The Economic Recovery Tax Act: Safe Harbor Rule for Leases

Steve Torkildson
THE ECONOMIC RECOVERY TAX ACT: SAFE HARBOR RULE FOR LEASES

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I. INTRODUCTION

THE ECONOMIC RECOVERY TAX ACT of 1981 (ERTA) has as one of its primary goals the encouragement of economic growth through the stimulation of investment in new business property. To create a greater incentive for such capital formation, ERTA's new Accelerated Cost Recovery System (ACRS) provides for faster depreciation writeoffs than were previously available. ERTA also shortens the useful life which an asset must have in order for the full investment tax credit to be taken. The Senate Finance Committee recognized, however, that ERTA's new tax benefits provided no incentive for those businesses with insufficient income to utilize the available deductions and credits. In order to extend the


The essence of the new leasing rules contained in ACRS is to allow firms making new investments to have the advantages of ACRS even
benefits of the new tax act to such businesses, the finance committee decided to facilitate the transfer of such tax write-offs through the use of leases. Thus, the new act contains a safe harbor provision which guarantees that a transaction will be characterized as a lease if certain requirements are met.

The new law is expected to be very beneficial to the airline industry, because it will help the less profitable carriers finance the acquisition of new aircraft. By using one of the new safe harbor leases, airlines which are unable to fully utilize their depreciation deductions and investment tax credits can transfer such tax benefits to profitable leasing companies, in exchange for lower rents on the leased planes or other equivalent benefits.

Prior to the passage of ERTA, parties wishing to transfer tax write-offs through leases were subject to several restrictive Internal Revenue Service (IRS or Service) guidelines. A comparison of the IRS guidelines and the new safe harbor rules reveals eight major differences between the two. These

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though their investments have not yet produced large profits. Without the new safe harbor leasing rules these firms would be denied a major portion of the ACRS benefits, and the purposes of ACRS would be significantly thwarted.

Id.


Lessors will be able to receive cost recovery allowances and investment tax credits with respect to qualified lease property, while it is expected that lessees will receive a very significant portion of the benefits of those advantages through reduced rental charges for the property (in the case of financial leases) or cash payments and/or reduced rental charges in the case of sale-leaseback transactions.

Id.

12 See infra notes 161-285 and accompanying text. Section 168(f)(8) affects the law regarding the transfer of tax benefits through leases in the following respects: it reduces the minimum at-risk investment required of the lessor; it relieves the lessor of the burden of showing that he expects to derive a profit from the transaction in addition to receiving favorable tax benefits; it permits the lessee to purchase the les-
changes are designed to increase the availability of leases as a means of spreading the benefits of the new tax act throughout the business community. In other words, the new law is based, not on the theory that IRS guidelines are incorrect with respect to determining the ownership of the property for tax purposes, but rather on Congress' concept of sound economic policy. Thus, parties who comply with the requirements of the safe harbor are automatically allowed to take advantage of its favorable tax benefits. Parties who either do not or cannot meet the new law's standards, however, are not precluded from using the IRS guidelines to obtain the desired tax consequences. The body of law existing prior to the enactment of section 168(f)(8), including the IRS guidelines, is still available for those taxpayers who cannot qualify for the safe harbor treatment.

sor's property at the end of the lease term at a price below its fair market value; it permits property to be the subject of a lease even if it will be useful to no one but the lessee at the end of the lease term; it allows the lessee to furnish part of the purchase price for the leased property; and it decreases the remaining useful life that the leased property is required to have at the end of the lease. Two areas in which § 168(f)(2) is more restrictive than the IRS guidelines are as follows: with certain limited exceptions only new § 38 property can qualify for the safe harbor; and again, with limited exceptions, only corporate lessors can use the safe harbor.


The committee recognizes that some businesses may not completely be able to use the increased cost recovery allowances and the increased investment tax credits available for recovery property under ACRS. ACRS will provide the greatest benefit to the economy if ACRS deductions and investments tax credits are more easily distributed throughout the corporate sector.

See Temp. Treas. Reg. 5c.168(f)(8)-1(c)(2) (1981). Thus, the fact that the lessee may be the owner of the property for state and local law purposes is irrelevant under federal tax law. Id.


See infra notes 163-286 and accompanying text.

See S. Rep. No. 144, 97th Cong., 1st Sess. 61, 62 (1981). By using the term "safe harbor" the legislature's obvious intent was to provide favorable tax treatment if certain requirements were met, but not to preclude such treatment if the parties could otherwise qualify under existing law. Id.

Id.
The purpose of this comment is to analyze the impact of the new leasing law on the existing body of tax law. Initially the analysis will focus on the various ways lease transactions can be structured. The analysis will then shift to a discussion of the business and the tax advantages to be gained through the use of leases. Finally, the old IRS guidelines will be compared to the new law, with emphasis given to the advantages and disadvantages of the two formats.

II. Structure of the Transaction

The ways in which lease transactions are structured vary widely depending on the needs of the parties involved. In many such transactions, however, the predominant motive is simply to allow both parties to reap some of the tax benefits provided by Congress. Thus, for example, in a sale/leaseback deal, the lessor’s principal and interest payments on the sale and the lessee’s rental payments on the lease may be merely paper transactions in which no money actually changes hands. In such an arrangement the lessor pays a certain amount of cash up front and borrows the remainder of the purchase price from the lessee by taking out a note. Because the lessor’s note payments exactly equal the lessee’s rental payments, the up-front money, in effect, becomes the full payment for the tax benefits.

Ignoring the intricacies of individual transactions, however, there are four basic ways in which leases traditionally have been used to acquire new assets. First, there is the sale/leaseback arrangement in which the owner of the asset sells the property to a willing investor and immediately thereafter leases the property back from that investor. Like the other

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20 The very reason for the passage of new Internal Revenue Code section 168(f)(8) was to spread the benefits of the new tax act to both profitable and unprofitable companies. See supra notes 6, 13 and accompanying text.
22 Id.
23 Id.
24 For cases involving straight sale/leasebacks see Stearns Magnetic Mfg. Co. v. Commissioner, 208 F.2d 849 (7th Cir. 1954); Shaffer Terminals, Inc. v. Commissioner, 194 F.2d 539 (9th Cir. 1952). See also Rev. Rul. 67-247, 1967-2 C.B. 53. See generally
types of leases used in this area, these agreements generally cover a substantial part of the property’s useful life and often give the lessee an option to reacquire the property at the end of the lease term. Also, like other financing leases, these are generally “net leases” in which the lessor holds bare title, while the lessee handles all operating expenses of the property such as insurance, taxes and maintenance expenses.

The second commonly used method is the so-called three-party leveraged lease. Under this technique the lessor, generally a business in need of some tax breaks, borrows money from a third party on a nonrecourse basis in order to purchase the desired asset. The lessor then leases the asset to a business in need of the specific asset but without sufficient income to adequately utilize the concomitant tax benefits. The “leverage” results from the fact that the lessor gets 100 percent of the tax benefits from the property while paying only a portion of its purchase price up front.

The third technique, the four-party leveraged lease, is just like the second method except that it involves four parties instead of three. In this transaction, a group of equity partici-
pants join together to establish the lessor organization, the sole functions of which are to purchase and to lease the property. The equity participants contribute to the lessor a percentage of the money needed to purchase the property and the rest is borrowed by the lessor from the lenders. The key in this type of plan is to structure the lessor as an entity such as a partnership, through which the tax benefits can flow to the equity participants. The remaining aspects of the four-party leveraged lease are exactly like the three-party model.

The fourth way to finance the acquisition of a new asset is through the leveraged sale/leaseback. This method is identical to the regular sale/leaseback, except that the lessor borrows the needed cash from a third party, instead of borrowing from the lessee or funding the purchase price himself. By way of example, in Frank Lyon Co. v. United States the Worthen Bank & Trust Company financed the construction of its new company headquarters by using such a scheme. Under its plan, Worthen sold the building, as constructed, to the Frank Lyon Co., the latter having obtained permanent construction and mortgage financing on the building. Lyon then leased the building back to Worthen under a separate agreement. As a national bank, Worthen was exempt, under Arkansas

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**Footnotes:**

84 See Mentz, Menaker and Pesiri, Leveraged Leasing, supra note 32, at 554. "Equity participants" are the parties who ultimately supply the capital to purchase the desired asset. For example, three small corporations, the equity participants, may each contribute $100 to a newly formed partnership. The partnership then buys the asset and leases it out. The depreciation and investment tax credit on the leased property flow through the partnership to the corporate equity participants. Id. See also 8 Wash. Tax Rev. 11 (August 1981).

85 See Mentz, Menaker and Pesiri, Leveraged Leasing, supra note 32, at 554.

86 Id.


88 See supra text accompanying notes 28-32.


90 Id. at 563-69.

91 Id. at 566.

92 Id. at 567.

93 Id. at 566.
law, from state sales taxes on the purchase of the construction materials. In addition, the sales of the building elements to Lyon were exempt from the sales tax because they were considered sales of real estate. Thus, by utilizing a leveraged sale/leaseback instead of a straight leveraged lease, under which Lyon would have purchased the construction materials subject to a state sales tax, the parties were able to enjoy a substantial savings in state sales taxes.

III. ADVANTAGES AND DISADVANTAGES OF LEASES

Choosing a particular lease form is difficult and requires careful consideration of both the business and tax aspects of the transaction. Undoubtedly, in any given transaction there will be a great deal of negotiation between the parties, because slight alterations in the structure of the lease can greatly change the business and tax consequences to each of the parties. In order to fully comprehend the factors the respective parties consider, it is necessary to briefly point out the various business and tax aspects of leases, as they affect both the lessor and the lessee.

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44 Id. at 566 n.2. See Ark. Stat. Ann. § 84-1904(1) (1960); First Agriculture Nat'l Bank v. Texas Comm'n, 392 U.S. 339 (1968) (holding that states are without the power, unless authorized by Congress, to tax federally created or national banks).


46 Id.

47 As indicated in the introduction, the main purpose of this article is to compare the new safe harbor law with the IRS leasing guidelines and to point out the ways in which the new law makes it easier or harder to engage in leases. A brief discussion of the various business and tax reasons for entering such leases is given here only to assist the reader in understanding the analysis in part IV of this comment. For a more complete discussion of the business advantages available through leasing see generally Cary, Corporate Financing Through the Sale and Leaseback of Property: Business, Tax and Policy Considerations, 62 Harv. L. Rev. 1, 5-16 (1948) [hereinafter cited as Cary, Corporate Financing]; Fiore, Gifts or Sales Coupled with Leasebacks, 32 S. Cal. Tax Inst. ¶ 1600 (1980); Fritch & Reisman, Leveraged Leasing, supra note 27; Mandell, Tax Aspects of Sales and Leasebacks as Practical Devices for Transfer and Operation of Real Property, in N.Y.U. 18th Inst. on Fed. Tax 17 (1960) [hereinafter cited as Mandell, Sale and Leasebacks]; Wilson, Sales and Leasebacks, 16 S. Cal. Tax Inst. 149, 150 (1964).

For a detailed discussion of the tax advantages of leasing see Fritch & Reisman, Leveraged Leasing, supra note 27, at 237-363, 365-77; Cary, Corporate Financing, supra note 47, at 5-16; Fiore, Gifts or Sales Coupled with Leasebacks, 32 S. Cal. Tax Inst. ¶¶ 1600, 1610 (1980); Greenfield, Real Estate Financing: Bootstrap, Sale and
A. Business Aspects

1. Lessee

Leasing can be an advantageous way for a lessee to borrow. First, the lessee will generally be able to acquire a greater amount of money by selling an asset and leasing it back than by executing a mortgage on the asset.\textsuperscript{48} Whereas the lessee will only be able to mortgage the property for a percentage of its fair market value, it will generally be able to sell the asset for its full fair market value.\textsuperscript{49}

Secondly a sale/leaseback, and in this case a leveraged lease, too, may keep the lessee from violating restrictions commonly contained in bond indentures, loan agreements and preferred stock certificates.\textsuperscript{50} For example, by selling a building and leasing it back, a corporation may be able to avoid restrictions requiring the maintenance of a certain debt equity ratio\textsuperscript{51} or net working capital.\textsuperscript{52} Likewise, a corporation could use a sale/leaseback or leveraged lease to avoid having similar problems with respect to future borrowing.\textsuperscript{53}

Thirdly, though it is possibly an outdated reason for using the sale/leaseback, such a maneuver may have a favorable impact on the corporation's credit standing.\textsuperscript{54} Under prior law, a loan created both an asset and a liability on the corporate balance sheet, but a sale/leaseback merely converted a fixed asset, such as a building or machine, into a current asset, such as a building or machine, into a current asset.


\textsuperscript{50} See Cary, Corporate Financing, supra note 47, at 14-15. Of course, investors could, if they so desired, extend restrictions as are commonly contained in bond indentures, etc., to cover the sale/leaseback area too. \textit{Id.}

\textsuperscript{51} BLACK'S LAW DICTIONARY 364 (5th ed. 1979). The debt equity ratio equals the corporation's total liabilities divided by its total equities. \textit{Id.}

\textsuperscript{52} A DICTIONARY FOR ACCOUNTANTS 293, 453 (4th ed. 1970). Net Working Capital is the excess of current assets over current liabilities. \textit{Id.}


\textsuperscript{54} \textit{Id.} at 11-13; Mandell, Sales and Leasebacks, supra note 47, at 18-19.
as cash, and created no liability. Under present law, however, many long term leases in sale/leaseback transactions must be classified on the corporate balance sheet as capital assets, with corresponding liabilities. Thus, in many cases there no longer exists the accounting incentive to engage in sale/leasebacks vis-a-vis other borrowing techniques.

Finally, the sale/leaseback or the leveraged lease, in some cases, may be the only legal way that the lessee can obtain sufficient capital. For example, in Frank Lyon Co. v. United States, the Worthen Bank & Trust Company was in the process of choosing a financing plan for the construction of its new headquarters. Because Arkansas law prohibited banks from issuing debentures which carried interest above a specified interest rate, Worthen found that it would be unable to

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56 Id.
57 3 AICPA Professional Standards (CCH), APB Opinion No. 5 (1973), repeated at, 3 AICPA Professional Standards (CCH) § 4053 (1976). Until 1976, absent circumstances indicating that lease rentals were really payments in an installment sale, long term lease obligations were only required to be disclosed in notes to the corporate balance sheet. Id.
58 3 AICPA Professional Standards (CCH) § 4053.007 (1976). Leases, other than leveraged leases, are classified as capital assets if they meet one or more of the following criteria: (1) the lease transfers ownership of the property to the lessee by the end of the lease term; (2) the lease contains a bargain purchase option; (3) the lease term is equal to 75% or more of the useful life of the property (unless the lease begins during the last 25% of the property's useful life, in which case this criterion does not apply); (4) at the beginning of the lease term, the present value of the minimum lease payments (excluding that portion of the payments representing insurance, maintenance and taxes to be paid by the lessor) equals or exceeds 90% of the excess of the fair value of the leased property, to the lessor, at the inception of the lease, over any related investment tax credit retained by the lessor and expected to be realized by him.

With respect to the lessee, leveraged leases are accounted for in the same manner as non-leveraged leases. 3 AICPA Professional Standards (CCH) § 4053.041 (1979).

For the accounting rules applicable to the lessor, see 3 AICPA Professional Standards (CCH) § 4053.042-.047 (1979).

A comparison of the above accounting standards with the leasing guidelines contained in IRS revenue procedure 75-21 shows that most leases that comply with the guidelines rigorous standards for favored tax treatment would not have to be accounted for as capital leases. See Rev. Proc. 75-21, 1975-1 C.B. 715.

59 It is not clear whether the new safe harbor leases must be accounted for as capital leases. See infra notes 303-318 and accompanying text.
61 Id. at 563.
62 Id.
market a sufficient number of securities to raise the needed cash. Furthermore, various statutes required Worthen to obtain permission from the Arkansas State Bank Department and from the Federal Reserve System prior to making an investment in banking premises. Worthen was denied permission to obtain conventional financing and, therefore, turned to leveraged leasing as the only available alternative.

While these lease transactions have several advantages, they are not without disadvantages. In both sale/leasebacks and leveraged leases the lessee will have to pay a higher rate of interest, implicit in his rental payments, than he would pay in an ordinary loan. General reasons given for this higher interest rate include the following: (1) the lessee may not be personally liable for the rent; (2) the lessor's investment is less marketable than in the case of a loan note; (3) the custom tailoring of such transactions result in higher costs to the lessor than in typical loan agreements. A further disadvantage of using a sale/leaseback is that the lessee may incur a state sales tax on the sale of the asset. A related disadvantage, applicable to both leveraged leases and sale/leasebacks, is the sales tax that some states impose on lease payments.

2. Lessor

Leasing provides several benefits to the lessor not available

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62 Id.
63 Id. at 564.
64 Id. at 565.
70 See Frank Lyon Co. v. United States, 435 U.S. 561, 566 n.2 (1978). In the Frank Lyon case, the sale of building elements was exempt from the state sales tax as sales of real estate. In a sale/leaseback involving a business machine, however, the above exemption presumably would not apply and the sales tax would be imposed. Id.
in other types of investments. Sale/leasebacks, and to an even greater extent leveraged leases, generally provide a higher rate of return than can be had with conventional loans.\footnote{The lessor's higher rate of return is the result of the same factors which cause a higher cost to the lessee in leasing transactions as opposed to regular loans. See supra text accompanying notes 67-69.} In addition, the lessor can avoid the burdensome foreclosure proceedings that may be necessary if the property is mortgaged.\footnote{See Cary, Corporate Financing, supra note 47, at 7.} In a leveraged lease or sale/leaseback transaction, the lessor generally has no foreclosure problems because he already owns the property.\footnote{Id.} Another benefit of holding title to the property is that, unlike the typical mortgage situation, a lease transaction provides the lessor with a hedge against inflation.\footnote{Mandell, Sales and Leasebacks, supra note 47, at 25. If an investor takes a mortgage on a piece of property, his only return is the interest which the borrower pays for the loan. Since the borrower owns the property, any increase in the property's fair market value will benefit him. In a lease situation, however, the lessor, by owning the property, receives the benefits of the property's appreciation. Cary, Corporate Financing, supra note 47, at 7.} Leases can further be used to avoid state usury limits by charging the equivalent of an greater rate of interest through higher rentals.\footnote{For examples of net leases, see Frank Lyon Co. v. United States, 435 U.S. 561, 567 (1978); Sun Oil Co. v. Commissioner, 562 F.2d 258, 263 (3d Cir. 1977). See also FRITCH & REISMAN, LEVERAGED LEASING, supra note 27, at 24; Mandell, Sales and Leasebacks, supra note 47, at 25. See also supra text accompanying note 27.} A lease may also be structured in the form of a net lease, under which the lessee takes care of all of the operating expenses of the property.\footnote{See generally 36-3d TAX MGMT (BNA) A-1 (1981).} Leasing transactions have some disadvantages to the lessor as well.\footnote{11 U.S.C. § 502(b)(7) (Supp. IV 1980). Under the Bankruptcy Code, if the lessee becomes bankrupt, the lessor's claim will be limited to the greater of one year's rental or fifteen percent of the total remaining rental to be paid under the lease. This figure cannot, however, exceed the total rental for three years. Id.} In some cases the sale/leaseback does not provide the lessor with the same security that a mortgage does because he will not have the personal obligation of the lessee.\footnote{See 36-3d TAX MGMT (BNA) A-1 (1981). Not only are leases less marketable...} Leases are also less marketable than mortgages.\footnote{Id.} Further-
more, although only the interest portion of a loan repayment is taxable to the lender, in a sale/leaseback the entire amount of rent received is included in the lender’s gross income.

B. Tax Aspects

1. Lessee

From the lessee’s point of view, all amounts paid as rentals for the property are deductible. In a loan transaction only the interest portion of each payment is deductible, whereas in a leveraged lease or sale/leaseback transaction the entire rental payment is deductible. Furthermore, a portion of the rental payments may be allocable to land that could not otherwise be written off through depreciation. Thus, from this standpoint, the usefulness of a lease to the lessee increases as the ratio of land to depreciable property increases.

The lessee also may recognize a loss on the sale of the asset, if the sales price is less than his basis. However, if the lease term is in excess of thirty years, the IRS may contend that the

than mortgages, but also, under the Treasury’s Temporary Regulations, if the lessor sells or assigns his interest in the lease, such lease will lose its safe harbor protection. Temp. Treas. Reg. § 5c.168(f)(8)-8(b)(1) (1978). See infra notes 91-103 for the tax effects of a loss of safe harbor protection.

I.R.C. § 61(4) (1976). Although no code section includes principal payments in gross income, interest payments are so included.

Id. § 61(5).

Id. § 162(a)(3). The lessee’s annual rent deduction is not necessarily the rent that he actually paid in that year; rather, it is a pro rata portion of the aggregate amount required to be paid by the lessee under the terms of the lease agreement. Temp. Treas. Reg. § 5c.168(f)(8)-7(d) (1978). If the lessee is required to purchase the property at the end of the lease term, or if the lessor has an option to sell the property to the lessee, the aggregate rent used in the above calculation does not include the lesser of: the amount of the lessee’s purchase obligation or the fair market value of the property at the end of the lease (determined without regard to inflation or deflation during the lease term). Id.


Id. § 162(a)(3). This general rule is subject to the limitation contained in Temp. Treas. Reg. § 5c.168(f)(8)-7(d) (1978). See supra note 83 and accompanying text.

See Cary, Corporate Financing, supra note 47, at 18; Mandell, Sales and Leasebacks, supra note 47 at 22.

See Cary, Corporate Financing, supra note 47, at 18.

parties to a sale/leaseback transaction have engaged in a like-kind exchange. In this event, the lessee is not allowed a loss deduction in the year of the sale and must instead amortize such loss over the term of the leaseback.

Once a lease has been properly set up, if a disqualifying event occurs, and if, without regard to section 168(f)(8) the

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8 See Century Elec. Co. v. Commissioner, 15 T.C. 581 (1950), aff'd, 192 F.2d 155 (8th Cir. 1951), cert. denied, 342 U.S. 954 (1952) (transfer of land and building in exchange for $150,000 and a net lease with an initial term of 25 years and renewal options totalling an additional 70 years held to be a § 1031 exchange on which no loss could be recognized). But see Leslie Co. v. Commissioner, 64 T.C. 247 (1975), aff'd, 539 F.2d 943 (3d Cir. 1976) (transfer of land and buildings in exchange for $2,400,000 and a lease for 30 years with options to renew for two additional 10 year periods held to result in a taxable loss since property was sold for its fair market value and the rentals charged on the leaseback were fair); City Investing Co. v. Commissioner, 38 T.C. 1 (1962) (taxpayer was allowed to recognize a loss on the sale portion of a sale/leaseback transaction, despite the existence of a lease term in excess of 30 years, including renewal periods, because there was a valid business purpose for the sale and because the sale was at fair market value). Jordan Marsh Co. v. Commissioner, 16 T.C.M. (CCH) 1094 (1957), rev'd 269 F.2d 453 (2d Cir. 1959) (transfer of land and buildings in exchange for a total consideration of approximately $2,300,000 and a lease of 30 years with a renewal option of 30 years held to result in a taxable loss since the property was sold for its full fair market value and the rentals charged on the leaseback were fair). The service has indicated that it does not acquiesce in any of the above decisions allowing the taxpayer a loss. See Rev. Rul. 60-43, 1960-1 C.B. 687 (Service will not follow Jordan Marsh); 1965-2 C.B. 6 (Service does not acquiesce in the City Investing decision); 1978-2 C.B. 3 (Service does not acquiesce in the Leslie decision).


91 For the key steps necessary to set up a valid safe harbor lease, see infra notes 163-285 and accompanying text.

92 Temp. Treas. Reg. § 5c.168(f)(8)-8(b) (1981). The following disqualifying events will cause the lessee to lose its safe harbor protection under I.R.C. § 168(f)(8) (West Supp. 1982): (1) the lessor sells or assigns its interest in the lease or in the leased property in a taxable transaction; (2) the lessor fails to file the information return required in § 5c.168(f)(8)-2(a)(3)(iii); (3) the lessee, voluntarily or involuntarily, sells or assigns its interest in the lease and the transferee fails to exercise, within the proper time, the consent required in § 5c.168(f)(8)-2(a)(5); (4) the leased property ceases to be section 38 property; (5) the lessor ceases to be a qualified lessor; (6) the lessor's minimum investment falls below 10 percent of the adjusted basis of the leased property; (7) the lease terminates; (8) the property becomes subject to more than one lease; (9) the property is transferred in a bankruptcy or similar proceeding and the lessor either fails to furnish the appropriate notification or to file a statement with its income tax return as required by § 5c.168(f)(8)-2(a)(6)(ii); (10) the property is transferred subsequent to a bankruptcy or similar proceeding and the lessor fails to furnish notice to the transferee prior to the transfer, or fails to file a statement with its income tax return, and either the lessor fails to secure the transferee's consent, or the lessor or the transferee fail to file statements with their returns. Id.
lessee would be considered the owner of the property, the disqualifying event will be deemed to be a sale of the property from the lessor to the lessee. If such a sale occurs, the lessor will be subject to recapture of his depreciation and investment tax credit. If the lessee subsequently sells the property, in calculating his recomputed basis for purposes of section 1245 recapture, the lessee must take into account any adjustments that would have been accounted for in figuring the recomputed basis of the lessor. The lessee's section 1245 recapture will, therefore, include all depreciation taken since the property was put in use, less that amount of depreciation already recaptured by the lessor. Likewise, upon a subsequent sale, the lessee's recapture of investment tax credit will include the total of such credits taken by the lessor and lessee less the amount of credits to which the lessor and lessee are permanently entitled and less any amount of

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94 Accelerated depreciation techniques allow the owner of an asset to write off the value of such asset faster than its fair market value actually declines. Thus when a taxpayer, utilizing an accelerated depreciation method, sells an asset, he will usually realize a gain since the selling price of his asset will generally exceed its adjusted basis. Because the accelerated depreciation is a deduction against ordinary income and because the gain on the sale of an asset is generally a capital gain, the depreciation deductions effectively allow the taxpayer to convert ordinary income into capital gains. The recapture provisions of § 1245, by treating the amount of depreciation taken in excess of the straight line method as ordinary income upon the sale of the asset, remove this loophole from the tax code. See S. Rep. No. 1881, 87th Cong., 2d Sess. 95 (1962).
96 I.R.C. § 1245(a)(2) (1976). The recomputed basis is the same as the adjusted basis of the property with certain modifications. Id.
97 Id. § 1245.
99 Id. § 1245.
100 Id.
102 Id. § 47(a)(5) (West Supp. 1982) (originally enacted as Economic Recovery Tax Act § 211(g)(2)(A), Pub. L. No. 97-34, 95 Stat. 172 (1981)). Each year the taxpayer holds on to the property reduces his potential recapture by two percent of the property's cost. For example, five year recovery property is entitled to an investment tax credit equal to 10 percent of the asset's cost. If such an asset is sold after being held for three years, the taxpayer will be permanently entitled to three-fifths of the 10 percent credit or six percent. Thus, his total recapture will be four percent.
credit that the lessor has already recaptured.\footnote{Id. § 47(a)(5)(D) (West Supp. 1982) (originally enacted as Economic Recovery Tax Act § 211(g)(2)(A)-(C), Pub. L. No. 97-34, 95 Stat. 172 (1981)).}

Finally, it should be noted that the lessee may not have to transfer all of the property's tax benefits to the lessor. The lessee may be able to engage in a so-called "pass-through"\footnote{See Temp. Treas. Reg. § 5c.168(f)(8)-9 [reserved] (1981). Such a result could be accomplished through a so-called lease/leaseback. See Wall St. J., Sept. 15, 1981, § 2, at 31, col. 4.} lease, a lease in which the lessee transfers only the investment tax credit and retains the depreciation write-offs.\footnote{See Temp. Treas. Reg. § 5c.168(f)(8)-(9) [reserved] (1981).} The Treasury, however, has specifically reserved the question of whether such leases are proper under section 168(f)(8).\footnote{Id.}

Thus, until further guidance is available on this issue, potential lessees would be advised to proceed only with great caution. The reverse of a "pass-through" lease, however, is expressly recognized in both the Internal Revenue Code (Code) and the Temporary Treasury Regulations. In certain situations, the lessee may keep the investment tax credit, leaving the lessor with only the depreciation deduction.\footnote{I.R.C. § 48(d) (1976) (allows the lessor to treat the lessee as having acquired the property for purposes of claiming the investment tax credit); see also Temp. Treas. Reg. § 5c.168(f)(8)-7(g) (1981) (requiring the lessee to use the lessor's basis, not the fair market value of the property, as his basis, for purposes of claiming the investment tax credit where the lessor has exercised his § 48(d) election).}

2. Lessor

Assuming that a leasing transaction is upheld,\footnote{Id.} one of its primary advantages is that it allows the lessor to take the depreciation deduction\footnote{Id.} and investment tax

\footnote{I.R.C. § 168 (West Supp. 1982) (originally enacted as Economic Recovery Tax Act § 201(g), Pub. L. No. 97-34, 95 Stat. 172 (1981)). For property placed in service before January 1, 1981, the old depreciation rules under I.R.C. § 167 will continue to apply. I.R.C. § 168(e) (West Supp. 1982) (originally enacted as Economic Recovery Tax Act § 201(g), Pub. L. No. 97-34, 95 Stat. 172 (1981)). For property placed in service after December 31, 1980, however, the new Accelerated Cost Recovery System (ACRS) will apply. Id. In addition to greatly shortening the length of time over which most kinds of property can be written off, for property purchased in 1982 and there-}
credit\textsuperscript{110} with respect to the property. These deductions and credits in turn allow the lessor to reduce the lessee's rental payments or to grant some other equivalent benefit to the lessee.\textsuperscript{111} In the case of a leveraged lease, the value of these tax benefits is even more pronounced because the lessor will obtain one hundred percent of such write-offs by investing in only a small portion of the property.\textsuperscript{112} Furthermore, in a leveraged lease transaction, the lessor is able to deduct the interest paid on the money borrowed from the lender.\textsuperscript{113}

There are, however, several limitations on the lessor's ability to reap these tax benefits. First, not everyone is eligible to take the investment tax credit.\textsuperscript{114} Noncorporate lessors are eligible only if they either manufactured or produced the leased property,\textsuperscript{115} or if the term of the lease, including options to renew, is less than fifty percent of the useful life of the property, and for one year after the transfer of the property to the lessee, the sum of the business deductions taken by the lessor with respect to the property exceeds fifteen percent of the rentals produced by the property.\textsuperscript{116} This limitation on the investment tax credit should not pose a problem for most lessors using the safe harbor rule, however, inasmuch as most of

\begin{itemize}
\item[\textsuperscript{110}] Id. § 46(a)(4). Prior to enactment of the new tax law the regular investment tax credit was 10 percent of the cost or other basis of property with a useful life of at least seven years. Id. If the property had a useful life of less than seven years the credit was accordingly reduced. Id. § 46(c)(2). Under the Economic Recovery Tax Act, property placed in service after December 31, 1980 need only have a recovery period (as defined in I.R.C. § 168(c)(2)) of five years in order to be eligible for the full 10 percent credit.
\item[\textsuperscript{112}] See supra note 32 and accompanying text. The use of leverage to gain greater deductions is limited by the at risk rules of § 465. See infra notes 118-38 and accompanying text.
\item[\textsuperscript{113}] I.R.C. § 163(a) (1976).
\item[\textsuperscript{114}] See Id. § 46(e), (f).
\item[\textsuperscript{115}] Id. § 46(e)(3)(A); Treas. Reg. § 1.46-4(d)(1)(i) (1972).
\end{itemize}
them will be corporations.\textsuperscript{117}

The lessor's deductions of depreciation and interest are, in addition, subject to the "at risk" rules.\textsuperscript{118} Generally, this means that the taxpayer's losses with respect to the property are limited to the amount of money\textsuperscript{119} plus the adjusted basis of any property he has invested in the activity,\textsuperscript{120} plus any amounts he has borrowed with respect to the activity for which he is personally liable.\textsuperscript{121} The "at risk" rules of section 465\textsuperscript{122} apply only to individuals,\textsuperscript{123} subchapter-S corporations\textsuperscript{124} and personal holding companies.\textsuperscript{125} The new leasing rules, however, require that the lessor be a corporation,\textsuperscript{126} other than a subchapter-S corporation and a personal holding company (§168(f)(8) corporations).\textsuperscript{127} It therefore appears that section 465 does not overlap with section 168(f)(8), and that consequently the lessor can take his deductions without regard to the amount of capital he has at risk. The Temporary Treasury Regulations\textsuperscript{128} eliminate any doubt about this issue,

\textsuperscript{117} See infra text accompanying notes 126-27, 275-77.
\textsuperscript{120} Id.
\textsuperscript{121} Id. § 465(b)(1)(B). Borrowed amounts are also considered at risk to the extent the taxpayer has pledged property, other than that used in the activity, as security for the loan. Id. § 465(b)(2)(B).
\textsuperscript{122} Id. § 465.
\textsuperscript{123} Id. § 465(a)(1)(A).
\textsuperscript{124} Id. § 465(a)(1)(B). A subchapter-S Corporation is a domestic corporation that is not a member of an affiliated group (as defined in § 1504) and which does not: have more than 25 shareholders; have as a shareholder a person who is not an individual (other than an estate or a trust); have a nonresident alien as a shareholder; have more than one class of stock. Id. § 1371(a), as amended by Economic Recovery Tax Act § 233(a), Pub. L. No. 97-34, 95 Stat. 172 (1981)).
\textsuperscript{125} Id. § 465(a)(1)(c). A personal holding company is a corporation that derives at least 60 percent of its adjusted gross income from personal holding company income and which, at any time during the last half of the taxable year, has 50 percent or more of its outstanding stock owned by five or fewer individuals. Id. § 542(a). Personal holding company income includes various passive types of income such as dividends, rents and royalties. Id. § 543(a).
\textsuperscript{126} Id. § 168(f)(8)(B) (West Supp. 1982) (originally enacted as Economic Recovery Tax Act § 201(a), Pub. L. No. 97-34, 96 Stat. 172 (1981)). The lessor may also be a partnership, if all the partners are corporations or a grantor trust, if certain other requirements are met. Id.
\textsuperscript{127} Id. § 168(f)(8)(B)(i)(I).
however, by expressly providing that the lessor’s deductions are limited to the extent that the “at risk” rules apply to either the lessee or the lessor. The regulations seem to be consistent with the purpose of section 168 because they “encourage transferability of credits and ACRS deductions without creating credits and deductions that would otherwise be unavailable.”

ERTA also extends the “at risk” rules to cover the investment tax credit. The law provides that, for purposes of determining the investment tax credit, the basis of the property cannot exceed the amount the taxpayer has at risk. “At

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129 Id. The regulations provide that in determining the amount that the lessor is at risk, section 168(f)(8) will not apply. Thus, if without regard to section 168(f)(8) the lessee would be treated as the owner of the property, the lessor may take tax losses with respect to the property, only to the extent that the lessee is at risk. For example, suppose Corporation A purchases a new plane by supplying 15 percent of the purchase price in cash and borrowing the other 85 percent through a non-recourse note. Corporation A then leases the plane to Corporation B. Assuming the other requirements of section 168(f)(8) are met, this transaction would qualify as a valid safe harbor lease. Under the IRS guidelines, however, this transaction would not qualify as a lease because the lessor failed to meet the 20 percent at risk minimum investment requirement. Thus, because without regard to section 168(f)(8) the lessee would be treated as the owner of the property, the lessor is only allowed to take tax losses to the extent the lessee is at risk. Id.

The availability of tax losses is also limited to the extent the at risk rules apply to the lessor as the owner of property under the §168(f)(8) lease. In the above example, if it is further assumed that Corporation A (the lessor) meets the stock ownership requirements of section 542(a)(2), then Corporation A will be subject to the at risk provisions contained in section 465 and section 46(c)(8). If Corporation A is not a personal holding company within the meaning of section 542(a), however, it can still qualify for the safe harbor protection under section 168(f)(8). In this case, where the at risk rules apply to both the lessee and the lessor, the lessor is allowed to take only the lesser of the deductions and credits allowable to the lessor or lessee. Id.


risk" is given the same general meaning that it has in section 465; however, a special provision is included which affects the "at risk" rules for leveraged leases. Section 46(c)(8)(b)(ii) permits a lessor to be considered "at risk" with respect to any amounts borrowed in connection with the property if: (1) he is, at all times, "at risk," within the meaning of §465, in an amount equal to twenty percent of the basis of the property; and (2) such money is borrowed from either a "qualified person" or a specified government body.

Furthermore, the lessor's interest payments on the leveraged portion of the transaction may not be completely deductible. If rents collected on an airplane lease are deemed to be investment income, any interest paid in connection

132 Id. § 46(c)(8)(A) See supra text accompanying notes 119-21.
136 Id. § 46(c)(8)(B)(ii).
137 Id.
138 Id. § 46(c)(8)(D). Qualified persons include certain financial institutions, insurance companies and pension trusts which are not persons related to the taxpayer, are not persons who receive a fee with respect to the taxpayer's investment in the property or a person related to such person, and are not persons from which the taxpayer acquired the property, or a person related to such person.
139 Id. § 46(c)(8)(B)(ii). Permissible government bodies include any federal, state or local government or instrumentality thereof. Id. Loans are also valid for this purpose if guaranteed by federal, state or local governments. Id.
140 I.R.C. § 163(d)(3)(B)(i) (1976). Any gross income from rents is investment income if such rents are not derived from the conduct of a trade or business. Id. Property is deemed to be held for investment, and not for use in a trade or business (i.e. subject to a net lease) if: the sum of the taxpayer's section 162 deductions (other than rents and reimbursed amounts with respect to such property) is less than 15 percent of the rental income produced by such property, or the lessor is guaranteed a specified return or is guaranteed in whole or in part against loss of income. Id. § 163(d)(4)(A).

The definition of a net lease in this context is a statutory one and is different from, although not inconsistent with, the general business definition of that term given earlier in this comment. Cf. "The lessor holds bare title, while the lessee handles all the operating expenses of the property . . . .", supra text accompanying note 27, with "the sum of the section 162 deductions of the lessor with respect to such property . . . . is less than 15 percent of the rental income produced by such property . . . ." I.R.C. § 163(d)(4)(A) (1976). Both definitions describe a situation where the lessor receives rental income from the property but incurs none (or at least few) of the operating expenses, such as taxes, insurance and repair costs, for such property.
with such lease will be investment interest.\textsuperscript{141} Section 163(d)(1)\textsuperscript{142} permits investment interest to be deducted only to the extent of $10,000, plus net investment income,\textsuperscript{143} plus the amount by which certain business deductions attributable to net lease property exceeds the rental income produced by such property.\textsuperscript{144} This limitation on investment interest deductions, however, is not applicable to corporations\textsuperscript{145} and thus should not pose problems for most leasing transactions under the new safe harbor law.

The Treasury’s Temporary Regulations contain a further limitation on the lessor’s ability to deduct interest payments.\textsuperscript{146} Under these regulations, the lessor’s interest deduction cannot be: (1) greater than the amount that would be allowed to an accrual basis taxpayer\textsuperscript{147} under a level payment mortgage, amortized over a period equal to the term of the lessor’s obligation;\textsuperscript{148} or (2) less than the amount that would be allowed to an accrual basis taxpayer under a straight line\textsuperscript{149} amortization of the principal over the term of the lessor’s obligation.\textsuperscript{150} The regulations, however, do allow the interest deduction computation to take into account fluctuations in the interest rate that are dependent on external factors, such as adjustments in the prime rate, if the property is not financed by the lessee or a party related to the lessee.\textsuperscript{151}

If an individual lessor leases §1245 property,\textsuperscript{152} all deprecia-
tion taken in excess of the amount that would have been deducted under the straight line method\textsuperscript{155} will be considered a tax preference item\textsuperscript{156} and thus subject to a fifteen percent minimum tax.\textsuperscript{157} For leased personal property placed in service after December 31, 1981, ERTA requires that all cost recovery taken in excess of the straight line method,\textsuperscript{158} including the half year convention\textsuperscript{159} and excluding salvage value,\textsuperscript{160} is a tax preference item.\textsuperscript{161} Like the old law, this section does not apply to corporations and therefore should not inhibit most safe harbor leasing transactions.\textsuperscript{162}

IV. IMPACT OF ERTA ON LEASING

The new safe harbor leasing law is part of Congress' plan to

all kinds of personal property including property used to furnish transportation. Airplanes are therefore included within this definition.

\textsuperscript{155} Treas. Reg. § 1.167(b)-1(b) (1956). Under the straight line method of depreciation the cost or other basis of the property less its estimated salvage value is deducted in equal annual amounts over the estimated useful life for the property. \textit{Id.} This is opposed to certain accelerated methods of depreciation such as the declining balance method (as defined in Treas. Reg. 1.167(b)-2 (1956)), the sum of the years digits method (as defined in Treas. Reg. § 1.167(b)-3 (1956)) and the new Accelerated Cost Recovery System (as defined in I.R.C. § 168 (West Supp. 1982)). Under these latter methods the cost of the property is recovered more quickly in the early years of the asset's useful life.

\textsuperscript{156} I.R.C. § 57 (1976). Tax preference items include deductions such as accelerated depreciation, capital gains, depletion and intangible drilling costs on oil and gas wells. \textit{Id.}

\textsuperscript{157} Id. § 56. A minimum tax is imposed on taxpayers who have taken a certain amount of deductions constituting tax preference items to insure that such taxpayers do not entirely avoid the payment of income taxes. \textit{See} R. Rice & L. Solomon, \textit{Federal Income Taxation} 96 (3d ed. 1979). Accelerated depreciation on leased personal property is not an item of tax preference for corporations. I.R.C. § 57(a) (1976); Treas. Reg. § 1.57-1(c)(8) (1978). For the definition of a section 168(f)(8) corporation, \textit{see supra} text accompanying note 127.

\textsuperscript{158} See \textit{supra} note 153 and accompanying text.

\textsuperscript{159} Treas. Reg. § 1.167(a)-11(c)(2)(iii) (1973). The half year convention allows the taxpayer to treat all properties placed in service during the taxable year as having been placed in service on the first day of the second half of the taxable year. \textit{Id.}

\textsuperscript{160} Treas. Reg. § 1.167(a)-12(c)(1) (1973). Gross salvage value is generally defined as the amount (determined at the time the asset is acquired) that is estimated will be realized on a sale of the property when it is no longer used in the taxpayer's trade or business. \textit{Id.}


\textsuperscript{162} \textit{Id.}
stimulate the economy by providing incentives for investment of new capital.\footnote{See S. Rep. No. 144, 97th Cong., 1st Sess. 11-13 (1981); S. Rep. No. 176, 97th Cong., 1st Sess. 1 (1981).} Section 168(f)(8), therefore is not designed to make leasing easier for everyone. On the contrary, the new law relaxes the leasing standards only for those taxpayers whose motives are compatible with the above stated Congressional intent.\footnote{Thus, for example, the safe harbor extends its benefits only to taxpayers who invest in new, as opposed to used, property. See infra text accompanying notes 259-74.} The following is an analysis of the eight major differences between the IRS leasing guidelines and the new safe harbor law and of how well these changes carry out Congress' intent.

A. \textit{Minimum At Risk Investment}

The IRS guidelines require the lessor to have an at risk investment of at least twenty percent of the cost of the property at all times throughout the term of the lease.\footnote{Rev. Proc. 75-21, 1975-1 C.B. 715.} Section 168(f)(8), however, imposes such a requirement only to the extent of ten percent of the property's adjusted basis.\footnote{I.R.C. § 168(f)(8)(B) (West Supp. 1982) (originally enacted as Economic Recovery Tax Act § 201(a), Pub. L. No. 97-34, 95 Stat. 172 (1981)). Adjusted basis is generally the cost of the property (as defined in § 1012) with certain adjustments, the most important of which is depreciation or, after the passage of the Economic Recovery Tax Act, cost recovery. I.R.C. § 1016 (1976).} While this requirement is based on the proposition that the lessor should have a substantial investment in the property before he is treated as its owner,\footnote{See Fritch & Reisman, Leveraged Leasing, supra note 27, at 247.} the percentage limitations are in themselves quite arbitrary.\footnote{Id.} The primary impact of this change will be an increase in the leverage available to the lessor/investor. Under the new act the lessor will still get one hundred percent of the tax benefits from the property, but at only a fraction of the cost previously required. This increased leverage will help the lessor's cash flow in two ways: (1) it will decrease the amount of money that the lessor must spend up front;\footnote{Id. at 248 n.22. The lessee has an incentive to keep the lessor's investment up,} and (2) by increasing the amount of his debt, it will...
increase his interest deductions.\textsuperscript{168}

As previously stated, the IRS guidelines use the property's cost as the benchmark against which to measure the minimum investment.\textsuperscript{169} The new law, however, focuses on the adjusted basis of the asset.\textsuperscript{170} Thus, as the property's adjusted basis is reduced through cost recovery deductions,\textsuperscript{171} so too can the minimum investment be reduced, although it must always remain at ten percent of the property's adjusted basis.\textsuperscript{172}

One uncertainty encountered under the IRS guidelines is whether interest, taxes and carrying charges incurred during the pre-lease period are properly includable as part of the property's "cost" for purposes of the minimum investment requirement.\textsuperscript{173} The definition of cost under section 1012\textsuperscript{174} of the Code sheds no light on this matter. By using the asset's adjusted basis as the benchmark figure Congress resolved this problem, because section 1016\textsuperscript{175} expressly permits an adjustments to basis for taxes and other carrying charges the taxpayer elects to capitalize under section 266.\textsuperscript{176}

\begin{footnotes}
\item[168] I.R.C. § 163(d) (1976). The noncorporate lessor's interest deductions are, of course, limited by § 163(d). See supra text accompanying notes 139-45.
\item[169] See supra text accompanying note 163.
\item[170] I.R.C. § 168(f)(8)(B) (West Supp. 1982). For the definition of Adjusted Basis, see supra note 164 and accompanying text.
\item[171] I.R.C. § 1016(a)(2) (1976). A taxpayer is allowed to reduce the basis of his property by the aggregate amount of depreciation deductions taken. Id.
\item[173] See FRITCH & REISMAN, LEVERAGED LEASING, supra note 27, at 248.
\item[174] I.R.C. § 1012 (1976). "The basis of property shall be the cost of such property, except as otherwise provided . . . . The cost of real property shall not include any amount in respect of real property taxes which are treated under section 164(d) as imposed on the taxpayer." Id.
\item[175] Id. § 1016.
\item[176] Id. § 266. I.R.C. § 1016 provides that:
\begin{quote}
[P]roper adjustment . . . shall in all cases be made for expenditures, receipts, losses, or other items, properly chargeable to capital account, but no such adjustment shall be made for taxes or other carrying charges described in section 266 . . . . for which deductions have been taken by the taxpayer in determining taxable income for the taxable year or prior taxable years . . . .
\end{quote}
\item[177] Id. § 1016.
\item[178] I.D. § 1016.
\end{footnotes}

Section 266 provides that no deduction shall be allowed for amounts paid for taxes or other carrying charges if the taxpayer elects to charge them to his capital account.
The IRS guidelines require the lessor's minimum investment to be an equity investment.\textsuperscript{177} For this purpose Revenue Procedure 75-21\textsuperscript{178} defines equity investment to include only the amount of consideration actually paid and personal liabilities incurred by the lessor to purchase the property.\textsuperscript{179} Furthermore, the lessor is required to have sufficient net worth to satisfy any personal liability so incurred.\textsuperscript{180} The new law retains these requirements in the form of its "at risk" definition.\textsuperscript{181} These requirements are necessary back-ups to the minimum investment standard, because they insure that the lessor has some of its own capital invested in the property and that its minimum investment is not just on paper.

While neither section 168(f)(8) nor the Treasury's temporary regulations include any of the "unconditional"\textsuperscript{182} language contained in the guidelines, presumably, this requirement is subsumed within the new law's requirement that the lessor maintain his ten percent minimum at risk investment throughout the term of the lease.\textsuperscript{183} Any lessor who takes on a conditional obligation as part of its ten percent minimum investment, will undoubtedly fail the maintenance requirement, if upon occurrence of the specified condition, he becomes entitled to a return of all or part of his original investment and thereby allows his minimum at risk investment to fall below the required ten percent of adjusted basis level.\textsuperscript{184}

\textit{Id.} § 266.

\textsuperscript{177} Rev. Proc. 75-21, 1975-1 C.B. 715.

\textsuperscript{178} Id.

\textsuperscript{179} Id.

\textsuperscript{180} Id.

\textsuperscript{181} Temp. Treas. Reg. 5c.168(f)(8)-4(b) (1981). For purposes of the "at risk" test, "net worth" does not include the value of leases qualifying under section 168(f)(8).

\textit{Id.}

\textsuperscript{182} Rev. Proc. 75-21, 1975-1 C.B. 715. Under the IRS guidelines the lessor's investment was required to be unconditional. In other words, he could not be entitled to a return of his investment after the leased property was placed in service unless the lease contract provided for such a return to the lessor in the event the property failed to meet specifications required in the contract. \textit{Id.}

\textsuperscript{183} I.R.C. § 168(f)(8)(B) (West Supp. 1982).

\textsuperscript{184} See Temp. Treas. Reg. 5c.168(f)(8)-4(b) (1981). Any amounts repaid to the lessor under a conditional agreement are not considered to be at risk with respect to the leased property. \textit{Id.}
B. Transaction Entered Into For Profit

Under the IRS guidelines the lessor must demonstrate that it expects to receive a profit from the transaction, apart from the benefits obtained from the tax deductions, allowances, credits and other tax attributes arising from such transaction.\(^{165}\) Under this profit test, the lessor has to show that his receipts\(^{166}\) over the term of the lease will exceed his expenses\(^{167}\) over such lease term.\(^{168}\) The new law, on the other hand, permits, and is in fact designed, to let the lessor enter the lease solely to obtain the desired tax benefits.\(^{169}\)

The IRS profit test stems from the idea that in order to have a tax effect, a transaction should have some demonstrable business purpose.\(^{190}\) While in certain situations the requirement of a business purpose is a necessary safeguard to prevent tax avoidance schemes,\(^{191}\) in the leasing context, such a requirement presents something of an anomaly.\(^{192}\) Despite the fact that Congress enacted certain tax provisions\(^{193}\) with the specific intent that investors, seeing the increased tax benefits available, would be encouraged to invest in new capital, the IRS guidelines ignore these tax incentives in determining whether a transaction has been entered into for a profit.\(^{194}\) By taking tax motives into account,\(^{195}\) the safe harbor provision


\(^{166}\) Id. Receipts include any amounts paid to or for the lessor plus the estimated residual value of the leased asset. Id.

\(^{167}\) Id. Expenses include any amounts paid by or for the lessor plus the lessor’s equity investment in the property. Id.

\(^{168}\) Id. The guidelines did not specify, however, how much profit was required in order to pass the test.


\(^{191}\) FRITCH & REISMAN, LEVERAGED LEASING, supra note 27, at 288.

\(^{192}\) Parshelsky’s Estate v. Commissioner, 303 F.2d 14 (2d Cir. 1962) (in corporate spinoffs a business purpose is required for both the separation of the two businesses and the distribution of stock, in order to prevent taxpayers from reorganizing their businesses in order to distribute earnings and profits tax free).

\(^{193}\) FRITCH & REISMAN, LEVERAGED LEASING, supra note 27, at 288.


\(^{195}\) See supra text accompanying note 185.

promotes rather than inhibits Congress' economic policy, and thus clearly marks a step in the right direction.

C. Options to Purchase Or Sell

Under the IRS guidelines, the lessee may not have an option to purchase the leased property except at its fair market value at the time the option is exercised.\textsuperscript{196} Furthermore, the lessor cannot have the right to cause anyone to purchase the property, even at fair market value.\textsuperscript{197} The first condition stems from the notion that an option held by the lessee to purchase the property at a nominal price makes the lease more like a contract for sale rather than a lease.\textsuperscript{198} The second requirement reflects the theory that one of the risks of owning property is that no market for the property will exist at the end of the lease term.\textsuperscript{199} If the lessor is allowed to have a "put",\textsuperscript{200} he can shift this burden to the lessee. The IRS feels that such a shift in burdens should destroy the lessor's status as owner of the property.\textsuperscript{201}

Even before the passage of ERTA, the United States Supreme Court indicated that the existence in the lessee of an option to purchase the property, although a factor in determining whether a true lease existed, was by no means dispositive on that issue.\textsuperscript{202} ERTA resolves this problem by allowing the parties to set up options for purchase or sale, at any price, without affecting the status of the lease.\textsuperscript{203} While there is no discussion in the committee reports as to why this element was changed, it presumably reflects a legislative judgment that the risk of leasing transactions being used as a subterfuge for transferring ownership is outweighed by the need to spread the benefits of the new tax act throughout the business

\textsuperscript{196} Rev. Proc. 75-21, 1975-1 C.B. 715, 716.  
\textsuperscript{197} Id.  
\textsuperscript{199} FRITCH & REISMAN, LEVERAGED LEASING, supra note 27, at 275.  
\textsuperscript{200} Id. at 274. A "put" is a right to cause someone to purchase something. Id.  
\textsuperscript{201} See Rev. Proc. 75-21, 1975-1 C.B. 715, 716.  
community.

One particular segment of the business community, the airline industry, fought especially hard to change this aspect of the leasing law. Airlines were tired of watching planes appreciate greatly during the term of their leases, only to have all of the profits from such appreciation go to the lessor/banks. Unfortunately, prior to the passage of ERTA there was little they could do to combat such a result. Now, however, airlines hope to capitalize on the new leasing law by greatly reducing option prices so that they can realize some, if not all, of the residual value of the planes.

It is not clear, however, whether ERTA's push will be enough to give the airline industry what it wants. Due to poor profits, many financial institutions will have only a minimum need for tax shelters at best. On the other hand, there are a great number of companies whose poor financial positions will make it desirable to sell their tax write-offs. The result will be a market in which many lessors find themselves in a good position to dictate the contractual terms of their leases. Consequently, it seems likely that lessors will continue to derive most of the benefits from asset residual values.

Accounting questions also pose a problem for airlines wishing to reap some of the benefits of residual value. If the lease contains a bargain purchase option, thus depriving the lessor of the residual value benefit, accounting standards require that the lease be carried as a capital asset, with a corresponding liability on the lessee's books. Some accounting experts

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205 Id.
206 Rev. Proc. 75-21, 1975-1 C.B. 715, 716. Options to purchase the aircraft at the end of the lease term had to be exercisable only at fair market value in order for the transaction to be considered a true lease. Id.
207 Rev. Proc. 75-21, 1975-1 C.B. 715. The residual value of an asset is the fair market value of such asset at the end of the lease term, without including in such fair market value any increase or decrease caused by inflation or deflation. Id.
209 Id. at 64.
210 Id.
211 Id.
212 Id.
213 See AICPA Professional Standards (CCH) § 4053.007 (1976). See supra notes
believe that these accounting problems will not inhibit the use of safe harbor leases because businesses will be more interested in obtaining the favorable tax benefits than they will be worried about the potential adverse impact such transactions may have on their financial statements. Other accountants, however, believe that many lessee businesses will shun capital leases as a sign of financial weakness and thus will draft leases that give the lessor an interest in the residual value of an asset.

D. Usefulness of the Leased Property at the End of the Lease Term.

The IRS guidelines will not characterize a transaction as a lease if at the end of the lease term the leased property will not be usable by anyone other than the lessee. The rationale of the IRS on this point seems to be that, if the lessee is going to “enjoy the benefits of the use or ownership of the property for substantially its entire useful life,” then in reality the use of such property is so limited that it should be deemed to be unleasable. The mere fact that the parties designate the transaction as a lease will not be sufficient to permit transfer of the tax benefits to the lessor.

There are two major problems with the Commissioner’s analysis of this point. First, this reasoning ignores the fact that the lessee, unlike the owner, will have to pay the fair market value for such use. Secondly, Revenue Procedure 76-30, which articulated this “limited use test,” relied on Revenue Ruling 55-541 in reaching its conclusion that such

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56-58 and accompanying text.


I.R.C. § 168(f)(8)(A) (West Supp. 1982). This is contrary to the rule under the Economic Recovery Tax Act where the party’s characterization of the transaction as a lease is essential to its safe harbor protection. Id.

See FRITCH & REISMAN, LEVERAGED LEASING, supra note 27, at 294.


property is not leasable.\textsuperscript{333} The latter ruling, however, which held that an equipment lease was in fact a transfer of equitable ownership to the lessee, involved a "lease" for nearly all of the property's useful life, coupled with a nominal renewal rental.\textsuperscript{224} Whether the subject property in that ruling was limited use property was not an issue.\textsuperscript{333}

The tax court indicated that it disagrees with this "limited use" requirement in its 1971 decision in \textit{Electric & Neon, Inc. v. Commissioner}.\textsuperscript{336} There, the court recognized that custom-tailored business signs were properly the subject of a lease, even though such signs would clearly have little use for anyone other than the original lessee.\textsuperscript{337} The Treasury's Temporary Regulations follow this result by proclaiming "whether or not a person other than the lessee may be able to use the property after the lease term" is not taken into account in determining whether a transaction is a lease.\textsuperscript{338}

E. \textit{Lessee Furnishing Part of the Purchase Price}

The original IRS guidelines, published in 1975, did not allow the lessee to provide any portion of the cost of the leased property or of any improvements on the leased property\textsuperscript{339} except those owned by the lessee and removable without damage to the rest of the leased property.\textsuperscript{340} The lessee was also prohibited from lending funds to the lessor or from guaranteeing any indebtedness of the lessor in connection with the property.\textsuperscript{351} In 1979 the IRS modified these guidelines by providing that the lessee could furnish the cost of certain severa-

\textsuperscript{335} See \textsc{Fritch \& Reisman, Leveraged Leasing}, \textit{supra} note 27, at 294 n.86.
\textsuperscript{336} 56 T.C. 1324 (1971).
\textsuperscript{337} \textit{Id.} at 1324-25.
\textsuperscript{339} Rev. Proc. 75-21, 1975-1 C.B. 715, 716.
\textsuperscript{340} \textit{Id.} Furthermore, as to such removable items of property, the lessee may not have an option to purchase such property at other than its fair market value. The lease, however, may provide for adjustment of the rent in the event the cost of the property exceeds the estimate on which the lease was based. For these purposes, ordinary maintenance and repairs performed by the lessee pursuant to his lease obligations are not considered improvements. \textit{Id.}
\textsuperscript{351} \textit{Id.}
ble and nonseverable improvements.\textsuperscript{333} As to the original leased property itself, however, the Service's position remained the same: the lessee was forbidden from providing for any of the property's cost.\textsuperscript{333}

Under the IRS guidelines the lessee's participation in the cost of the property has been a particularly difficult problem. For example, in the case of special order property the exact cost of the property is often unknown in advance of its completion.\textsuperscript{334} The commitments of the lessor, however, must generally be fixed well in advance of closing.\textsuperscript{335} Thus, a useful provision to include in a lease agreement permits the lessee to make up any cost overruns to the manufacturer or supplier.\textsuperscript{336} Because the guidelines prohibit the lessee from providing any of the cost of the property, however, the lessee must refrain from shouldering the burden of cost overruns\textsuperscript{337} in order to gain the desired tax benefits of a lease. While certain techniques can be used to avoid this problem and to preserve the lessor's valuable tax status, they all result in increasing the overall cost of the transaction and therefore are undesirable.\textsuperscript{338}

The guidelines also create problems when the lessee is the manufacturer of the leased property.\textsuperscript{339} If the manufacturer/lessee sells the property at its fair market value, but at less than his cost, he may be deemed to have furnished part of the cost of the property.\textsuperscript{340} Furthermore, if the lessee fails to properly indentify the costs included in the lessor's purchase price, the Service may hold that the lessee supplied such un-

\textsuperscript{334} Id.
\textsuperscript{335} Fritch & Reisman, Leveraged Leasing, supra note 27, at 278.
\textsuperscript{336} Id.
\textsuperscript{337} Id.
\textsuperscript{338} Id. at 278-79. Setting a higher purchase price to cover potential cost overruns will result in higher commitment fees paid to the lender. Excluding units from the transaction, to the extent their cost exceeds the total price, is not feasible in the case of property all of whose elements are essential to proper operation. Id.
\textsuperscript{339} Id. at 279.
\textsuperscript{340} Id. at 280.
identified costs. In cases such as these in which events unforeseen at the time of contracting cause a technical allocation of cost to the lessee, but do not really change the economic substance or business purpose of the transaction, there is no good reason to deny the parties the tax benefits of a true lease.

While the strict IRS rules with respect to the cost of basic leased property seem contrary to good business and tax policy, the Service's position on leasehold improvements not only represents bad policy, but also seems inconsistent with the established case and statutory law in the area. Two United States Supreme Court cases discussing the issue of whether leasehold improvements by the lessee constitute income to the lessor, gave absolutely no indication that such improvements upset the validity of the lease. In addition, the Code and the regulations thereunder implicitly recognize the consistency of lessee improvements with the continued efficacy of a lease.

Under ERTA, the fact that the lessee has provided financing for the leased property or has guaranteed such financing is not taken into account in determining whether the transaction is a lease. Presumably, the lessee can provide for the entire cost of the property except for the ten percent minimum in-

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241 Id. at 279.
242 Id. at 282.
243 See Helvering v. Bruun, 309 U.S. 461 (1940) (holding that upon termination of a lease, the lessor realizes income to the extent of the fair market value measured at the time the lease terminated, of improvements made by the lessee during the lease term. This case was reversed by Code section 109 which postpones the lessor's income from such improvements to real property until he makes a taxable disposition of the property); M. E. Blatt Co. v. United States, 305 U.S. 267 (1938) (holding that a lessor realizes no income during the term of a lease when the lessee makes leasehold improvements).
244 I.R.C. § 178(a)(1) (1976). In recognizing that improvements made by the lessee on the leased property may be depreciated, section 178 implicitly recognizes that such improvements do not invalidate the lease. Id.
245 Treas. Reg. § 1.167(a)-4 (1960). The regulations, in permitting such improvements on leased property to be depreciated, likewise recognize the consistency of the improvements with the status of the lease. Id.
vestment required of the lessor. The Senate Reports provide no rationale for this change, other than the blunt statement that this factor will not be taken into account. The change is probably a good one, however, because it will alleviate the problems that existed under the IRS rules, and yet will retain the requirement that the lessor have enough money invested in the property that he can properly be considered its owner.

While neither the Code nor the regulations touch on this point, there seems to be nothing wrong with the lessee providing the cost of improvements to the leased property. Care must be taken, however, to keep the lessor's minimum investment from falling below ten percent. Because the ten percent standard is measured against the adjusted basis of the leased property and because the cost of improvements may increase the basis, an unwitting lessee could accidentally push the lessor's minimum investment below the required level. Should such an event occur, the lease will terminate and the tax consequences could be disastrous.

Another potential problem in the area of improvements concerns the requirement that "the property" be subject to only one lease. If the improvement is held to be part of "the property" and is financed through a separate leasing arrangement, the safe harbor may be lost for the entire transaction. A related problem is the requirement that there be only one lessor per leased property. If the improvement is

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249 I.R.C. § 168(f)(8)(B)(ii) (West Supp. 1982). The lessor is required to have a minimum at risk investment of 10 percent of the property's basis at all times throughout the term of the lease. See supra notes 163-184 and accompanying text.
253 See supra text accompanying notes 92-103.
255 Id.
256 Id.
deemed to be part of the original leased property but is leased from a different owner, again, the entire arrangement may be ruined. 268

F. New v. Used Property

One respect in which the safe harbor provision is more restrictive than the IRS guidelines is in regard to the type of property that can qualify for its protection. Whereas any type of property, new or used, can qualify as true lease property under the IRS guidelines, 259 ERTA permits only new section 38 property 260 and certain mass commuting vehicles 261 to qualify for the safe harbor. 262 Furthermore, new section 38 property must be leased within three months after it is placed in service 263 and must be property that, if acquired by the lessee, would have been new section 38 property of the lessee. 264 This requirement again highlights the fact that the motivation behind section 168(f)(8) was not a belief that the IRS rules with regard to leased property are based on incorrect notions of legal ownership, but rather on the economic policy that investment in new capital should be encouraged. 265

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259 Id.
260 Rev. Proc. 75-21, 1975-1 C.B. 715; Rev. Proc. 75-28, 1975-1 C.B. 752. Unlike the new safe harbor law, the IRS guidelines contained no language limiting their use to new property. Id.
261 I.R.C. § 48(b) (1976). "New section 38 property" is property the construction, reconstruction or erection of which is completed by the taxpayer after December 31, 1961, or which was acquired after December 31, 1961, if the original use of such property commenced with the taxpayer. Id.
262 I.R.C. § 168(f)(8)(D)(iii) (West Supp. 1982). Mass commuting vehicles include buses, subway cars or similar equipment which is leased to a transit system wholly-owned by one or more governmental units and which is used by such system in providing mass transportation services. I.R.C. § 103(b)(9) (West Supp. 1982) (originally enacted as Economic Recovery Tax Act § 811(c), Pub. L. No. 97-34, 95 Stat. 172 (1981)). In order to qualify as property subject to the safe harbor rules, such mass transportation vehicles must also be financed at least in part, by obligations, the interest of which is excludable from income under section 103(a). I.R.C. § 168(f)(8)(D)(iii) (West Supp. 1982).
264 Id. § 168(f)(8)(D)(i).
265 Id. New section 38 property of the lessee is property which is constructed, reconstructed, erected or owned by the lessee and which otherwise meets the requirements of section 48(b). See supra note 260 and accompanying text.
266 See supra notes 13-19 and accompanying text.
A special rule is provided for sale/leaseback transactions. Under this rule, the leased property must not only be section 38 property of the lessee that was leased within three months after it was placed in service by the lessee, but the lessor's adjusted basis for the property also cannot exceed the lessee's adjusted basis. For example, suppose an airline contracts to have a plane constructed for $10 million and over the term of the contract the value of the plane rises to $11 million. The airline buys the plane at the contract price of $10 million, and before it is placed in service, sells it at its fair market value of $11 million and then leases it back. This transaction would not qualify for safe harbor protection because the lessor's adjusted basis exceeds the lessee's adjusted basis.

The Treasury's rationale behind this rule is that approval of a fair market value basis for the lessor would, in effect, allow greater depreciation and investment tax credit write-offs through leasing, than those available absent such a transaction. While this view is supported by language in the Senate Reports, an equally viable argument can be made that the lessor should be allowed to take the fair market value basis. First, the Treasury's view ignores the fact that, in order for the lessor to get that step-up in basis, he must pay for it. If the lessor pays $11 million, why should he only get the tax benefits of a $10 million asset? Second, giving the lessor the step-up in basis in no way conflicts with the ultimate policy

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270 Id.
272 S. REP. No. 144, 97th Cong., 1st Sess., 61 (1981). "The Committee recognizes that some businesses may not be able to use completely, the increased cost recovery allowances and the increased investment credits available for recovery property under ACRS. ACRS will provide the greatest benefit if ACRS deductions and ITCs are more easily distributed throughout the corporate sector." Id.
behind ERTA: to stimulate investment in new equipment.\(^{773}\) On the contrary, such a construction of section 168(f)(8) would put the lessee, the party whom that section is designed primarily to benefit,\(^{774}\) in an even better position to finance the investment in new capital.

G. Who Can Use the Safe Harbor

Another area in which the new law is more conservative than the IRS guidelines is in regard to the lessor's status. Under the guidelines no particular organizational structure is mandated.\(^{775}\) To take advantage of the safe harbor, however, the lessor must either be a section 168(f)(8) corporation;\(^{776}\) a partnership, all the partners of which are section 168(f)(8) corporations; or a grantor trust with respect to which the grantor and all the beneficiaries fall into the first two categories described above.\(^{777}\) Congress evidently did not want to make available the safe harbor law as another tax shelter for wealthy individuals.\(^{778}\)

H. Useful Life of the Property At the End Of The Lease

A final point of departure under the safe harbor law involves an easing of the lease term requirements.\(^{779}\) Under the guidelines, the remaining useful life of the property at the end of the lease term must be one year or twenty percent of the property's original estimated useful life, whichever is longer.\(^{780}\) For purposes of the guideline test, the lease term includes all renewal periods except those that are exercisable only at the option of the lessee and at the fair rental value at the time of

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\(^{773}\) See id. at 11-13.

\(^{774}\) See supra notes 6-7 and accompanying text.

\(^{775}\) Rev. Proc. 75-21, 1975-1 C.B. 715. Unlike the safe harbor law, the IRS guidelines contain no language limiting the lessor to any particular organizational form. Id.


\(^{778}\) Remarks of John E. Chapoton, Ass't Sec'y of Treasury (Tax Policy) U.S. Tax WEEK, Oct. 9, 1981, at 1192. "The new leasing rules do not encourage uneconomical tax shelter investments nor may leasing be used to inflate tax benefits."


\(^{780}\) Rev. Proc. 75-21, 1975-1 C.B. 715, 716.
the renewal.\textsuperscript{281}

Under ERTA the lease term cannot exceed the greater of ninety percent of the useful life of the property or one hundred fifty percent of the present class life of such property.\textsuperscript{283} For purposes of this test, "useful life" means the period during which one can reasonably expect the asset to be economically useful.\textsuperscript{284} Also, under ERTA, the lease term includes all options to extend the lease, regardless of whether such options are exercisable at fair market value.\textsuperscript{284} ERTA also imposes a requirement that the minimum lease term be at least equal to the period described in section 168(c)(2)\textsuperscript{286} for the requisite class of property.\textsuperscript{286}

\section*{V. Problems and Unanswered Questions}

A primary problem with the new leasing law is that the Treasury's regulations have substantially limited the statute's potential for reviving unprofitable companies. Critics of these regulations say that the Treasury feared that the revenue lost because of the new leasing law would be much greater than originally expected.\textsuperscript{287} As a result, the critics say the Treasury acted too restrictively in drafting its regulations.\textsuperscript{288}

Probably the most detrimental sections of the new regulations are the provisions that subject the lessor to recapture of his tax benefits if the leased property is seized by the bankruptcy trustee or secured creditor of the lessee.\textsuperscript{289} In order to

\textsuperscript{281} Id.


\textsuperscript{285} Id.

\textsuperscript{286} I.R.C. § 168(c)(2) (1976).


\textsuperscript{289} Id.

\textsuperscript{289} Temp. Treas. Reg. § 5c.168(f)(8)-8(b)(3), (C), (D) (1981). Subsequent to the writing of this comment the Treasury amended its temporary regulations. These amendments relaxed the rules where the leased property is seized by a bankruptcy trustee or a secured creditor of the lessee. For the specific rules that a lessor must comply with under these circumstances in order to preserve the tax status of his lease, see Temp. Treas. Reg. § 5c.168(f)(8)-2(a)(6), T.D. 7795, 1981-50 I.R.B. 5.
protect its investment, the lessor will have to obtain waivers from the lessee's creditors. In addition to being costly and time consuming, however, obtaining such a waiver in some cases, may be impossible. For example, how can such a waiver be obtained from a bankruptcy trustee who has not yet been appointed at the time the lease is executed? Thus, many companies with poor credit ratings and low profits, the very companies that section 168(f)(8) is designed to help, will find it difficult, if not impossible, to utilize safe harbor leases to sell their unused tax credits and deductions.

Two other problems raised by the new regulations involve the Treasury's reservation of its opinion on "pass-through" leases and its provision regarding disqualification of the lessee. As to the former, it is estimated that with the uncertain validity and consequent high risk of such transactions, over $1 billion worth of investment tax credit leases will be abandoned. Furthermore, the latter provision is expected to ruin the plans of many large brokers to spread the benefits of the new lease law to small, profitable companies. The statute itself permits the lessor to be a partnership composed of corporations. Accordingly, lease agents had hoped to combine groups of small companies into such partnerships by selling them interests in large leases. The regulations, however, provide that if, subsequent to the formation of the partnership one of the partner corporations changes its tax status, the transaction will collapse for the entire partnership.

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291 Id.
292 Id.
293 See supra, notes 6-7 and accompanying text.
298 Id.
as through its acquisition by another company, it is unlikely that partnerships will flourish as lessors under section 168(f)(8).\footnote{302}

The new safe harbor rule also raises several difficult accounting questions that have not yet been answered. While the new transactions may be treated as leases under federal tax law, it is not clear whether they will be treated as capital leases under generally accepted accounting principles.\footnote{303} If they are so treated, the lessee's books will show a shift from fixed to current assets and a corresponding increase in liabilities,\footnote{304} a shift that can be quite harmful to a company's credit rating.\footnote{305}

Another key issue for the lessee's accountants is the treatment of money that the lessee receives in exchange for the investment tax credit.\footnote{306} Company accountants, of course, would prefer to treat the cash received just like the investment tax credit by flowing it directly into income.\footnote{307} But others say that such cash should be treated as a reduction in the equipment cost and thus amortized over the life of the lease.\footnote{308} The weight of opinion, assuming the new transactions look like sales of tax credits and not like leases, is to allow companies to treat the cash received just as they would have treated an investment tax credit.\footnote{309} If, however, the transactions are considered to be capital leases, the Financial Accounting Standards Board (FASB) may require companies to amortize the cash received over the life of the lease.\footnote{310}

\footnote{303} Bus. Wk., Oct. 12, 1981, at 81; Dun's Bus. Month, Oct. 1981, at 64. For the FASB opinion regarding capital leases, prior to the passage of ERTA, see supra notes 56-58 and accompanying text.
\footnote{305} Id. See also Dun's Bus. Month, Oct., 1981, at 64.
\footnote{308} Id.
\footnote{309} Id.
\footnote{310} Id. at 84. J. T. Bell, Assistant Director of Research and Technical Activities for the Financial Accounting Standards Board, stated, prior to the Treasury's adoption of the new leasing regulations, that the addition of extra gimmicks (such as differences in timing between the lessee's rent payments and the lessor's payments of interest and principal or the parties' sharing of the asset's residual value) to leveraged
On the lessor's side, the major issue concerns the status of the purchased investment tax credit. Most company accountants would prefer to treat the investment tax credit as a return on an investment. On the other hand, if the FASB decides that the new safe harbor transactions are in fact capital leases, companies will be faced with huge write-offs in the year of the transaction and consequent drops in reported earnings.

The ultimate issue in all of these accounting problems is whether the new safe harbor leases will be viewed by the FASB as pure sales of tax benefits or as capital leases. While many tax experts think the Treasury's new regulations are too strict, the regulations permit many intricacies that, if utilized, may hurt a company's financial accounting statements. Thus, the decision concerning the structure of a new safe harbor lease will involve a careful balancing of tax and accounting advantages and disadvantages. If the parties utilize all of the intricate variations permitted by the tax laws in order to minimize their tax liability, they may find themselves in embarrassing positions with regard to their financial statements. Yet, if they structure the transactions so as to clean up their balance sheets, companies will be faced with the possibility of real cash losses caused by overly cautious tax planning.

VI. CONCLUSION

The passage of the new Safe Harbor Leasing Law was a long over-due stimulant necessary to bolster our economy. To
fully utilize the investment tax credit and accelerated depreciation deductions as a means of promoting domestic capital development, it is imperative that such benefits be available to everyone. If for no other reason, therefore, the new law is a good idea because it recognizes that the sole motivation for leveraged leases and sale/leasebacks may be the transfer of tax write-offs. Excessive concern over issues of title and ownership, such as the IRS guidelines display, results in a failure to recognize the real import of these transactions. Leveraged leases and sale/leasebacks are not simply leases of property, but rather are sales of tax benefits that would otherwise go unused. In recognizing this concept Congress has taken a strong first step not only toward revitalizing ailing industries, but toward promoting the establishment of new ones as well.

See supra notes 185-194 and accompanying text.