable use restriction on the investment tax credit. In the final section, the rules governing ACRS and the investment credit for foreign-use property are discussed.

B. The Ownership Issue

In general

The determination of ownership of property requires a case-by-case analysis of all facts and circumstances. Although the determination of ownership is inherently factual, a number of general principles have been developed in court cases, revenue rulings, and revenue procedures.[3]

In general, both the courts and the IRS focus on the substance of the transaction rather than its form. The courts do not disregard the form of a transaction simply because tax considerations are a significant motive, so long as the transaction also has a bona fide business purpose and the person claiming tax ownership retains sufficient burdens and benefits of ownership.

In general, for Federal income tax purposes, the owner of property must retain meaningful burdens and benefits of ownership.[4] The lessor must be the person who suffers (or benefits) from fluctuations in value. Thus, lease treatment is denied, and the lessee is treated as the owner, if the user has the option to obtain title to the property at the end of the lease for a price that is nominal in relation to the value of the property at the time when the option is exercisable (as determined at the time the parties entered into the agreement), or which is relatively small when compared with the total payments required to be made.[5]

Where the lessor's residual value in the property is nominal, the lessor is viewed as having transferred full ownership of the property for the rental. Where the purchase option is more than nominal but relatively small in comparison with fair market value, the lessor is viewed as having transferred full ownership because of the likelihood that the lessee will exercise the bargain purchase option.[6] Furthermore, if the lessor has a contractual right to require the lessee to purchase the property at the end of the lease (a "put"), the transaction could be denied lease treatment because the put eliminates the lessor's risks of fluctuation in value of the residual interest and the risk that there will be no market for the property at the end of the lease.

[2] See the pamphlet "Tax Aspects of Federal Leasing Arrangements" (JCS-3-83), published on February 25, 1983, by the staff of the Joint Committee on Taxation, for a discussion of the policy issues raised by leasing and similar arrangements involving nontaxable entities.

[3] These general principles are described fully in the Joint Committee staff pamphlet "Analysis of Safe Harbor Leasing" (JCS-23-82), and to a lesser extent in the pamphlet "Tax Aspects of Federal Leasing Arrangements" (JCS-3-83).

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

[5] See, Rev. Rul. 55-540, 1955—2 C.B. 39 (and cases cited therein).

[6] See, *M&W Gear Co.* v. *Commissioner*, 446 F.2d 841 (7th Cir. 1971).

Objective guidelines used in structuring transactions

To give taxpayers guidance in structuring leveraged leases (i.e., where the property is financed by a nonrecourse loan from a third party) of equipment, the IRS issued Revenue Procedure 75-21, 1975-1 C.B. 715, and a companion document, Revenue Procedure 75-28, 1975-1 C.B. 752 (the guidelines). If the requirements of the guidelines are met and if the facts and circumstances do not indicate a contrary result, the IRS will issue an advance letter ruling that the transaction is a lease and that the lessor is the owner for Federal income tax purposes.

The guidelines are not by their terms a definitive statement of legal principles and are not intended for audit purposes. Thus, if all requirements of the guidelines are not met, a transaction might still be considered a lease if, after considering all facts and circumstances, the transaction is a lease under the general principles described above.

The specific requirements for obtaining a ruling under the guidelines are as follows:

1. *Minimum investment.*—The lessor must have a minimum 20-percent unconditional at-risk investment in the property.

2. *Purchase options.*—In general, the lessee may not have an option to purchase the property at the end of the lease term unless, under the lease agreement, the option can be exercised only at fair market value (determined at the time of exercise). This rule precludes fixed price purchase options, even at a bona fide estimate of the projected fair market value of the property at the option date.

3. *Lessee investment precluded.*—Neither the lessee nor a party related to the lessee may furnish any part of the cost of the property.

4. *No lessee loans or guarantees.*—As a corollary to the prior rule, the lessee must not loan to the lessor any of the funds necessary to acquire the property. In addition, the lessee must not guarantee any loan to the lessor.

5. *Profit and cash flow requirements.*—The lessor must expect to receive a profit from the transaction and have a positive cash flow independent of tax benefits.

6. *Limited use property.*—Under Revenue Procedure 76-30, 1976-2 C.B. 647, property that can be used only by the lessee (limited use property) is not eligible for lease treatment.

C. Nontaxable Use Restriction on the Investment Credit

General rule

Property that is "used by" a tax-exempt organization in an exempt function or a governmental unit generally is ineligible for the investment tax credit (secs. 48(a)(4) and 48(a)(5)). For this purpose, a governmental unit includes the U.S. government, any State or local government, most international organizations, and any agency or instrumentality of the foregoing. A tax-exempt organization is any organization exempt from Federal income tax, such as a charitable or educational organization.

To determine whether property is subject to the nontaxable use restriction, it is first necessary to evaluate the economic substance of the transaction under the general principles for determining who is the tax owner of property.[7] Under the nontaxable use restriction the investment credit is unavailable with respect to property that is treated for Federal income tax purposes as being owned by a governmental unit or a tax-exempt organization for use in its exempt function. In addition, it is clear that property leased to a governmental unit or a tax-exempt organization is subject to the nontaxable use restriction. However, in addition to several statutory exceptions to the nontaxable use restriction, one court has held (and the IRS has ruled) that the investment tax credit can be claimed where the governmental unit essentially has contracted for a service, to be provided by the owner of property, rather than for the use of the property itself.

Rationale for the nontaxable use restriction

When the investment credit was enacted in 1962, it was designed to stimulate expansion of the Nation's productive facilities by reducing the net costs of acquiring new equipment. At that time, the restriction on government use was premised on the view that governmental demand for property is not dependent on its price. Thus, a reduction in price, which would, in effect, result if the investment credit were available, would not cause any corresponding increase in production.[8]

The restriction on use by a tax-exempt organization was enacted to prevent an investment credit for property used in a tax-exempt function from reducing the tax attributable to a taxable unrelated trade or business of the organization.

Statutory exceptions to the nontaxable use restriction

Tax-exempt organizations.—Under present law, certain farmers' cooperatives (which are considered exempt from tax even though they are subject to the rules of tax under subchapter T, relating to cooperatives and their patrons) are excluded from the restriction on use by a tax-exempt organization. Also, the credit is allowed for property used by a tax-exempt organization in a taxable unrelated trade or business.

Foreign governmental units.—Although international organizations generally are subject to the restriction, property used by the International Satellite Consortium, the International Maritime Satellite Organization, and any successor organizations, is excluded from the restriction on government use. Foreign governments and possessions of the United States are not subject to the restriction. Thus, a computer leased to the U.S. government is denied the credit, but a computer leased to a foreign embassy located in the United States is allowed the credit.

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[7] See, Rev. Rul. 68-590, 1968-2 C.B. 66. Revenue ruling 68-590 involved arrangements between a taxable corporation and a political subdivision of a State, providing for the tax-exempt financing, construction, and operation of an industrial project. The IRS did not apply the nontaxable use restriction, even though the governmental unit held legal title under a sale-leaseback. Rather, the IRS held that the corporation was the tax owner of the property. The IRS reasoned that, in view of the economic substance of the arrangement, the sale-leaseback arrangement was nothing more than a security device for the protection of the holders of the tax-exempt bonds.

[8] Somewhat different issues are discussed in part III and in the staff pamphlet "Tax Aspects of Federal Leasing Arrangements" (JCS-3-83.)

Rehabilitated buildings.—Under present law, rehabilitation tax credits are available for qualified rehabilitation expenditures incurred for older buildings leased to tax-exempt organizations or to governmental units.

Foreign persons.—Property used by foreign persons is not subject to the nontaxable use restriction. However, special rules (discussed below) apply if property is used predominantly outside the United States.

"Casual or short-term lease" exception

Under Treasury regulations, there is an exception to the nontaxable use restriction for property that is leased on a "casual or short-term basis." (Treas. reg. § 1.48-1 (j) and (k)).

Casual leases.—The term "casual lease" has been interpreted to mean a lease that lacks the formalities inherent in a written lease.[9] Another example of a casual lease might be the lease of an automobile from a car rental company by a governmental employee traveling on governmental business.[10]

Short-term leases.—The exception for short-term leases has been recognized as a means of allowing the government to fulfill an unforeseen or extraordinary need for obtaining the short-term use of property from the private sector, without causing the taxpayer to lose the credit.[11] Thus, property not ordinarily intended for lease to a tax-exempt organization or governmental entity may be leased under the exception for a short period in unforeseen or extraordinary circumstances.

In determining whether the exception for short-term leases applies, the courts have rejected the contention that the relevant consideration is whether the nonqualifying use constitutes a substantial portion of the useful life of the property.[12] The courts have also rejected the position that short-term use should be determined on the basis of the minimum legally enforceable period of a lease.[13]

"Service Contract" exception

Internal Revenue Service rulings.—Under Treasury regulations (§ 1.48-1(j) and (k)), property used by a governmental unit or tax-exempt organization means only property owned by or leased to one of those nontaxable entities. In Revenue Ruling 68-109, 1968-1 C.B. 10, the IRS ruled that property provided to a governmental unit as an integral part of a service is not "used by" the government within the meaning of section 48(a)(5).

Revenue Ruling 68-109 involved communications equipment installed by a public utility on the premises of governmental units. In ruling that the taxpayer's agreements with its customers were not sales or leases, but rather service contracts, the IRS relied on the fact that the taxpayer retained all ownership in and possession

[9] See, *Xerox Corporation* v. *United States,* 656 F.2d 659 (Ct. Cl. 1981).
[10] Id.
[11] *World Airways, Inc.* v. *Commissioner,* 564 F.2d 886 (9th Cir. 1977), *aff'g,* 62 T.C. 786 (1974).
[12] *World Airways Inc.* v. *Commissioner,* 62 T.C. 786 (1974), *aff'd* 564 F.2d 886 (9th Cir. 1977).
[13] Thus, the mere fact that a lease contains a cancellation clause will not result in application of this exception. *Xerox Corporation* v. *United States,* 656 F.2d 659 (Ct. Cl. 1981); *Stewart* v. *U.S.,*

and control over the equipment. The IRS also focused on the fact that the communications equipment was part of an integrated network used to render services to the customer, not property placed with a user to allow it to provide services to itself.

The IRS has issued a number of other rulings, including private rulings,[14] interpreting the service contract exception. For example, the investment tax credit has been denied in situations involving trucks operated under a service contract by government employees (Rev. Rul. 72-407, 1972 2 C.B. 10) and school buses operated by a private party under contract with a local school district (LTR 8104001 (February 27, 1980)). However, in LTR 8217040 (January 27, 1982), the IRS allowed the investment tax credit in a situation involving a time charter of a vessel to the Federal government. The IRS ruled that the taxpayer could claim an investment credit for the vessel, based on the taxpayer's representations that the taxpayer bore the risk of loss with respect to the vessel, had to retain possession and control over the vessel, was required to provide maintenance and secure insurance for the vessel, had to furnish and control the crew of the vessel, and that the time charter transferred no legal interest in the property to the Federal government.

The case law.—The only judicial decision dealing with the service contract exception to the nontaxable use restriction is *Xerox Corporation* v. *United States*, 656 F.2d 659 (Ct. Cl. 1981). In *Xerox*, a manufacturer provided duplicating machines to the Federal government. The Internal Revenue Service had issued a revenue ruling involving the same basic facts as in *Xerox* that held that the agreements were leases (Rev. Rul. 71-397, 1971-2 C.B. 63). The Court of Claims rejected the taxpayer's contention that its agreements were short-term leases, which are eligible for an exception to the governmental use restriction. However, the court held that the machines were eligible for the investment credit because they were provided as an integral part of a service contract.

Essentially, the Court of Claims based its decision on the IRS's own formulation of the service contract exception, as set forth in the holdings of published and private rulings (other than Rev. Rul. 71-397, 1971-2 C.B 63, which reached a contrary result on the same facts considered by the court in *Xerox*). The court rejected the government's contention that the service contract exception cannot ever apply where the customer's own personnel operate the machines, because this factor was present in the first ruling adopting the exception (i.e., Rev. Rul. 68-109, 1968-1 C.B. 10). The court emphasized that *Xerox* was not a case in which the cost or value of the property dominated the price of the total arrangement. The court also noted that, conceivably, its decision would be different if the Treasury regulations had formulated the precise confines of the service contract exception.

Although the published and private rulings do not articulate any single test for use in determining whether an agreement is a service arrangement or a lease, the court felt that the factors deemed common to service contracts in those rulings related to two broad areas of inquiry: (1) the nature of the possessory interest retained

[14] Although a private ruling is not binding on the IRS or the courts, a private ruling is helpful in interpreting the law in the absence of other authority.

by the taxpayer, and (2) the degree to which the property supplied is a component of an integrated operation in which the taxpayer has other responsibilities.[15]

Finally, in holding that the taxpayer's contractual arrangements could reasonably be deemed to be within the purpose of the investment credit, the court focused on the fact that the taxpayer manufactured machines for all customers not just the government, and that governmental use represented only 5 or 6 percent of the taxpayer's machines.

D. Foreign-use Limitations

Overview

Property "used predominantly outside the United States" is subject to reduced ACRS deductions and is not allowed investment credits (secs. 168(f)(2) and 48(a)(2)).

In general, the term "used predominantly outside the United States" means use outside the United States for more than half of the taxable year. However, there are a number of exceptions to this general rule. For example, communications satellites are excepted from the rules for foreign-use property. U.S.-flag vessels operated in the foreign or domestic commerce of the United States are excepted. Also, any aircraft registered by the Federal Aviation Agency and operated to and from the United States or operated under contract with the United States is eligible for the credit, even if operated by a foreign airline.

ACRS deductions

The recovery period for computing ACRS deductions for foreign-use personal property is equal to the present class life (midpoint life) for the property, as of January 1, 1981, under the prior law Asset Depreciation Range (ADR) system. For personal property for which there is no ADR midpoint life as of January 1, 1981, a 12-year recovery period must be used. The determination of useful lives based on facts and circumstances is not permitted. The owner of foreign-use personal property generally is allowed to use the 200-percent declining balance method of depreciation for the early years of the recovery period, and the straight-line method for later years.

For foreign real property (including all components of a building), the recovery period is 35 years. The owner of foreign real property is generally allowed to use the 150-percent declining balance method for the early years of the recovery period, switching to the straight-line method in later years.

In the case of foreign-use personal property or foreign real property, the straight-line method of depreciation can be used in lieu of the prescribed accelerated methods. In addition, for foreign-use personal property, the taxpayer may elect the straight-line method over one of the optional recovery periods allowed for domestic property (but the period elected may not be shorter than the ADR midpoint life, or, for property without an ADR midpoint life as of Jan-

[15] For a more detailed discussion of the court's analysis of these factors, see the Joint Committee staff pamphlet "Tax Aspects of Federal Leasing Arrangements" (JCS-3-83).

uary 1, 1981, 12 years). For foreign real property, the taxpayer may elect to use the straight-line method over a recovery period of 45 years (instead of 35 years).

III. TAX POLICY ISSUES

The recent increase in leasing and similar transactions by tax-exempt entities raises a number of tax policy issues.

One issue is the extent to which the benefits of ACRS deductions, investment credits and deductions for interest expenses should be made available to tax-exempt entities that engage in leasing. Currently, it is possible for the combined value of these tax benefits to exceed the tax on the lessor's rental income from a lease, so that there is a positive Federal subsidy to the transaction. When the lessee is tax-exempt, this subsidy cannot be offset by any tax that might have been generated by the lessee's use. In this situation, an entity that might have issued bonds at a tax-exempt interest rate to purchase an asset can lease it at a lower, tax-subsidized financing rate. This subsidy and this tax-driven advantage to leasing could be reduced or eliminated by an appropriate slowing down of ACRS deductions for property leased to tax-exempt entities and by a tightening of the various exceptions to the denial of the investment tax credit.

The second issue is whether leasing arrangements are an efficient way to provide Federal assistance to tax-exempt entities. Some of the tax benefits in a lease are retained by lawyers, investment bankers, leasing companies, and other agents or investors that are involved in the transaction, instead of being flowed through to the lessee as lower rents. To this extent, leasing is inefficient and raises the total government cost of financing.

A third issue is the revenue loss to the Treasury. The potential loss from the sale and leaseback of existing buildings could be considerable, and, in the long run, the leasing of new property could impose a comparable revenue cost. Yet, in some cases the revenue loss may be justified because of an overriding congressional commitment to a particular policy objective. For example, Congress has expressed a clear desire to encourage the rehabilitation of older buildings.

A fourth issue is the impact of governmental leasing on the appropriations process. Under present law, leasing by Federal, State, and local agencies can distort capital and operating budgets at all levels of government. Costs are shifted from the agencies' budgets to the U.S. Treasury. Lowering the tax incentive for government agencies to lease versus purchase property would reduce these distortions in the appropriations process.

A fifth issue relates to whether the use of tax-motivated arrangements by tax-exempt entities creates perceptions that the tax system is unfair or working badly. This possibility seems especially likely when highly visible assets, such as a city hall or college campus, are offered in sale-leaseback transactions.

The relative importance of these issues varies according to whether the lessee is a Federal government agency, a State or local government agency, a nonprofit organization, or a foreign government or person.

Federal Government

The main issues involved in leasing by Federal government agencies appear to be the distortion of the appropriations process, the potential inefficiency of tax-oriented leases, and the public's perception of the integrity of the Federal tax system. Leasing by a Federal agency distorts the appropriations process by shifting capital acquisition costs from the agency's budget to the Treasury in the form of reduced tax revenues. Thus, it reduces the control over spending normally exercised by the appropriations process by converting direct outlays, which require appropriations, into tax benefits, which do not. Leasing also shifts the disbursement of funds from the agency's procurement account to a possibly less scrutinized part of the budget, such as an operations and maintenance account. When a Federal agency leases, there is no lump sum authorization or annual outlay in the procurement section of the agency's budget; rather, the annual rental payments appear as outlay items as they occur. In addition, leasing may be inefficient and raise the total government cost of acquiring property. Finally, the sale of tax benefits by a Federal government agency, and the indemnification of these benefits against adverse IRS rulings, may contribute to a public perception of inequity in the Federal income tax system.

State and Local Governments

The main tax issue involved in State and local governmental leasing appears to be the extent to which tax benefits originally designed to encourage private sector capital formation should provide assistance to State and local governments.

Congress already provides assistance through the tax system to State and local governments by means of the exclusion from Federal tax of interest paid on municipal bonds and the itemized deduction for most State and local taxes. The 1983 combined cost to the Treasury of these items is expected to exceed $45 billion. Leasing increases the amount of assistance that State and local governments receive through the tax system, especially where it is done because bond issues have been rejected or limits on indebtedness have been reached.

In some instances, State and local governments combine the benefits of leasing and tax-exempt debt in the same transaction. In these transactions, industrial development bonds (IDBs) are issued to finance the sale of public property to the lessor. The proceeds of the sale may then be invested by the State or local government in taxable bonds, the interest on which is used to cover rental payments. However, such arrangements may be subject to the anti-arbitrage rules which prohibit the issuance of tax-exempt bonds for the purpose of purchasing taxable securities yielding a higher rate of return.

Finally, the potential revenue cost of sale-leasebacks appears to be very large due to the dollar value of the property currently owned by State and local governments.

Nonprofit Organizations

Leasing by nonprofit organizations generally raises similar tax policy issues as State and local governmental leasing. By selling its real estate and leasing it back, a nonprofit organization, in effect, borrows money at a very low cost because the lessor receives part of its return from tax benefits. The nonprofit organization can then reinvest the proceeds in securities and effectively earn an arbitrage profit from the Federal government.

Foreign Governments and Persons

As is the case with any other lessee, a foreign person leasing property from a U.S. lessor may receive an indirect tax subsidy from the U.S. Treasury. If the foreign person is taxable by the United States on the income generated by that property the subsidy is as justifiable as that provided to any other taxable user. However, if the foreigner is not subject to U.S. tax because it is a foreign government or a foreign entity not doing business in the United States, then many of the same issues as are described above are raised.

In addition, there is a further issue of whether the U.S. tax system should subsidize investment by a foreign government or foreign person. This issue would exist even if it were determined that it is appropriate to subsidize the use of property by U.S. nontaxable persons. For U.S.-produced goods, the subsidy might be justified as an export incentive. However, no similar justification exists where foreign-produced goods are leased. A related issue is the potential revenue cost if foreigners are able to take unrestricted advantage of U.S. tax subsidies by leasing property from U.S. lessors.

IV. REPORT OF THE WAYS AND MEANS SUBCOMMITTEE ON OVERSIGHT

The Subcommittee on Oversight of the Committee on Ways and Means held a public hearing on February 28, 1983, to examine Federal leasing practices and related matters.[1] The subcommittee transmitted its report, "Tax and Budget Issues Related to Leasing by Nontaxable Entities," to the committee on May 25, 1983.

The subcommittee's report found that entities which are not subject to U.S. income tax can, nevertheless, benefit from income tax deductions and, in some cases, income tax credits by obtaining the use of property through a lease, a service contract, or a similar arrangement. This occurs when a taxable lessor claims the tax benefits of ownership and shares them with a nontaxable lessee in the form of lower rents or service charges.

With respect to long-term leasing by Federal agencies and departments, the report concluded that the government pays more to lease property than to purchase it outright, because not all of the tax benefits generated by the lease are passed through as lower rents to the agency or department. The report recommended that a uniform method be used throughout the executive branch for determining the cost of leasing an asset, so that the associated revenue loss would effectively be treated as a Federal cost. Also, the report recommended changes in procedures regarding the congressional review of proposals for long-term leases by agencies and departments.

The subcommittee's report made two recommendations concerning investment credits and cost recovery deductions for property used by nontaxable entities. First, the report recommended that Congress clarify by statute that the investment credit limitation applies to this property when it is used under a lease which is structured as a service contract or a similar arrangement. Second, the report recommended that Congress consider limiting cost recovery deductions for this property so that the tax system does not make leasing more attractive to nontaxable entities than direct ownership.

Finally, the report expressed concern about any development that would permit nontaxable entities to obtain a tax subsidy by making minimal changes in the economic substance of transactions, so that transactions normally structured as purchases would qualify for lease treatment.

[1] See the Joint Committee staff pamphlet prepared for this hearing, "Tax Aspects of Federal Leasing Arrangements," (JCS-3-83), February 25, 1983.

V. DESCRIPTION OF THE BILL

Explanation of Provisions

Overview

In general, H.R. 3110 would reduce the tax benefits that would otherwise be available for property used by "tax-exempt entities" (as defined below). ACRS deductions would be reduced for this property. The nontaxable use restriction under present law would be clarified and expanded to cover U.S. possessions, all international organizations, foreign governments, and foreign persons not subject to U.S. tax. The rehabilitation tax credit would continue to be available for property leased to tax-exempt entities or governmental units except where the acquisition or reconstruction of the property is financed with the proceeds of tax-exempt industrial development bonds (IDBs).

The present law rules for determining ownership of property would be undisturbed by the bill. Thus, the bill would leave open the possibility that the tax-exempt entity could be treated as the owner of the property. As under present law, if the tax-exempt entity were treated as the owner, the tax benefits of ownership generally would be eliminated. Also, the bill would create no inferences regarding the present law treatment of service contracts under the nontaxable use restriction.

Depreciation

Reduced deductions.—In the case of property used by tax-exempt entities (tax-exempt use property), the bill would require that ACRS deductions (or depreciation deductions for property not eligible for ACRS) be computed by using the straight-line method (without regard to salvage value) over the following extended recovery periods:

In the case of:	*The recover period shall be:*
3-year property	5 years.
5-year property	12 years.
10-year property	25 years.
15-year public utility property	35 years.
15-year real property	35 years.

This set of recovery periods is intended to approximate a result, within the 5-class structure of ACRS, under which a tax-exempt entity would find the leasing of an asset from a taxable person no more or less attractive than direct ownership.

If a taxpayer elects under ACRS to recover the cost of property over an optional recovery period that exceeds the recovery period provided by the bill, then the cost of the property would be recovered over the longer period. For property that is not eligible for ACRS (e.g., by virtue of the anti-churning rules) or is excluded from ACRS by election of the taxpayer (e.g., where the taxpayer elects to depreciate under the unit-of-production method), the provisions of the bill would be applied by determining the class in which such property would fall if the property were subject to ACRS rules.

For property other than 15-year real property, the half-year convention used under prior law depreciation rules would apply. In the case of 15-year real property, first-year ACRS deductions would be determined on the basis of the number of months in the year in which the property was in service.

There would be an exception from the ACRS cutback provisions for short-term or casual leases of property other than 15-year real property.

Tax-exempt use property.—For depreciation purposes, property "used by" a tax-exempt entity would be defined generally the same as for the nontaxable use restriction (as modified by the bill and described below) on the investment credit. Thus, property used by a tax-exempt entity would include property owned by, leased to, or used under certain service contracts.

As an exception, 15-year real property would be treated as tax-exempt use property to the extent that the property is "used by" a tax-exempt entity, but only if more than 20 percent of the use of the property consists of use described in at least one of the following circumstances:

(1) The tax-exempt entity (or a related entity) participated in the financing of the property by issuing obligations the interest on which is exempt from Federal income tax under Code section 103;

(2) The property is subject to a lease containing a fixed-price purchase option exercisable by the tax-exempt entity (or a related entity), or a sale option under which the lessor can require such an entity to purchase the property (e.g., a put);

(3) The tax-exempt entity (or a related entity), directly or indirectly, protects the lessor from loss on its investment in the property; or

(4) The tax-exempt entity uses the property after a sale-leaseback or lease-leaseback.

For example, the provisions of the bill would apply if a municipality leases 25 percent of a building, 20 percent (or more) of the construction of which was financed with tax-exempt industrial development bonds issued by a municipality (or a related entity such as the State), but only to the extent of 25 percent of the cost of the property.

Investment tax credits

Service contracts.—The present law nontaxable use restriction on the investment credit would be clarified to apply to certain service contracts (in addition to leases and direct purchases by the tax-exempt entity) more properly treated as a lease (i.e., as if the property were used directly by the nontaxable entity). In determining whether a transaction structured as a service contract or similar arrangement is subject to the modified nontaxable use restriction, all facts and circumstances must be taken into account, including the degree of control exerted by the tax-exempt entity and facts indicating that the tax-exempt entity has a significant possessory or economic interest.

For example, the credit would be denied if all of the following factors were present in a transaction: (1) the property is used primarily to provide services for a tax-exempt entity for a large portion of the useful life (or value) of the property; (2) the tax-exempt entity bore the risk that the property will decline in value (e.g., if the tax-exempt entity upon early termination of the agreement must make up any difference between the actual value upon termination and an amount approximating the owner's unrecovered equity, remaining debt, and any tax liabilities generated); and (3) the tax-exempt entity bore the risk of damage to or loss of the property. On these facts, the result may be the same under present law. Moreover, under these facts, the tax-exempt entity might be considered the owner for Federal income tax purposes, eliminating both ACRS deductions and the investment credit.

On the other hand, the credit would be allowed where property is used to provide both a service to a tax-exempt entity and a service or product to one or more taxable entities such that the economic benefits and burdens of ownership are not borne primarily by the tax-exempt entity.

The present law exception for short-term or casual leases would be retained.

Rehabilitation credits.—In general, the bill would continue the exception provided by present law for qualified rehabilitation expenditures. Thus, the 15-, 20-, or 25-percent credit for rehabilitation expenditures would be available, notwithstanding the fact that a building is used by a tax-exempt organization or governmental unit. However, if any portion of the cost of acquiring or rehabilitating the building is financed with the proceeds of an industrial development bond (IDB) the interest on which is exempt from Federal income tax, such expenditures would not be treated as qualified rehabilitation expenditures. Thus, taxpayers would no longer be able to obtain the combined benefits of IDB financing and the credit for qualified rehabilitation expenditures. The restriction on IDB financing would apply, regardless of whether the user is a tax-exempt entity or whether the property is leased.

Definition of tax-exempt entity

The bill would define "tax-exempt entity," for purposes of the depreciation and investment credit rules, as: (1) the United States, any State or political subdivision thereof, any possession of the United States, any foreign government, any international organization (including the International Telecommunication Satellite Consortium and the International Maritime Satellite Organization, or any successor organization), or any agency or instrumentality of the foregoing; (2) any organization (other than certain farmers' cooperatives) that is exempt from U.S. income taxation; and (3) any foreign person, but only if the foreign person's income from use of the property is not subject to U.S. tax. A foreign person would be a tax-exempt entity if it were exempt from U.S. tax by virtue of an income tax treaty or other bilateral agreement.

Effective Date

Except as otherwise provided, the provisions of the bill would apply to property placed in service by the taxpayer after May 23, 1983.

Binding contracts.—The provisions of the bill would not apply to any property that is used by a tax-exempt entity pursuant to one or more written contracts, if (1) such contract or contracts were binding on May 23, 1983, and at all times thereafter, and (2) such contract or contracts required the taxpayer (or a predecessor in interest under the contract) to acquire, construct, reconstruct, or rehabilitate such property, and (3) such contract or contracts required the tax-exempt entity (or a related entity) to use the property (i.e., under a lease or service contract). However, in the case of property used by the United States, or a tax-exempt agency or instrumentality thereof, the transitional rule for binding contracts would not apply unless the property were placed in service before January 1, 1984. A technical revision (i.e., a cross-reference) is necessary to make clear that the definition of a tax-exempt entity for purposes of this binding contract rule would be the same as for the investment credit and depreciation provisions in the bill.

Mass commuting vehicles.—The provisions of the bill would not apply to any qualified mass commuting vehicle (as defined in section 103(b)(9)), which is financed in whole or in part by obligations the interest on which is exempt from tax under section 103(a), if (1) the vehicle is placed in service before January 1, 1988, or (2) the vehicle is placed in service after that date because of conditions not within the control of the lessor or the lessee and there was a binding contract or commitment entered into on or before May 23, 1983, for the acquisition or construction of the property. For purposes of this transitional rule, a binding commitment would include bids that have been accepted by a transit system but that may be challenged by third parties. In addition, change orders that would not affect the substance of a contract or commitment would be permitted. Such vehicles are eligible to be safe-harbor leased under the transitional rules provided by TEFRA (except that vehicles to be placed in service after 1988 under the safe harbor rules must have binding contracts in effect before April 1, 1983) (sec. 306(a)(4)).