[JOINT COMMITTEE PRINT]

DESCRIPTION OF S. 1564 (GOVERNMENTAL LEASE FINANCING REFORM ACT OF 1983)

RELATING TO

TAX TREATMENT OF PROPERTY LEASED TO TAX-EXEMPT ENTITIES

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON FINANCE

ON JULY 19, 1983

PREPARED BY THE STAFF

OF THE

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INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on July 19, 1983, on S. 1564 (Governmental Lease Financing Reform Act of 1983), introduced by Senators Dole, Metzenbaum, Durenberger, and Grassley. The bill relates to the tax treatment of property used by tax-exempt entities. This pamphlet, prepared in connection with the hearing, provides a description of the bill, 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 description of the provisions of the bill, including a comparison with the provisions of H.R. 3110 (on which a hearing was held by the House Committee on Ways and Means on June 9, 1983).

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 (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 qualified 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 is allowed for 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, then, in general, ACRS deductions are reduced and 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 and investment credits should be made available to tax-exempt entities that engage in leasing; (b) the efficiency of leasing as a means of providing assistance to tax-exempt lessees; (c) the Federal revenue loss; (d) the impact of governmental leasing on public budgeting processes; (e) the possibly adverse effect on public perceptions about the fairness of the income tax system; and (f) whether leasing facilitates the private supply of public services ("privatization"). These issues are addressed in part III.

Description of the Bill

In general, S. 1564 would reduce the tax benefits available for property that is leased to or otherwise used by tax-exempt entities (with exceptions for certain short-lived property, certain real property and property subject to short-term leases).

In general, the bill would require that ACRS deductions for property used by tax-exempt entities be computed using the straight-line method over a recovery period equal to the greater of the present class life of the property under the Asset Depreciation Range (ADR) system (40 years in the case of 15-year real property) or, in the case of property subject to a lease, 125 percent of the term of the lease. 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 50 percent of the property is used under circumstances 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 also provide criteria for determining whether a transaction that is structured as a service contract should be treated as a lease for purposes of the depreciation and investment tax credit provisions. The rehabilitation credit would be denied for real property that is subject to the slower depreciation rules provided 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 IV.

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), then, in general, ACRS deductions are reduced and 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 property 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

Overview

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 risk 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.

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[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 by 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 instrumentality of the foregoing. A tax-exempt organization is almost 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 use by a governmental unit 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 governmental 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-and-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. sec. 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 (sec. 1.48-1(j) and (k)), property used by a governmental unit or tax-exempt organization means 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.*, 77-2 U.S.T.C. 9648 (D. Neb. 1977).

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 have been 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

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[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, as are aircraft registered by the Federal Aviation Agency and operated to and from the United States or operated under contract with the United States, 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 mid-

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

point life, or, for property without an ADR midpoint life as of January 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

Overview

The recent increase in leasing and similar transactions by tax-exempt entities raises a number of tax policy issues. The relative importance of these issues varies according to whether the lessee is a Federal agency, a State or local governmental agency, a nonprofit organization, or a foreign government or person.

Neutrality

One issue is the extent to which economic distortions are created by making the benefits of ACRS deductions, investment credits and deductions for interest expenses available to tax-exempt entities that engage in leasing.

This issue arises because the present tax system can act to subsidize certain investments in buildings and equipment. In the case of equity-financed investments in equipment, the present combination of 3-year or 5-year accelerated cost recovery and the investment tax credit is approximately equivalent to writing off the entire cost of the equipment in the year the asset is placed in service (expensing). Expensing, in turn, is equivalent to a tax exemption for the asset because the present value of the deductions and credits for a taxable investor will be equal to the present value of the income from the asset. Thus, under this analysis, tax-exempt entities have the same incentives to make equity-financed investments in equipment as taxable persons, and the tax system provides no tax incentive for tax-exempt entities to lease, rather than own, equity-financed equipment. In the case of equity-financed purchases of buildings, for which cost recovery deductions are less generous than expensing, there is a positive tax for taxable persons, and tax-exempt entities have both greater incentives to purchase the building than taxable persons and an incentive to own rather than lease it.

However, these results change considerably when the possibility of debt finance is allowed for. For debt-financed investments in equipment, the additional interest deductions mean that the total value of the cost recovery deductions, interest deductions and investment credit to a taxable investor will frequently exceed the tax paid on the income generated by the equipment. In effect, the federal government subsidizes the investment to the extent of this negative tax.[16] Tax-exempt entities are denied this subsidy for the equipment they own and may only receive it by leasing the equipment they use. For buildings owned by taxable persons, which typically are highly leveraged, interest deductions can convert the posi-

[16] More precisely, there is a subsidy to the extent that the negative tax exceeds the income tax paid on the interest income received by the lender.

tive tax on equity-financed structures into a negative tax, so that there can be a tax incentive for tax-exempt entities to lease, rather than own, the buildings they use.

According to one theory, tax subsidies should be made equally available to both taxable and tax-exempt entities. It is argued that this would provide for an efficient allocation of capital between the tax-exempt and taxable sectors. Under this theory, it would be wrong to prevent tax-exempt entities from receiving the benefits of tax incentives through leasing.

However, there are at least two problems with this analysis. First, if one carries to its logical conclusion the notion that taxable and tax-exempt entities should be given equal incentives, it leads to the result that these entities should be treated equally in all respects; that is, that tax-exempt status should be repealed. Second, providing tax-exempt entities with tax benefits through leasing could lead to the curious result that they would eventually lease rather than own most or all of their buildings and equipment.

A second position, embodied in S. 1564, is that the tax benefits available to a tax-exempt lessee ought to be sufficient to produce tax-free financing but not tax-subsidized financing. Then the tax system would be neutral with respect to a tax-exempt entity's decision to lease an asset or to purchase it (with proceeds of tax-exempt bonds), as tax-free financing would result in either case. One way to reduce or eliminate the current potential for subsidy and the tax-driven advantage to leasing over purchasing would be to slow down ACRS deductions for property leased to tax-exempt entities and tighten the various exceptions to the denial of investment tax credit.

Efficiency

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 may be an inefficient way of assisting tax-exempt entities compared with direct spending programs like general revenue sharing.

Revenue loss

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. In some cases the revenue loss may be justified because of an overriding congressional commitment to a particular policy objective. However, the current tax subsidy for tax-exempt lessees is generally available on an open-ended basis and without limitation to specific cases.

Budget process

A fourth issue is the impact of governmental leasing on the budget 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

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U.S. Treasury, making it difficult to determine how much Federal assistance is being provided and to whom or for what purposes it is being provided. Lowering the tax incentive for government agencies to lease rather than purchase property would reduce these distortions in the budget process.

Public perceptions

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, or when U.S. tax benefits are allowed for assets that are neither produced nor used domestically.

Privatization

A sixth issue has been raised by some who contend that private parties can provide public services more economically than can governments. It is argued that, as leasing is a mechanism for promoting the "privatization" of public services, it should be encouraged. The greater expertise of private providers, as well as their ability to bypass negotiations with public labor unions, requirements of the Davis-Bacon Act, facility design or other criteria specified by public agencies, and delays in obtaining financing through public budgeting processes are among the sources of the cost advantages cited for privatization.

Others take the position that relative expertise in the supply of services is irrelevant in certain leasing transactions, such as sale-leasebacks that do not essentially change the responsibility for providing services. Further, if the tax system provided no special incentive to lease rather than purchase, governmental units would be more likely to lease for reasons of efficiency than tax advantage. Also, critics argue that the Internal Revenue Code ought not be used to supersede laws and procedures which Congress can amend directly upon a full consideration of their merits.

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, meet other current expenses, and establish a sinking fund for repurchasing the property. Such arrangements may not 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.

Relative to the Federal government, State and local governments spend a larger proportion of their budgets on the direct provision of public services and a smaller proportion on transfer payments. Thus, the relative importance of the privatization issue would appear to be greater at the State and local governmental levels.

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.

Congress currently provides other assistance to nonprofit organizations through the tax system. For example, the cost to the Treasury of deductions of charitable contributions is expected to exceed $9 billion in 1983.

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 all the income generated by that property, the subsidy is as justifiable as that provided to any other taxable user. However, if only a very small proportion of the income is taxable by the United States, or 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 U.S., then many of the same issues as are described above are raised.

For U.S.-produced goods, the subsidy for foreign investment 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. DESCRIPTION OF THE BILL

Explanation of Provisions

Overview

In general, S. 1564 would reduce the tax benefits that would be otherwise available for property used by tax-exempt entities, with exceptions for certain short-lived property, certain real property and property subject to short-term leases. The bill would define the term "tax-exempt entity" to include Federal, State, local, and foreign governments, possessions of the United States, international organizations, certain instrumentalities of the foregoing, and certain foreign persons, as well as most organizations that are exempt from Federal income tax.

The bill would also provide criteria for use in determining whether an arrangement that is structured as a service contract should be treated as a lease. However, the bill would create no inferences regarding the present-law treatment of purported service contracts under the nontaxable use restrictions on the investment credit. Under certain circumstances, the rehabilitation credit would be denied for real property that is leased to a tax-exempt entity.

The present law rules for determining the tax owner of property would be undisturbed. Thus, the bill would leave open the possibility that a tax-exempt entity could be treated as the owner of property. As under present law, if a tax-exempt entity were considered the owner, generally no tax benefits would be available with respect to the property. Again, however, the bill would create no inferences regarding who should be treated as the owner of property involved in a transaction that is subject to the bill or would have been subject to the bill but for its effective date provisions.

Depreciation

Reduced deductions.—In the case of "tax-exempt use property" (defined below), accelerated cost recovery (ACRS) deductions and any other deduction allowable for depreciation or amortization would be computed by using the straight-line method and disregarding salvage value. The recovery period for tax-exempt use property in the 15-year real property class would be 40 years or 125 percent of the term of the lease, whichever is greater. The recovery period for all other tax-exempt use property would equal the midpoint life of the property as of January 1, 1981, under the Asset Depreciation Range (ADR) system or 125 percent of the term of the lease, whichever is greater. Personal property that has no ADR life would be treated as having a midpoint life of 12 years. For purposes of applying these rules, the term of a lease would include any period for which the lease may be renewed or extended at the lessee's option.

If a taxpayer elects under ACRS to recover the cost of property over an optional recovery period that exceeds the recovery period prescribed by the bill, then the cost of the property would be recovered over the longer period.

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

Investment tax credits

Overview.—As under present law, the investment credit generally would be denied for property leased to or otherwise used by a tax-exempt entity. However, the present-law nontaxable use restriction would be modified by expanding the category of tax-exempt entities subject to the restriction and by providing guidelines for distinguishing a service contract from a lease (see discussion of tax-exempt use property below).

The present-law exception to the nontaxable use restriction for short-term or casual leases would be replaced with an objective short-term lease exception (described below).

Rehabilitation credits.—Expenditures attributable to the rehabilitation of the portion of a building that is (or may reasonably be expected to be) tax-exempt use property would be excluded from the definition of qualified rehabilitation expenditures eligible for the investment credit. The excluded expenditures would not be taken into account in determining whether there is a substantial rehabilitation of the building.

If the building with respect to which a rehabilitation credit was allowed were to become tax-exempt use property, the portion of the building that constitutes tax-exempt use property would be treated as having been disposed of at the time such property becomes tax-exempt use property. Thus, for example, if an entire qualified rehabilitated building becomes tax-exempt use property more than one but less than two years after the close of the year in which the building was placed in service, 80 percent of the rehabilitation credit would be recaptured. On the other hand, if the building becomes tax-exempt use property after five full years have passed, the credit would not be recaptured.

Tax-exempt use property

General rule.—For the depreciation and investment credit provisions of the bill, tax-exempt use property (other than 15-year real property) would include property leased to or otherwise used by a tax-exempt entity.

Exception for certain short-lived property.—Property with a midpoint life of six years or less would be excluded from the depreciation provisions of the bill, but only where the term of the lease to which such property is subject is 75 percent or less of the property's midpoint life.

Real property.—15-year real property would be treated as tax-exempt use property only to the extent that all or a portion of the property is leased to or otherwise used by a tax-exempt entity, and only if more than 50 percent of the use of the property consists of use described in at least one of the following circumstances:

(1) The property was financed in whole or in part by obligations the interest on which is exempt from Federal income tax under Code section 103 and the tax-exempt entity (or a related party) participated in such financing;

(2) Such use is pursuant 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) Such use occurs after a sale-leaseback or lease-leaseback of the property by the tax-exempt entity (or a related entity); or

(4) Such use is pursuant to a lease the term of which is greater than 10 years.

For example, the provisions of the bill would apply if a municipality leases 75 percent of a building, the construction of which was financed in whole or in part with tax-exempt bonds issued by the municipality (or a related entity), but only to the extent of 75 percent of the cost of the property.

Short-term lease exceptions.—For purposes of both the depreciation and the investment credit provisions, tax-exempt use property would not include personal property leased for a term that is less than one year or 30 percent (up to a maximum of three years) of the property's midpoint life, whichever is greater. In the case of 15-year real property, tax-exempt use property would not include property leased for a term that is less than three years (one year in the case of a qualified rehabilitated building or portion thereof).

Exception for property used in a taxable activity.—Tax-exempt use property would not include any portion of property that is used predominantly in a tax-exempt entity's unrelated trade or business, where the income from such trade or business is subject to tax under section 511.

Treatment of renewal options.—In determining whether property is tax-exempt use property the bill would require the term of the lease to be computed by including any period for which the lease may be renewed, extended, or continued pursuant to an option exercisable by the lessee. A technical amendment is necessary to make clear that this rule applies to the investment tax credit provisions of the bill.

For example, the provisions of the bill would apply if equipment with a midpoint life of seven years is leased for a two-year term subject to the lessee's option to renew the lease for another two years, even at the then fair rental value, regardless of whether the lease is in fact renewed.

Service contracts.—In determining whether a transaction structured as a service contract should be treated as a lease, the bill would require that all relevant factors be taken into account, including:

(1) Whether the tax-exempt entity controls or is in physical possession of the property;

(2) Whether the tax-exempt entity has a significant possessory or economic interest in the property; and

(3) Whether the service provider (a) bears any substantial risk of loss from nonperformance, or (b) concurrently uses the property to provide services to taxable entities.

For example, a transaction structured as a service contract would be treated as a lease or other use if all of the following factors were present:

(1) Employees of the tax-exempt entity operate or assist in the operation of the property,

(2) The property is dedicated solely to the tax-exempt entity for a substantial portion of the useful life of the property,

(3) The cost or value of the property itself dominates the price of the total arrangement,

(4) The tax-exempt entity bears the risk that the property will decline in value (*e.g.*, if the entity terminates the contract prematurely and is required to make up any difference between the then fair market value and an amount approximating the owner's unrecovered equity, remaining debt, and tax liability incurred), and

(5) The tax-exempt entity bears the risk of damage to or loss of the property.

On these facts, the tax-exempt entity may be considered the owner of the property under the general principles of Federal income tax law. If, however, the service provider were considered the tax owner, the tax-exempt entity would be treated as using the property under the bill. Thus, in either case, the property would be tax-exempt use property.

Definition of tax-exempt entity

In general, 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. However, the term "tax-exempt entity" would include an agency or instrumentality of a government or international organization, or a foreign person, only with respect to property 20 percent or less of the income derived from which is subject to U.S. tax. For example, the bill would apply to an aircraft leased to a foreign person unless more than 20 percent of the income derived from the use of the aircraft is subject to U.S. tax. This conclusion would be the same even if the aircraft is registered by the Administrator of the Federal Aviation Agency and operated to and from the United States or operated under a contract with the United States. 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, (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. However, in the case of property used by the United States, or an agency or instrumentality thereof that is subject to the bill, the transitional rule for binding contracts would not apply unless the property were also placed in service before January 1, 1984. 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 before April 1, 1983, for the acquisition or construction of the property. For this purpose, 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.

Comparison with H.R. 3110

H.R. 3110, introduced by Congressman Pickle and other cosponsors, contains provisions relating to tax-exempt use property which are similar to those of S. 1564. A public hearing was held on H.R. 3110 before the Committee on Ways and Means on June 9, 1983.[17] The principal differences between the two bills are summarized below.

Recovery period.—Under H.R. 3110, ACRS (or depreciation) deductions would be computed over the following extended recovery periods: 5 years for property in the 3-year ACRS class, 12 years for property in the 5-year ACRS class, 25 years for property in the 10-year ACRS class, and 35 years for property in the 15-year public utility or real property ACRS class. Under S. 1564, the recovery period would be the ADR midpoint life (40 years for property in the 15-year real property ACRS class) or 125 percent of the lease term, whichever is greater.

Short-term lease exception.—H.R. 3110 would provide a short-term or casual lease exception determined under a facts-and-circumstances test. The exception under S. 1564 would be based on a length-of-lease test.

Short-lived personal property.—H.R. 3110 does not contain an exception for the short-lived personal property that would be excepted from the definition of tax-exempt use property under S. 1564.

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[17] See also Joint Committee staff pamphlet, "Description of H.R. 3110 Relating to Tax Treatment of Property used by Nontaxable Entities" (JCS–21–83).

15-year real property.—The circumstances under which the two bills would apply to real property are substantially similar. However, H.R. 3110 does not include a provision for long-term leases. H.R. 3110 would apply where a tax-exempt entity protects the lessor from loss on its investment. Finally, H.R. 3110 would apply only if more than 20 percent (50 percent under S. 1564) of the property is used under circumstances described in the bill.

Service contracts.—The two bills would provide different (nonexclusive) factors to be taken into account for determining whether a service contract is more properly treated as a lease.

Rehabilitation credit.—H.R. 3110 would deny the rehabilitation credit if any portion of the cost of acquiring or rehabilitating a building was financed with industrial development bonds. S. 1564 would deny this credit for tax-exempt use property.

Definition of tax-exempt entity.—H.R. 3110 would not except instrumentalities of governmental units or international organizations that are subject to U.S. tax from the definition of tax-exempt entity. Also, H.R. 3110 would except any foreign person with respect to property the income from use of which is subject to U.S. tax, with no requirement that a minimum percentage of the income be subject to tax.

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