[JOINT COMMITTEE PRINT]

DESCRIPTION OF S. 2933 RELATING TO LEASING OF QUALIFIED CORRECTIONAL FACILITIES TO STATE AND LOCAL GOVERNMENTAL UNITS

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

SENATE COMMITTEE ON FINANCE

ON

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PREPARED BY THE STAFF

OF THE

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INTRODUCTION

The Subcommittee on Taxation and Debt Management of the Senate Committee on Finance has scheduled a public hearing, to be held on September 14, 1984, on S. 2933 (introduced by Senator D'Amato). In general, S. 2933 would exempt certain correctional facilities from the tax-exempt entity leasing provisions of the Deficit Reduction Act of 1984 (P.L. 98-369) (the Act).

The first part of this document is a summary of S. 2933. The second part is a more detailed description of the bill, including present law, issues, explanation of provisions, and effective date.

I. SUMMARY

Present law imposes restrictions on cost recovery, or depreciation, deductions with respect to certain property, including certain correctional facilities, leased by a taxable entity to a State or political subdivision thereof (or any agency or instrumentality of either). Similarly, present law disallows rehabilitation tax credits with respect to such facilities which would otherwise be available.

The bill would generally remove those restrictions for certain correctional facilities. In addition, the bill would provide that any agreement with respect to such facilities which is characterized by all parties to the agreement as a lease is to be treated as a lease for all purposes of the Internal Revenue Code.

The bill would apply to certain correctional facilities placed in service after December 31, 1984.

II. DESCRIPTION OF THE BILL

A. Present Law

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 in revenue rulings and revenue procedures issued by the IRS. Essentially, these rules focus on the economic substance of a transaction, not its form, for determining who is entitled to the tax benefits associated with ownership of the property. Thus, in a purported lease or similar arrangement, the person claiming ownership for Federal income tax purposes must show that it has sufficient economic indicia of ownership.

In general, tax benefits associated with ownership of tangible property include depreciation or accelerated cost recovery deductions and investment tax credits. Generally, ACRS or other depreciation deductions and investment credits are allowed only for property used for a business or income-producing purpose. The accelerated cost recovery system generally permits taxpayers to depreciate qualifying property on an accelerated basis over a relatively short period of time. For most property, the ACRS recovery period is shorter than the actual useful economic life of the property. For example, as a result of the Act, real property may generally be depreciated on an accelerated basis over an 18-year period. Investment credits permit taxpayers to reduce their tax liability by a percentage of their investment in eligible property. Eligible property generally includes certain depreciable personal property. Additional investment credits are available for certain improvements to buildings at least 30 years old (the rehabilitation tax credit).

As a general rule, States and political subdivisions thereof (and agencies and instrumentalities of either) are not entitled to depreciation deductions or investment credits for property owned by them. In addition, as a result of the Act, generally depreciation deductions are slowed down for property, including correctional facilities, leased to such a governmental unit. Moreover, no investment credit is allowed for certain property leased to (but not owned by) such a governmental unit (the nontaxable use restriction).

The ownership issue

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

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 has sufficient burdens and benefits of ownership.

In general, for Federal income tax purposes, the owner of property must possess meaningful burdens and benefits of ownership. The lessor must be the person who suffers, or benefits, from fluctuations in the value of the property. Thus, lease treatment is denied, and the nominal lessee is treated as the owner, if the nominal lessee has an option to obtain title to the property at the end of the nominal lease for a price that is small in relation to the value of the property at the time 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 to be made under the nominal lease.

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

To give taxpayers guidance in structuring certain leveraged leases (e.g., leases in which the property is financed by a nonrecourse loan from a third party), 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 generally will issue an advance letter ruling that the transaction is a lease and that the nominal lessor is the owner for Federal income tax purposes.

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). That rule precludes fixed price purchase options, even at a bona fide estimate of the projected fair market value of the property at the exercise 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 and have a positive cash flow from the transaction 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 leveraged lease treatment.

In the Economic Recovery Tax Act of 1981, the Congress enacted rules substantially liberalizing, in many cases, the principles to be applied in determining whether a nominal lessor of property would be treated as the tax owner of the property. Under those rules (the safe-harbor lease rules), a nominal lessor could be treated as the tax owner of the property, and entitled to the tax benefits resulting from such characterization, even though under general tax principles and the guidelines it would not have been treated as the tax owner. However, the safe-harbor lease rules did not apply if the nominal lessee was a governmental unit.

Largely because of a popular perception that the safe-harbor lease rules opened the tax system to manipulation, they were generally repealed by the Tax Equity and Fiscal Responsibility Tax Act of 1982.

Depreciation

Generally, property eligible for depreciation may be depreciated on an accelerated basis over a recovery period which is shorter than the economic useful life of the property. For example, real property may generally be written off on an accelerated basis over as little as 18 years, and depreciable personal property may generally be written off on an accelerated basis over 3 years or 5 years.

However, as a result of the Act, accelerated methods of depreciation with respect to certain depreciable property leased to a governmental unit (tax-exempt use property) are not allowed and the applicable recovery period is extended. In the case of tax-exempt use real property, depreciation deductions generally must be taken on a straight-line basis over the greater of (1) 40 years, or (2) 125 percent of the lease term. In the case of tax-exempt use personal property, depreciation deductions generally must be taken over the greater of (1) the property's midpoint life under the Asset Depreciation Range system, or (2) 125 percent of the lease term.

Under the Act, real property leased to a governmental unit is treated as tax-exempt use property to the extent of disqualified uses, but only if disqualified uses of the property exceed 35 percent of all uses of the property. In general, a disqualified use includes a lease of property to a governmental unit if (1) the governmental unit participates in financing the property through the issuance of tax-exempt obligations, (2) the lease contains a fixed or determinable price purchase or sale option or the equivalent thereof, (3) the lease has a term exceeding 20 years, or (4) the lease occurs after a sale by, lease from, or other transfer by the governmental unit of the property and the property was used by the governmental unit prior to the transfer. With certain exceptions, any personal property leased to a governmental unit is treated as tax-exempt use property.

Investment tax credit

Generally, property that is used by a governmental unit is ineligible for the investment tax credit.

To determine whether property is subject to this 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 the property. 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. In addition, property leased to a governmental unit is generally subject to the nontaxable use restriction. As a result of the Act, the rehabilitation tax credit is unavailable for all tax-exempt use real property.

B. Issues

As discussed above, the Deficit Reduction Act of 1984 slowed down allowable depreciation deductions for certain depreciable property leased to governmental units. In addition, the Act generally made the rehabilitation tax credit unavailable for tax-exempt use real property. Prior to the Act, when a governmental unit used property under lease arrangements, they paid reduced rents that reflected a pass-through from the owner of the property of some or all of the benefits of the investment incentives provided by the rules regarding depreciation and investment credits. Governmental units thereby benefitted from investment incentives for which they did not qualify directly and effectively gained the advantage of taking income tax deductions and credits while having no corresponding liability to pay any tax on income from the property. In this way, investment incentives that were intended to reduce the tax on taxable entities were turned into unintended benefits for governmental units. Concerned that those benefits were equivalent to an open-ended spending program, operated within the tax system, that increased the Federal deficit and encouraged tax-exempt entities to dispose of the assets they owned and forego control over the assets they use, the Congress reacted by enacting the tax-exempt entity leasing rules in the Act. Those rules enable governmental units to lease property on terms no more beneficial to them than would be the case if they were purchasing the property.

On the other hand, in many States in this country there is a great need for new correctional facilities. In addition, in at least some States, substantial funds for new correctional facilities may not be readily available. Relaxing with respect to correctional facilities restrictions on depreciation deductions and rehabilitation tax credits imposed by the Act (and by general tax principles regarding who is the tax owner of the property) would tend to reduce the cost of those facilities to governmental units, by providing a Federal income tax subsidy, and thereby tend to increase the stock of correctional facilities' capacity.

C. Explanation of Provisions

In general, the bill would repeal the restrictions imposed by the Act on the depreciation of qualified correctional facilities leased by a tax-paying entity to a State or political subdivision (or an agency or instrumentality of either). As a result, the tax-paying entity would generally be able to depreciate the facility on an accelerated basis over as little as 18 years (to the extent the leased facility is real property) or as little as 3 or 5 years (to the extent the leased facility is personal property).

In addition, the bill, for all purposes of the Internal Revenue Code, would treat an agreement with respect to a qualified correctional facility as a lease, the nominal lessor as the tax owner of the facility, and the nominal lessee as lessee of the facility if all parties to the agreement characterize it as a lease. This rule would apply notwithstanding the fact that, under general Federal income tax principles, the nominal lessee would be treated as tax owner of the facility. Under this rule, for example, the nominal lessor would be entitled to rapid depreciation deductions even though, had the Act not been enacted, it would not have been treated as tax owner of the facility and therefore would have been entitled to no depreciation deductions with respect to the facility. This rule would in effect make the now-repeated safe-harbor lease rules available in the case of certain correctional facilities nominally leased to a State or political subdivision thereof (or an agency or instrumentality of either).

The bill generally would also have the effect of allowing a rehabilitation tax credit to the nominal lessor with respect to the facility if, prior to the Act, a rehabilitation tax credit would have been available to it. That credit would also be available to the nominal lessor even though under general tax principles, the nominal lessor would not be treated as owning the facility. However, the bill would generally have no effect on the availability of other investment tax credits.

Under the bill, a qualified correctional facility means any property devoted primarily for use as a prison, jail, or other detention facility (and any related facility) which is leased by a State or political subdivision (or agency or instrumentality of either) within 90 days (1) after it is originally placed in service by the nominal lessor or nominal lessee, or (2) of the completion of a substantial rehabilitation by the nominal lessor or nominal lessee.

D. Effective Date

The bill would apply to property placed in service after December 31, 1984.

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