Equipment Leasing
Tax Principles and Structuring

Portfolio 545-3rd

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Description

Tax Management Portfolio, *Equipment Leasing: Tax Principles and Structuring,* No. 545-3rd, examines key equipment leasing issues and offers advice for both novice and tenured practitioners based on the authors' decades of real-world experience. To the uninitiated, equipment leasing sounds like a mundane topic involving an industry that transacts business using preprinted forms. However, it has been the source of some of the most important case law with a reach that goes well beyond equipment leasing. Equipment leasing transactions invoke many fundamental tax law concepts: ownership, substance versus form, economic substance, application of tax accounting concepts, and principles of administrative law. In fact, equipment leasing has been, in many respects, the catalyst for such concepts. More than being the means to procure rented cars and photocopiers, equipment leasing involves planning to ensure the tax incentives that Congress provides for investment in equipment are available to the party best positioned to monetize them. However, given the complexity of the Internal Revenue Code and the underlying regulations, ensuring such a monetization is successful requires a nuanced understanding of authorities that span from private letter rulings to Supreme Court cases.

This Portfolio explains the true lease doctrine and its origin, the IRS safe harbor for equipment leveraged leases, terminal rental adjustment clause (TRAC) leases under §7701(h), and how a service contract is distinguished from a lease under §7701(e) and the consequences thereof. In addition, the Portfolio includes discussion of the tax attributes available in a true lease, including accelerated depreciation under §168, interest deductions on the balance of §467 loans, transaction expense deductions, and the energy investment tax credit under §48 and the related recapture rules in §50. Further, this Portfolio analyzes statutory rules that curtail the tax benefits available in leases to tax-exempt entities in §168(g)'s Pickle Rule and its progeny §470.

Equipment leasing is more than an archaic form of doing business. It is an opportunity that exists now for investors and developers who want to deploy their resources in a tax-efficient way. This Portfolio explains what structuring tools are available and what pitfalls to avoid to capitalize on that opportunity.

This Bloomberg Tax Portfolio is not intended to provide legal, accounting, or tax advice for any purpose and does not apply to any particular person or factual situation. Neither the author nor the publisher assumes responsibility for the reader's reliance on information or opinions expressed in it, and the reader is encouraged to verify all items by reviewing the original sources.

I. Introduction

One origin of the verb "to lease" dates back to Middle English and means "To tell lies."[1] We do not believe the connection between "leasing" and "lying" is anything nefarious, but rather the connection developed because the owner of leased property is not who it appears to be. For instance, rather than the user of a leased plough being its owner, the owner is the party that supplied some or all of the capital to purchase the plough and takes the risk of the plough's long-term value. That can make a lease seem like a lie: its owner is not Francis Farmer, who uses it, but rather Laura Lessor, who funded its purchase and is entitled to the benefit or the detriment of the value of the plough when the lease is over.

[1] Oxford English Dictionary.

The fundamental question in income tax planning for equipment leasing is whether a line has been crossed whereby the lessee, rather than the lessor, is the tax owner of the equipment. One way to think about this question is a hierarchy of ownership where tax benefits for the purported owner of the equipment become progressively limited as the transactional structure moves down the hierarchy.

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A. Hierarchy of Tax Ownership

The table below is a hierarchy of tax ownership illustrating various forms of leasing transactions that progressively limit the tax benefits available to the lessor.[2] The "paradigm" case described is not a lease transaction at all, but a taxpayer ("party") that both owns and operates the equipment and has purchased it with some combination of equity and recourse debt. Each described transaction in the table imposes additional challenges to the owner's use of tax benefits.

Hierarchy Scenario:	**Transaction Features:**	**Tax Benefits:**
I. Paradigm	The same party is the owner and the operator and funded the purchase of the equipment with equity, a recourse loan or a combination thereof.	The owner is entitled to depreciation deductions and any income tax credits (the "Paradigm").
II. Paradigm with nonrecourse debt	The same party is the owner and the operator and funded the purchase of the equipment with nonrecourse debt.	Same as the Paradigm, but any depreciation losses and any investment tax credits may be subject to the "at risk" limitations if the owner is an individual, a partnership with individual partners, or a closely held corporation with individual shareholders.[3]
III. Short-term lease and purchase with equity and/or recourse debt	The owner enters into a "short-term" lease[4] as lessor and funded the purchase of the equipment with equity, a recourse loan or a combination thereof.	Same as the Paradigm, except if the leased property is a wind project or other renewable energy asset eligible for the renewable electricity production tax credit,[5] that credit is not available[6] (unless the asset is a biomass project, in which case the lessee is entitled to the credit).[7] However, the lessor would be able to claim an investment tax credit attributable to the portion of such project that is "qualified property" if such project is a "qualified investment credit facility."[8]
IV. Short-term lease with nonrecourse debt	The owner enters into a short-term lease as lessor and funded the purchase of the equipment with nonrecourse debt.	Same as Scenario II, except the production tax credit result is the same as Scenario III. However, if (i) the leased property is a motor vehicle or trailer and (ii) the lease has a "terminal rental adjustment clause" ("TRAC"), then the lease does not qualify for the special treatment provided for in §7701(h) (i.e., the "lease" could be characterized as

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		debt for income tax purposes).[9]
V. Long-term lease and purchase with equity and/or recourse debt	The owner enters into a long-term lease as lessor and funded the purchase with equity, a recourse loan or a combination thereof.	Same as Scenario III, except (i) §467 rent leveling principles may be triggered[10] (ii) and if the lessee is tax-exempt, the lease will not avoid the Pickle depreciation rules.[11]
VI. Long-term lease and purchase with nonrecourse debt	The owner enters into a long-term lease as lessor and funded the purchase of the asset with nonrecourse debt.	Same as Scenario V, except like Scenario II, any depreciation losses and any investment tax credits may be subject to the “at risk” limitations if the owner is an individual, a partnership with individual partners or a closely held corporation with individual shareholders.
VII. Long or short-term lease, purchase with equity and/or recourse debt and noncompelling purchase option	The owner enters into a lease, as lessor, funded the purchase with equity, a recourse loan or a combination thereof, and the lease has a fixed-price purchase option that is not a bargain or economically compelled.	Same as Scenario III if the lease is short-term and Scenario V if the lease is long-term, except if (i) the lessee is tax-exempt and (ii) the equipment has a class life longer than seven years and is not a fixed-wing aircraft or a vessel, then the §470 loss trapping rules are triggered.[12]
VIII. Long or short-term lease, purchase with nonrecourse debt and noncompelling purchase option	The owner enters into a lease, as lessor, funded the purchase with nonrecourse debt, and the lease has a fixed-price purchase option that is not a bargain or economically compelled.	Same as Scenario VII, except like Scenario II, any depreciation losses and any investment tax credits may be subject to the “at risk” limitations if the owner is an individual, a partnership with individual partners or a closely-held corporation.
IX. Long or short-term lease with compelling purchase option or other factors shifting ownership to the lessee	The owner enters into a lease, as lessor, the lease has a fixed-price purchase option that “is nominal in relation to the value” of the equipment,[13] the lessor has the ability to force the lessee to purchase the equipment,[14] or the term of the lease is too long relative to the equipment's economic useful life.[15]	The lessee is likely the owner of the equipment for income tax purposes, whether or not there is recourse or nonrecourse debt or the lease is short-term or long-term, and thus the lessor is unlikely to prevail in claiming tax benefits associated with ownership of the equipment.

[2] For the sake of simplicity, this hierarchy does not address various international tax rules that apply to leases. For more information about those rules, see David Burton et al., *Leasing Outside the United States: Pickle, Loss Trapping, Subpart F & Foreign Tax Credits,* in Equipment Leasing-Leveraged Leasing (W. Veatch, ed.), Apr. 2021.

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[3] *See* §49 (investment tax credit at-risk limitation) and §465 (at-risk limitation on losses). Unless otherwise indicated, all references to Code sections are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder.

[4] As defined in §168(h)(1)(C)(ii).

[5] *See* §45.

[6] *See* §45(a)(2)(A) ("produced by the taxpayer") and §45(a)(2)(B) ("sold by the taxpayer").

[7] §45(d)(2)(C) (closed loop biomass), §45(d)(3)(C) (open loop biomass).

[8] *See* §48(a)(5).

[9] *See* §7701(h)(2)(B). TRAC leases are discussed in II.F.2., below.

[10] *See* §467(b)(4)(A). Section 467 is discussed in V., below.

[11] *See* §168(h)(1)(C). Pickle depreciation is discussed in IV.C., below. Note, the short-term lease exception does not apply for purposes of the §470 loss-trapping rules. §470(c)(2)(A)(i).

[12] *See* §470(d)(4). Section 470 is discussed in IV.D., below.

[13] *See* Rev. Rul. 55-540, §4.01(e).

[14 th] *See e.g., Norman Baker Smith v. Commissioner*, 51 T.C. 429 (1968) (exercise of option required by an agreement with a third party) (cited for the same by *Estate of Thomas v. Commissioner*, 84 TC 412, 436 (1985)); Paul Carman and Christine Galinksi, *Benefits and Burdens of Ownership Still Govern True Lease Characterization,* Real Estate Tax'n (4 Q. 2013) ("If the parties structure the economics of the transaction so that the lessee is economically compelled to exercise the option, the result may be that the lease is ignored and the transaction is treated as a sale for U.S. federal tax purposes.").

[15] *Helvering v. F.R. Lazarus*, 308 U.S. 252 (1939) ("ninety-nine year 'leases' back" was "no more than security for a loan").

B. The Vernacular of Leasing and Related Background

Leasing vernacular can be reminiscent of the Tower of Babel. All too often different people assign different connotations to the same term or are unsure what a term means. One commentator has summarized the problem as follows:

> For example, a lease that creates a security interest has been called a "lease intended as security," "disguised financing," a "dirty lease," a "finance lease," a "quasi-lease" or a "conditional sale lease." A true lease has likewise been called a "finance lease," an "operating lease" or even a "guidelines lease." A true tax lease has been called a "tax lease" or an "operating lease." [M]any of these terms cross the boundaries of usage into tax, accounting or other state law concepts that foster misunderstanding.[16]

[16] David Mayer, *True Leases Under Attack: Lessors Face Persistent Challenges to True Lease Transactions,* J. of Equipment Leasing, p. 8 (Fall 2005).

1.True Lease –

In the quoted language, the author seems to be trying to carve out "true lease" as a term of art for bankruptcy and Uniform Commercial Code purposes, while suggesting "true tax lease" is what should apply in an income tax context; however, the Supreme Court ascribed the term to income tax characterization.

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The Supreme Court, in one of its seminal decisions about the tax consequences of leasing, *Frank Lyon*, referred to the question before it as to whether to respect the form of a sale-leaseback as determining who was the "true owner of the property."[17] Thus, the term "true lease" came to be used to refer to a lease that was respected as a lease for federal income tax purposes. One could deduce that this means that in a true lease, the lessor is entitled to the depreciation associated with the leased equipment, but such a conclusion ignores subleasing. For instance, A owns equipment and leases it to B, and B subleases it to C. The sublease can be a true lease, but that does not mean that B is entitled to depreciation.

[17] 435 U.S. 561 (1978).

2.Operating Lease —

It seems likely that the term "operating lease" was first applied to a transaction in which the lessor also provided an "operator." This is what the aircraft industry currently calls a "wet lease" (i.e., an aircraft provided with a crew, which is distinguished from a "dry lease," which is an aircraft without a crew). Today, the concept of a lease of equipment with an operator in income tax parlance is closer to a "service contract." Some of the indicia of a "service contract" are that the fees "substantially exceed the rental value"[18] as would be the case if an operator were provided, and that the recipient of the services does not "control" the equipment, which would also be the case if an operator were provided.[19]

[18] §7701(e)(1)(F).

[19] §7701(e)(1)(B).

In 1976, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Account Standards No. 13 ("FAS 13") providing guidance as to how to report a lease for financial statement purposes. FAS 13 was the first time the FASB used the term "operating lease." The term had first been used by the American Institute of Certified Public Accountants four years before the publication of FAS 13 in "Accounting for Lease Transactions by Manufacturer or Dealer Lessors" and "Disclosure of Lease Commitments by Lessees."[20]

[20] *APB Opinion No. 27* (Nov. 1972) and *APB Opinion No. 31* (June 1973).

Under FAS 13, "operating lease" meant for the lessee a lease that did not result in an asset or a liability on the lessee's balance sheet, and for the lessor a transaction that resulted in (i) the equipment being recorded on its balance sheet as an asset and (ii) rental income being recognized without an element of profit from a sale of equipment. FAS 13 has been overhauled as Accounting Standards Codification 840 ("ASC 840"), which retains some "operating lease" concepts but generally presumes each of the lessor and lessee have an asset and liability as the result of entering into a lease transaction.

FAS 13 had relatively objective standards to characterize a lease for GAAP purposes and was taught in accounting courses. Thus, operating lease became synonymous in the minds of the thousands of students who took those courses as a transaction in which the lessee has rent expense on its income statement and nothing on its balance sheet, and the lessor has a depreciable asset on its balance sheet and rental income on its income statement. This sounds similar to a lease in which the lessor depreciates the equipment for income tax purposes and recognizes rent as income, and the lessee deducts rent as an expense. Thus, "operating lease" became blurred with "true lease" with business executives often making statements like "the lessor wants the tax depreciation, so it has to be an operating lease."

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But if someone says, "it needs to be an operating lease," are they referring to it from the perspective of the lessor's financial statements, the lessee's financial statements, or for income tax purposes? First, the FASB itself acknowledged that the fact that a lease is an "operating lease" for financial accounting purposes is not indicative of the income tax treatment of the lease. The FASB received a comment that if the lessee treated a lease as a purchase for tax purposes (i.e., not a true lease), then the lessee should not be able to treat the lease as an operating lease for financial statement purposes. The FASB rejected this criterion, stating that "[t]here are many instances in which tax and financial accounting treatments diverge, and the question of a possible need for conformity between them is beyond the scope of this Statement."[21]

[21] FAS 13 at 33.

Second, the FASB allowed divergence between the lessee and the lessor's financial statement treatment of a lease: "Because of this divergence in both concept and criteria, a particular leasing transaction might be recorded [for financial statement purposes] as a sale or as a financing by the lessor and as an operating lease by the lessee."[22] This is in contrast to the tax law; the IRS will challenge leasing transactions if it learns the tax reporting is not consistent by the lessee and the lessor because inconsistent reporting could be costly to the fisc (e.g., depreciation claimed without another taxpayer reporting a corresponding gain or two taxpayers claiming the same tax credits) and is logically inconsistent with the principle that the same unit of property (as opposed to undivided interests in a unit of property) may have only a single tax owner.[23]

[22] FAS 13 at 28.

[23] *See, e.g., Transamerica Corp. v. United States*, 15 Cl. Ct. 420, 440 (1988) ("The parties consistently treated the transaction as leases for both financial and tax reporting purposes").

Six years after FAS 13 established "operating lease" as a term of art for financial statement purposes, Congress seized the opportunity to add to the confusion by codifying the term "motor vehicle operating lease" in the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA").[24] The legislation was enacted in response to the *Swift Dodge* case in which the Tax Court held that a lease in which the lessee was (i) responsible for the value of the vehicle at lease end in excess of a stipulated amount and (ii) entitled to be paid the value of the vehicle at lease end in excess of such stipulated amount was not a true lease. The legislation referred to such a provision as a *terminal rental adjustment clause* ("TRAC"). The provision resulted from lobbying by the automobile industry, so the special treatment was limited to motor vehicles and trailers and only if the lessee used them for business.

[24] Currently codified in §7701(h). The TRAC lease rules are discussed in II.F.2., below.

The "motor vehicle operating lease" was a cause of further confusion for the uninitiated. First, no "operator" is provided in a "motor vehicle operating lease." Second, it has nothing to do with financial statement treatment, despite Congress using FASB's term "operating lease." Third, it effectively deemed a transaction with loan economics to be a true lease, so it added to the interweaving of the concepts of true lease and operating lease.

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3.Synthetic Lease –

The FASB's rejection in 1976 of the comment that the lessee treating itself as the tax owner of the equipment should preclude operating lease treatment, as discussed above, turned out to be a harbinger of a lease structure that would become commonplace almost two decades later — the synthetic lease.[25] Synthetic lease is an industry term and not a name adopted by Congress, the FASB or the IRS.

[25] The first formal reference to a synthetic lease was in a 1995 New Mexico property tax ruling. *New Mexico Tax'n and Rev. Dept. Rul. 440-95-02* (Aug. 11, 1995) ("X is contemplating entering into a re-financing arrangement (known as a 'synthetic lease') with F, a financial institution whereby X will assign its leasehold interest in the equipment to F'). The term "synthetic lease" first appeared in the Wall Street Journal in 1997. Shelia Muto and Mark Veverka, *Firms Flock to Type of Leasing,* Wall St. J. (Apr. 2, 1997); *see also* Tom Erlandson, *'Synthetic' Lease Could Provide Advantages,* Puget Sound Bus. J. (Sept. 13, 1998).

A synthetic lease was for FAS 13 purposes an operating lease to the lessee and for income tax purposes a conditional sale (i.e., a debt instrument that results in the lessee as the owner of the equipment for income tax purposes). The FAS 13 treatment to the lessor was typically as a "direct finance lease" (i.e., the financial statement treatment for the lessee and the lessor diverged).

The synthetic lease was attractive to equipment owners that wanted to raise financing using their equipment but had a low tax basis in that equipment (i.e., a sale-leaseback if respected as such for tax purposes would result in large tax gain). It was also attractive to equipment users acquiring new equipment that could use the tax depreciation themselves: using the tax depreciation yourself is more efficient than a leasing company applying a discount rate to the stream of tax benefits.

A synthetic lease achieved these characterization results by having it be a triple net lease for a term of less than 75% of the property's useful life, with a fixed-price purchase option set at projected fair market value (i.e., not a bargain) and an obligation of the lessee to guarantee a portion of the first loss residual value risk if it does not exercise the purchase option. The theory was this satisfied operating lease requirements under FAS 13, so long as the present value of the rents and the residual guarantee was less than 90% of the price paid by the lessor to acquire title to the equipment. The tax theory was that as the "lessee" had upside due to the fixed purchase option and most likely the residual risk due to the first loss residual value guarantee the lessee should characterized as the tax owner of the equipment.[26]

[26] *See* Arnold Gough et al., *Synthetic Leasing,* in Equipment Leasing-Leveraged Leasing (W. Veatch, ed.), Apr. 2021 (this chapter has not been updated for the overhaul of FAS 13: "the [FAS 13 overhaul] is expected to have a dramatic impact on lessee operating lease accounting. While the general direction of the [FAS 13 overhaul] points to the capitalization of all operating leases, as of this writing the [FAS 13 overhaul] is still underway".); David Burton, *Missouri DOR Bungles Synthetic Lease Reference in Sales Tax Ruling,* State Tax Notes (Aug. 11, 2014) (available at https://www.projectfinance.law/media/5404/mo-synthetic-lease-ruling-article_mod1.pdf).

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Today, the synthetic lease structure is generally a dinosaur due to the FASB's overhaul of FAS 13. The FASB, in ASC 840, sought to for the most part eliminate the binary financial statement treatment of operating lease versus capital lease. Under ASC 840, the result of most leasing transactions is an asset and a liability for each of the lessor and the lessee. In contrast, a bedrock of the tax law's true lease doctrine is that it is binary: a transaction is either a true lease or a debt financing (i.e., a conditional sale), and cannot be 40% one and 60% the other.[27] Outside of leasing, there is some indication that the tax law is starting to be receptive to a split characterization of financial instruments.[28] Of course in structuring a transaction, a tax advisor can try to keep the transaction away from the grey area. However, when characterizing an executed transaction for tax return reporting purposes, the option to change the terms is not available. The advisor must select either lease or debt.

[27] *See* Paul Carman and Kelley Bender, *Debt, Equity or Other: Applying a Binary Analysis in Multidimensional World,* J. of Tax'n (2007) (“Under a binary analysis, an investment along the borders of one or the other classification gets pushed completely into one of the two baskets, disguising the hybrid nature of the investment.”)

[28] *See e.g., PLR 2021131005* (holding that a portion of a financial instrument is “stock” within the meaning of §382 and a portion of the same financial instrument is not stock).

4.Tax Lease –

Before the rise of the synthetic lease, a leasing executive could ask the CFO of a leasing company if she wanted an “operating lease” or a “capital lease” and it was relatively likely that an “operating lease” meant a true lease for tax purposes and “capital lease” meant a conditional sale for tax purposes; however, the advent of the synthetic lease meant there were two kinds of operating leases: one in which the lessor was the tax owner and one in which the lessee was the tax owner. To refer to the first one, the vernacular term “tax lease” (i.e., a lease that is respected as such, so the lessor is entitled to the depreciation) was coined. To some tax lawyers, the term “tax lease” is like fingernails on a blackboard in contrast to the more judicious “true lease.” This Portfolio will use the term “true lease,” while acknowledging the prevalence of the term “tax lease,” particularly in the middle market and small ticket sectors of the leasing industry.

5.Leveraged Lease –

The IRS recognized the term “leveraged lease” in 1975:

> The type of transaction covered by this Revenue Procedure is commonly called a “leveraged lease”. Such a lease transaction generally involves three parties: a lessor, a lessee, and a lender to the lessor. In general, these leases are net leases, the lease term covers a substantial part of the useful life of the leased property, and the lessee's payments to the lessor are sufficient to discharge the lessor's payments to the lender.[29]

[29] Rev. Proc. 75-21, §1 (updated without substantive change in Rev. Proc. 2001-28).

A year later, the Financial Accounting Standards Board (FASB) provided its definition of a “leveraged lease” in FAS 13 as a “direct finance lease” to the lessor that has the following additional characteristics:

- It involves at least three parties: a lessee, a long-term creditor, and a lessor (commonly called the equity

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participant).

• The financing provided by the long-term creditor is nonrecourse as to the general credit of the lessor (although the creditor may have recourse to the specific property leased and the unremitted rentals relating to it). The amount of the financing is sufficient to provide the lessor with substantial "leverage" in the transaction.

• The lessor's net investment . . . declines during the early years once the investment has been completed and rises during the later years of the lease before its final elimination.

In the process of overhauling FAS 13, the FASB eliminated "leveraged lease accounting" for lessors in ASC 842. The elimination was for reporting periods beginning on or after December 15, 2018. Although the favorable lessor financial statement treatment was eliminated, a lessor, a lessee, and a lender could still transact and execute a leveraged lease. The tax treatment of a leveraged lease has not changed. Nonetheless, since the elimination of leveraged lease accounting, new leveraged leases have been few and far between.

There is some thought that the limitation on the deduction of business interest expense enacted as §163(j) as part of the Tax Cuts and Jobs Act of 2017 (TCJA)[30] could lead to a renaissance for the leveraged lease structure. That is because a borrower facing a limit on its ability to deduct its interest expense could opt to lease its equipment, rather than borrow to fund its purchase. Its lender could make a nonrecourse loan to the lessor to fund 80% (or possibly more) of the lessor's cost of acquiring the equipment and be secured by the lessee's net lease obligation. Rent is not subject to the interest limitation on deductibility. The interest accruing on the loan would be included in the lessor's interest limitation; however, if the lessor is a bank, as lessors often are, it should have plenty of ability to deduct that interest due to the fact that a bank's primary business is to borrow from its account holders at low rates and lend to borrowers at a reasonable spread (i.e., the interest deductibility rules are avoided if interest income exceeds interest expense).[31]

[30] Pub. L. No. 115-97 (Dec. 22, 2017).

[31] For more on the use of a leveraged lease to avoid the application of the interest expense limitation rules, see David Burton & Anne Levin-Nussbaum, *The Impact of Tax Reform: What Equipment Leasing Companies Need to Know* (published by the Equipment Leasing and Finance Association) (Jan. 19, 2018), available at https://www.projectfinance.law/media/5552/2018-01-19-elfa-tax-reform-article-by-d-burton-and-a-levin-nussbaum.pdf.

Comment: As of this writing, a renaissance in leveraged leasing has not materialized. However, starting in 2022, interest deductions are limited to 50% of "adjusted taxable income," which in a major change, will be *reduced* by depreciation, amortization, and depletion.[32] Accordingly, borrowers with significant depreciation deductions may find themselves newly constrained by §163(j) and may look for solutions like leveraged leases. For a detailed discussion of §163(j), see 536 T.M., *Interest Expense Deductions,* at V.E.

[32] §163(j)(8)(a)(v) ("computed without regard to . . . in the case of taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion").

6.Lease Financing –

Lease financing is a term commonly used in business. The IRS has tried to deny true lease treatment by asserting transactions are merely "financing arrangements." The Tax Court has appropriately rebuffed such efforts: "With regard to [the IRS's] 'financing arrangement' theory, we see little to distinguish this case from *Frank Lyon*, where the Supreme Court upheld the form of a transaction structured very similarly to this one before us, but in some respects not as strongly indicative of a lease transaction."[33] Accordingly, referring to a transaction in correspondence as a "lease financing" should not be a red flag from a tax perspective, but it is also not a particularly apt term with respect to the

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desired tax, financial statement, or bankruptcy characterization of the transaction.

[33] *Estate of Thomas v. Commissioner*, 84 T.C. 412, 436 (1985).

C. The Challenge of Lease Characterization

What makes leasing challenging is that at times Congress (and to some extent the courts) views equipment leasing as an important tool for capital formation that should be encouraged, while at other times Congress views equipment leasing as the realm of brokers, bankers, lawyers, and accountants who are out to line their pockets at the expense of the fisc and needs to be curtailed.

In the realm of Congress viewing leasing as a useful tool to promote capital formation, the investment tax credit rules (discussed in 512 T.M., *Tax Incentives for Production and Conservation of Energy and Natural Resources,* at III.A.), and the bonus depreciation rules (discussed in 532 T.M., *First-Year Expensing and Additional Depreciation*) provide special dispensations for leasing regarding the requirement for that the taxpayer claiming the tax benefit be the original user of the equipment (i.e., place it in service).[34] In a further generosity, a lessor may elect to pass through the investment tax credit to its lessee and separate tax ownership and depreciation from the investment tax credit.[35] Finally, the terminal rental adjustment clause (TRAC) lease rules allow leases that are substantively similar to loans to be respected as true leases if the leased equipment is a motor vehicle or trailer used in the lessee's business.[36]

[34] *See* §50(d)(4), former §168(k)(3). Since 2018, bonus depreciation has been allowed for used property that was not previously used by the taxpayer (or related parties), not acquired from a related party or from another member of the same controlled group of corporations, not acquired in a nonrecognition transaction, not inherited from a decedent, and not carryover basis property. *See* §168(k)(2)(A)(ii) (bonus depreciation allowed for used property if used property acquisition requirements are met), §168(k)(2)(E)(ii) (used property acquisition requirements).

[35] *See* §50(d)(5).

[36] *See* §7701(h). The TRAC lease rules are discussed in II.F.2., below.

In contrast, the Pickle depreciation rules for tax-exempt and foreign use property and §50(b)(3)-§50(b)(4), §467, §469(b)(2), and §470 were all enacted by Congress to curtail perceived abuses that generally involved tax-motivated leasing by individuals as lessors or leases to tax-exempt entities that could not use the deductions or the investment tax credit that was transferred to the lessor through a lease transaction.[37]

[37] *See* §45(a)(2)(A), §168(g)(1)(B), §168(g)(3), §168(h)(1), §467, §469(b)(2), and §470.

Unfortunately, in structuring a lease transaction, it is not possible to know whether the court will view it through the lens of leasing as an important tool for capital formation or as a financial manipulation in which the parties' genuine economic intent is camouflaged in complicated contracts.

We believe it is difficult to wrap a lease transaction in the *capital formation* flag if no capital is actually currently provided to the lessee. The failure to provide current capital is what seems to have been the fundamental shortcoming in the “LILOs” and “SILOs” of the late 1990s and early 2000s. At least 95% of the capital provided to the equipment user (i.e., the lessee) was used to fund economic defeasance arrangements to secure the obligation to pay rent, fund the purchase option price, and pay transaction costs. The requirement to provide

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current financing to the lessee in a lease, at least where the lessee is a tax-exempt entity, is now codified in §470(d)(1).

D. Scope of Portfolio

This Portfolio provides (i) a framework for analyzing the tax consequences of leasing transactions in light of the case law and IRS guidance and (ii) an understanding of the federal income tax attributes available to the lessee and the lessor. Chapter II provides an analysis of the characterization of a transaction as a lease versus a loan for federal income tax purposes.

Chapter III provides a detailed discussion of the tax benefits associated with a true lease. Chapter IV focuses on tax-exempt use property. Chapter V discusses the application of §467 to equipment leases. Chapter VI provides an overview of the role of partnerships in equipment leases.

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