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

Prior law

Under prior law, if a transfer of property is treated as a lease, the payments by the lessee will be treated as rent, which is 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 payments received by the lessor are treated as rent, which is taxed 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 benefits, 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 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 portion treated as imputed interest under section 483 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 term of the lease by a person other than the lesser 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 fully utilize 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 fully utilize their tax benefits. 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. 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.

Traditionally, companies unable to use the tax benefits of owning equipment have leased the equipment, obtaining indirectly the tax benefit allowed the lessor in the form of reduced payments. However, the determination of whether a transaction is a lease or a financing arrangement has generated a considerable amount of litigation and uncertainty. Despite numerous court opinions, the issues generally must be resolved on a case-by-case basis, significantly eliminating the availability of lease financing as a means of transferability.

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 hooding 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;

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. Whether 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. Whether or not a 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 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. See generally, Gregory v. Helvering, 293 U.S. 465 (1935). Many of the transactions that will be characterized as a lease under the safe harbor have no business purpose (other than to transfer to 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 5 years 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. An equity investment is not the same necessarily as an "at-risk" investment within the meaning of section 465. Thus, in the case of a partnership of corporations, a distribution of income to a partner would not reduce the amount at risk. Also, the fact that the deductions allowed the lessor exceed the rental income under the lease will not affect the lessor's amount at risk.

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 leaseback 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 the lease is a sale-leaseback) for the definition of qualified leased property.

The Act also requires the Secretary to prescribe regulations limiting the aggregate amount and timing of deductions and credits for qualified leased property to the aggregate amount and timing allowable without regard to the safe harbor leasing provisions. For example, if the obligation of the lessor is contingent or offset by rental payments, the basis of the lessor in the qualified leased property includes the entire amount of that obligation. This eliminates the necessity of the parties actually making the offsetting payments to obtain 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 baloon payment agreement. However, with respect to interest deductions, calculations under a level payment mortgage assumption will be permitted.