Joint Committee on Taxation
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Safe Harbor Leasing Provisions Under Accelerated Cost Recovery System

Prior law

The benefits of depreciation deductions and investment credits attributable to property generally are available only to the owner of the property. In many cases, companies in a tax loss position and thus unable to use currently the tax benefits of owning equipment have been able to obtain a portion of those benefits indirectly by leasing the equipment from companies having sufficient taxable income to use the tax benefits. The use of the tax benefits by the leasing company would be reflected in reduced rental payments charged to the loss company. The determination of whether these "lease financing" transactions should be treated for tax purposes in accordance with their form as leases or whether they should be recharacterized as in substance conditional sales or financing arrangements has generated considerable litigation and uncertainty.

If a transfer of property is treated as a lease, reasonable rental payments by the lessee will be deductible by a lessee using the property in a trade or business. Also, since ownership under a lease remains with the lessor, the lessor is entitled to recover its costs through depreciation and investment tax credits. The rental payments received by the lessor are taxable at ordinary income rates. On the other hand, if the transfer is a financing arrangement or installment sale by the nominal lessor rather than a lease, the transferee of the property would not be able to deduct its payments as rent. Rather, the lessee's cost would be recovered in the form of depreciation and investment tax credits since it would be treated as the owner of the property by virtue of the sale.

If the lessee is not in a position to utilize these benfits, characterization of the transaction as a financing arrangement will result in a higher cost to the lessee than if the lessor took the benefits and passed them through to the lessee in the form of lower rents. For the lessor, no depreciation or investment credit would be allowed. Any difference between the lessor's basis in the property and the amount received from the lessee would be treated as gain from the sale of the property. Assuming the asset is a capital asset and has been held for more than 1 year, the gain would generally be capital gain (except for the portion treated as imputed interest under section 483, which is taxable at ordinary income rates). Installment reporting of the gain may be available to the seller.

The Internal Revenue Service in a series of Revenue Procedures has established guidelines for determining whether a transaction is a lease or merely a financing arrangement by the nominal lessor.

Included among the requirements for a transaction to be a true lease under the IRS guidelines are the following:

1. The lessor must have a 20 percent minimum at risk investment in the property throughout the lease term;

2. The lessor must have a positive cash flow and a profit from the lease independent of tax benefits;

3. The lessee must not have a right to purchase the property at less than fair market value;

4. The lessee must not have an investment in the lease and must not lend any of the purchase cost to the owner; and

5. The use of the property at the end of the term of the lease by a person other than the lessor must be commercially feasible.

Reasons for change

Under the depreciation rules that existed prior to enactment of the Economic Recovery Tax Act of 1981, many corporations were in a loss position and thus unable to utilize fully the tax benefits of depreciation deductions. Deductions that could not be used in a taxable year generated a net operating loss which had to be carried back 3 years and forward 7 years. Since, in many instances, the deductions permitted under ACRS will exceed those permitted under prior law depreciation rules, the net operating losses of companies previously in a loss position would be increased and companies that previously were marginally profitable would be thrown into a loss position.

Although the flexibility provisions under ACRS and extension of the carryover period for net operating losses to 15 years will enable some companies to avoid loss of tax benefits, many capital intensive companies still will be unable to utilize fully their tax benefits. Moreover, even if the tax benefits can be carried over and used in later years, in present value terms the tax benefits are reduced. Since ACRS is intended in part to provide loss companies with the same cost of capital as other firms, some form of transferability of tax benefits was considered necessary. In addition, some mechanism to prevent loss of tax benefits was considered necessary as an alternative to the increase in merger activity that might otherwise result.

During consideration of the tax bill, three options were considered: (1) a refundable investment tax credit, (2) a pure sale of tax benefits, and (3) a safe harbor guarantee of lease treatment. The first two options were not adopted primarily because of administrative difficulties in determining whether the property has been disposed of by the user in a transaction requiring recapture of investment credit or depreciation. Instead, the leasing rules were chosen as a means of introducing a form of transferability of tax benefits that differs from pure transferability in that the lessor must pick up an income stream from the transaction in the form of rent payments.

Explanation of Provision

Overview

The Act provides a safe harbor that guarantees a transaction will be a lease, rather than a financing arrangement, even though the transaction does not comply with the IRS guidelines. To be eligible for the safe harbor, the following requirements must be met:

1. Both parties must elect;

2. The nominal lessor must be a (a) corporation (other than a subchapter S corporation or a personal holding company), (b) a partnership all of the partners of which are one of those corporations, or (c) a grantor trust with respect to which the grantor and all beneficiaries of the trust are corporations or a partnership comprised of corporations;

3. The lessor must have a minimum at-risk investment in the property at all times during the lease term of at least 10 percent of the adjusted basis of the property;

4. The lease term must not exceed the greater of 90 percent of the property's useful life or of 150 percent of the ADR midpoint life of the property; and

5. The property must be "qualified leased property".

Factors disregarded

If a transaction meets the safe harbor requirements, the transaction will be treated as a lease entered into by the parties to the agreement and the nominal lessor will be treated as the owner for Federal tax purposes entitling him to depreciation and investment credit. The following factors will therefore not be taken into account in determining whether a transaction is a lease:

1. The fact the lessor or lessee must take the tax benefits into account in order to make a profit or cash flow from the transaction;

2. The fact the lessee is the owner of the property for State or local law purposes (e.g., has title to the property and retains the burdens, benefits, and incidents of ownership, such as payment of taxes and maintenance charges with respect to the property);

3. The fact that no person other than the lessee may be able to use the property after the lease term;

4. The fact the property may (or must) be bought or sold at the end of the lease term at a fixed or determinable price or the fact that a rental adjustment is made upward or downward to reflect the difference between the expected residual value of the property and the actual sales price;

5. The fact the lessee or a related party has provided financing or has guaranteed financing for the transaction (other than for the lessor's minimum 10 percent investment); and

6. The fact the obligation of any person is subject to any contingency or offset agreement.

The new provision is a significant change overriding several fundamental principles of tax law. Traditionally, the substance of a transaction rather than its form controls the tax consequences of a transaction. If a transaction has more than one step, separate steps must be considered as a whole to determine the true substance of the transaction. In addition, a transaction generally will not be given effect for tax purposes unless it serves some business purpose aside from reducing taxes. Many of the transactions that will be characterized as a lease under the safe harbor have no business purpose (other than to transfer tax benefits). When the substance of the transaction is examined the transaction may not bear any resemblance to a lease.

For example, assume corporation X acquires property worth $1 million but can't use the tax benefits. X and corporation Y agree, pursuant to the safe harbor rules, that X will transfer the property in a paper transaction to Y but X will retain all economic benefits and burdens of ownership, including title for State law purposes. Y will then lease back the property to X for the projected economic useful life of the property at which time there will be a paper transfer of the property back to X for $1. Y agrees to pay X $100,000 in cash and give X a note for $900,000 plus interest at 15 percent. In return, X agrees to pay rent in an amount exactly equal to Y's $900,000 net obligation plus interest.

Looking at the substance of the transaction between X and Y, which is cast in the form of a sale-leaseback, there has been no change of ownership or business purpose for the transaction. X is still in actuality the owner and user of the property and Y has no profit from the transaction excluding tax benefits. However, since the transaction would be treated as a sale by Y and leaseback to X under the safe harbor provisions, the Federal tax law will recognize the form of the transaction producing the following economic consequences because of tax benefits.

For Y, the 10 percent investment tax credit will offset exactly the $100,000 cash payment made to X. The present value of the tax savings due to depreciation, ITC, and interest deductions will exceed the present value of the tax on the rental income producing a return on Y's initial investment solely from tax savings.

For X, the transaction results in a reduction of cost of $100,000, which is the amount of the up-front cost payment by Y.

Minimum At-risk investment

In general, the requirement that a lessor maintain a 10 percent minimum at-risk investment in the property throughout the lease term means that the lessor must have an equity investment in the property. For this purpose, an equity investment includes only consideration paid and personal liability incurred by the lessor to purchase the property. Contrary to prior law, the minimum investment rule is determined with respect to the adjusted basis of the property rather than its original basis.

Qualified leased property

"Qualified leased property" means recovery property (other than a "rehabilitated building") which meets one of three requirements. First, "qualified leased property" includes new section 38 property of the lessor which is leased within 3 months after the property was placed in service and which, if acquired by the lessee, would have been new section 38 property of the lessee. Although the original use of the property must commence with the lessor to be new section 38 property, the lessor may use the property within the 3-month period prior to the lease.

Second, with respect to a sale-leaseback, "qualified leased property" includes property that was new section 38 property when acquired by the lessee. The sale to the nominal lessor and the leaseback to the lessee (the original user) must occur within 3 months after the property was placed in service by the lessee and the adjusted basis of the lessor must not exceed the adjusted basis of the lessee at the time of the lease.

For property placed in service before the date of enactment (August 13, 1981), property will be considered to have met the requirement that the property be leased within 3 months of the date the property was placed in service if the property is leased by November 13, 1981.

Since, except for a special rule relating to qualified mass commuting vehicles, the property must be new section 38 property in the hands of the lessee, the safe harbor rules will not apply with respect to the portion of any property used by the lessee for personal purposes.

Amount and timing of deductions and credits

Qualified leased property used during the 3-month period prior to the lease will be considered first placed in service at the time of the lease for purposes of determining when the cost recovery allowances and investment credits are taken. For a sale-leaseback, this rule prevents both the lessor and the lessee from claiming the

tax benefits for the property. This rule does not apply for purposes of determining whether the property is new section 38 property when acquired by the lessor (or by the lessee in a sale-leaseback) and thus meets the definition of qualified leased property.

The legislative history suggests that a lessor's basis in the leased property includes the entire amount of any obligation with respect to the property even if the obligation of the lessor is contingent or offset by rental payments. This rule, which overrides prior case law, eliminates the necessity of the parties actually making the offsetting payments to ensure the tax consequences of basis, income, and deductions that would have occurred if the payment had been made. However, the Secretary shall prescribe regulations to ensure that the lessor reports as income all rental payments due, even if not actually received because of the offset agreement. In addition, the Secretary shall prescribe regulations requiring the lessor to report the rental income on a ratable basis eliminating deferral of income to the lessor that would result by virtue of, for example, a balloon payment agreement. However, with respect to interest deductions, calculations under a level payment mortgage assumption will be permitted.

The Act also gives the Treasury authority to prescribe regulations necessary to carry out the purposes of the safe harbor, including (but not limited to) regulations consistent with those purposes that limit the amount and timing of deductions to the amount allowable without regard to the safe harbor rules. The Statement of Managers indicates that the conferees intended the amount and timing of cost recovery allowances in the hands of the lessor to be the same as they would have been in the hands of the lessee.

Appendix 1

Numerical Example of Sale-Leaseback Under Present Law

Parties: Corporation X, the nominal lessee, which expects to have no income tax liability in future years
Corporation Y, the nominal lessor, which expects to have income taxable at a 46-percent rate.

Agreement

1. X purchases new equipment having a 10-year ADR life for $1 million.
2. X sells the asset to Y for $1 million. Y pays X $200,000 cash and an $800,000 note. The note is for 15 years (150 percent of ADR life) at 15 percent annual interest and is paid in equal annual installments of $136,800 (that is, a level payment loan).
3. Y leases the equipment to X for 15 years and charges an annual rental of $136,800, which exactly offsets the debt service. Thus, the only money which changes hands between X and Y is $200,000 from Y to X.
4. At the end of the lease, Y sells the equipment to X for $1.

Results

1. X purchases a $1 million asset for $800,000. (X's rental payments and receipt of loan payments do not affect cash flow--because they are offsetting--or tax liability--because X is not in a taxable position.)
2. Y purchases for $200,000 tax savings worth more than $200,000. Y's tax savings year by year are shown below. Y has deductions for depreciation (column 2) and interest paid (column 3), and it has rental income (column 4). Y's net deduction and tax change are shown in columns 5 and 6, respectively. The present value of this stream (discounted at the after-tax rate of 8.1 percent, which corresponds to a pre-tax rate of 15 percent) is $321,000. Thus, by paying $200,000 to X, Y pays $321,100 less in tax, a gain of $121,000 in constant (present) dollars.

Another way to express Y's gain is as follows. If Y had purchased at par a 15-year, 15-percent bond for $200,000, then Y would have (net of tax on interest income) $643,300 after 15 years. On the other hand, if Y invests the tax savings of column 6 at 15 percent, then Y would have (net of tax on interest income) $1,032,700 after 15 years, a gain of $389,400 in comparable (future) dollars.

Benefits and Costs of Leasing to Y
(All amounts in $1,000)

	Deductions				
End of year	Depreciation	Interest paid	Rental income	Net	Change in tax
0	150	0	0	150	-169.0*
1	220	120.0	136.8	203.2	-93.5
2	210	117.5	136.8	190.7	-87.7
3	210	114.6	136.8	187.8	-86.4
4	210	111.2	136.8	184.4	-84.8
5		107.4	136.8	-29.4	13.5
6		103.0	136.8	-33.8	15.6
7		97.9	136.8	-38.9	17.9
8		92.1	136.8	-44.7	20.6
9		85.4	136.8	-51.4	23.7
10		77.7	136.8	-59.1	27.2
11		68.8	136.8	-68.0	31.3
12		58.6	136.8	-78.2	36.0
13		46.9	136.8	-90.0	41.4
14		33.4	136.8	-103.6	47.6
15		17.9	136.8	-119.0	54.7

* Includes regular investment tax credit of $100,000. Lease is executed at end of taxable year.

Appendix 2

ITC Strip

There has been some discussion of whether the new safe harbor leasing provisions can be used to transfer the investment credit (ITC) attributable to a property without also transferring the associated cost recovery deductions through a transaction sometimes referred to as an "ITC strip." It is not clear at present whether this transaction will be permitted.

The contemplated transaction would combine the new safe harbor leasing rules with the rule of prior law (sec. 48(d)) which permits the lessor of property to pass through the ITC to the lessee (in effect treating the lessee as the owner for ITC purposes) even though the lessor remains the owner for all other tax purposes and thus cannot pass through the depreciation benefits. If the ITC strip were to be permitted, it would be accomplished by having the user of the equipment lease it in a safe harbor lease to the company which is in effect acquiring the ITC. An election under section 48(d) would be made to pass the ITC to the lessee. The lessee would then sublease the property back to the user. The sublessee/user would retain the depreciation benefits as owner/lessor and the lessee/sublessor would obtain the ITC pursuant to the section 48(d) pass-through election under the original safe harbor lease.

The ITC strip may be illustrated by the following example of a company that acquires a $1 million of equipment for use in its business. It would like to "sell" the ITC attributable to the equipment because it is currently in a tax loss position. However, it projects long-term profitability and thus would like to retain the depreciation benefits which, assuming its projections are correct, it will be able to use in the years they arise. Accordingly, it would lease the equipment to the "buyer" of the ITC under a safe harbor lease and would elect to pass the $100,000 ITC through pursuant to section 48(d). Simultaneously, the "buyer" of the ITC would sublease the property back to the loss company under terms substantially similar to those contained in the original lease. The rental payments from the ITC buyer to the loss company on the original lease would exceed the offsetting rental payments in the opposite direction under the sublease by, say, $150,000. Assuming the $150,000 excess rent is deductible at a 46 percent rate, the lessee/sublessor would have purchased the $100,000 credit for an after-tax cost of $81,000 (54 percent of $150,000).