Lawyers at GCD have written a client alert discussing the proposed changes to tax laws regarding tax-exempt leasing transactions. The Treasury Department proposed a variety of changes to current tax laws regarding tax-exempt leasing transactions. In support of Treasury’s efforts, both the Senate and the House have passed similar proposals. CFOs and business executives for exempt organizations and governmental entities involved in leasing transactions need to be aware of these proposals and their far-reaching scope.

Assuming these tax law changes are enacted, they would subject certain leasing transactions entered into by state, local, and tribal governments and tax-exempt entities to a complex loss-limitation regime. Where applicable, the regime would impose significant compliance burdens on lessors and costs likely to be passed on to exempt lessees. Without careful planning and proper structuring, CFOs run the risk of having to pay more for leased equipment due to the slower depreciation and deduction limitations under the pending legislation. Exempt organizations’ involvement in abusive leasing transactions also runs the risk of attracting IRS scrutiny and triggering IRS penalties.

Over the past few months, the Treasury Department and key committees in both houses of Congress have proposed a variety of changes to the Tax Code that are likely to make leasing transactions involving so-called “tax-indifferent” parties, such as local, tribal, state and foreign governments and tax-exempt organizations, more complicated and expensive. Although the articulated goal of the proposals is to curtail abusive sale-leaseback transactions (referred to by the Treasury Department as SILOs, or “sale in/lease out” transactions), the proposals contain changes that would affect a large number of leasing transactions entered into by tax-exempt entities and municipalities, regardless of whether or not they are tax-motivated. In a SILO, a tax-exempt entity nominally sells its equipment or infrastructure and then leases it back, with the goal of transferring the applicable depreciation deductions to a taxable entity capable of utilizing the tax deductions.

THE PROPOSALS

Both the Senate and House bills (S.1637 and H.R. 4520, respectively) contain proposals that make a variety of changes to current tax-exempt leasing rules. These changes would affect both ordinary business leases and tax-motivated or abusive leasing transactions.

Changes Generally Affecting Ordinary Leasing Transactions

The following provisions included in the proposals would affect a large number of leases, whether or not they are part of an abusive transaction:

- A provision specifying that the depreciation for qualified technological equipment leased to a tax-exempt entity would have to be computed on a straight-line basis over a longer depreciation recovery period, unless the lease is for a term of five years or less.
- A provision specifying that the period of any “service contract” that is entered into in connection with a lease would be included in the lease term. This could result in a longer lease period, and therefore, a longer depreciation period.

Qualified technological equipment (“QTE”) is defined in the Tax Code as including any computer equipment, high-tech medical equipment, or high-tech telephone station equipment.

GCD Comment: These two provisions have the potential of negatively affecting a large number of leasing transactions entered into by tax-exempt entities. When a taxable lessor loses depreciation deductions, the lessor will increase lease rates to make up the difference. However, the House bill ameliorates the two provisions described above by also expanding the short-term lease exception for QTE.
Under the House bill, an option to renew of 24 months or less would be excluded from the term of a QTE lease of five years or less. This provision would enable QTE to be leased for up to seven years without losing favorable depreciation treatment.

**Changes Intended to Curtail Abusive Transactions**

As a means of curtailing the tax benefits available to lessors in a perceived tax-motivated or abusive leasing transaction, the proposals would subject a leasing transaction involving an exempt or governmental entity to a new loss-limitation regime, unless the transaction satisfies several specific conditions. Under the loss-limitation regime, the lessor could not claim deductions in excess of the income relating to the leased property. Moreover, the lessor would be required to account for each property separately so that the deductions related to a particular lease would have to be matched against the income from that same lease. Deductions that cannot be claimed in a particular year may be carried forward to future years, and claimed subject to the same rules.

The conditions set forth in the proposals are alike in the following respects:

1. The taxable lessor must make and maintain at least a 20% at-risk equity investment in the leased property throughout the term of the lease. (Both proposals contain a short-term lease exception for the requirement that the lessor maintain this level of equity in the investment. However, the House bill’s exception is broader than that provided by the Senate.)

2. The lessee must not enter into arrangements to monetize its lease obligations. Therefore, only an “allowable amount” of funds may be set aside by the lessee for the benefit of the lessor in connection with the financing of the transaction. Under this factor, a “reasonable person” standard is used in determining whether the restriction on the amounts of funds set aside is satisfied.

3. The lessee must not bear more than a minimal risk of loss in the value of the leased property. (The House bill contains an exemption for any lease with a term of five years or less.)

**GCD Comment:** All of these conditions are aimed at distinguishing between a real sale of the leased property (to the lessor) and a nominal transfer of property rights.

The conditions set forth in the proposals differ in the following respects:

- The first condition under the Senate bill is that no part of the property involved in the lease arrangement be financed (directly or indirectly) with tax-exempt bonds. Chairman Bill Thomas deleted this condition in the current version of the House bill.

- While the Senate bill includes a broad grant of regulatory authority to the Treasury to promulgate additional conditions (as the Treasury’s own proposal suggested), the House bill contains no such grant of regulatory authority.

- Under the Senate bill, a sixth condition must be satisfied by any lease transaction involving property with more than a seven-year class life that includes a purchase option. The purchase option must be exercised at the fair market value of the property (determined at time of exercise).

For purposes of the new loss-limitation regime, the Senate and House bills would include QTE in the definition of tax-exempt use property, whether or not the QTE lease term is for five years or less. Thus, even though QTE in a lease that is for a term of five years or less would not be considered a tax-exempt use property subject to a less favorable depreciation period and method, leased QTE would be a tax-exempt use property for purposes of the loss-limitation regime. Under the proposed legislation, all QTE leases would be subject to the loss-limitation regime unless the specified conditions are met.

**Effective Dates**

The Senate provisions intended to curtail abusive leases contain a general effective date of November 19, 2003, and a special (less favorable) effective date of taxable years after January 31, 2004 for foreign-use property leases entered into on or before November 18, 2003. However, the other leasing provisions discussed above have an effective date of January 1, 2004.

The House bill provisions have a general effective date of March 13, 2004. However, the legislation would not apply to leasing transactions that were pending at the Federal Transit Administration after June 30, 2003 and before March 13, 2004 and leasing transactions that are approved by the Federal Transit Administration before January 1, 2005.
CONCERNS

The proposals have evoked serious concerns from various participants in the leasing industry. The following is a summary of some of these concerns:

- The legislation would impose heavy compliance burdens and accounting costs, which would translate into increased costs for a wide spectrum of commonly leased equipment, including emergency call center equipment, HVAC equipment, buses and mass transit equipment, and high-tech medical equipment (e.g., MRI machines) leased by tax-exempt hospitals.

- There is no clear indication that legitimate (non-abusive) leasing transactions would be excluded from the application of the legislation. Thus, “garden-variety” leases could be subject to increased compliance and transactional costs.

- Under the Senate bill, leasing transactions involving a tax-exempt entity would be subject to the loss-limitation regime if any part of the leased property is financed with tax-exempt bonds (even if the transaction meets all the other conditions).

- The retroactive effective dates included in the proposals would make the new rules applicable to leasing transactions entered into several months before any legislation is enacted.\(^2\)

LEGISLATIVE OUTLOOK

Notwithstanding the expression of concerns by opponents and critics, it is highly likely that some anti-SILO legislation will be enacted in the very near future. Key legislators in both the House and Senate agree that legislative reform measures are urgently needed to restrain abusive tax-driven leasing transactions.

As noted above, bills containing these leasing provisions have been passed by the Senate and the House. The Senate passed S. 1637 on May 11, 2004, by a vote of 92-5 and the House passed H.R. 4520 on June 17, 2004 by a 251-178 margin. However, the differences between the two bills still have to be ironed out by a Conference Committee, which is yet to be appointed. Although several observers have expressed some doubt as to whether the House and Senate will be able to reach an acceptable compromise, certain factors favor an eventual resolution by the conference. For instance, the bills contain provisions that would, among other things, repeal an export subsidy that the World Trade Organization has deemed illegal and for which the U.S. is currently incurring significant and increasing trade sanctions. In addition, the bills contain extensions to several important tax provisions that are set to expire soon. Thus, it is likely that an acceptable compromise will be negotiated and legislation enacted before year end.

Concluding GCD Comments: While the leasing industry awaits the eventual passage of SILO legislation, deals continue to move forward. Lessors continue to propose and structure leaseback transactions, as well as garden-variety business leases, with tax-exempt entities. In the interim, CFOs and business executives for exempt organizations and governmental entities involved in any such leasing transactions may need to consult legal counsel for assistance in negotiating and structuring the terms of such leases.

A leasing transaction that is not properly structured may contain elements that would qualify it as an abusive transaction. As such, it may be either reportable under existing tax shelter rules (LILOs), or subject to the new proposed loss-limitation regime (SILOs).\(^2\)

In entering into leasing transactions, lessees also need to look out for “tax indemnity” or “bailout” provisions that lessors may seek to include in the agreements. Such provisions are often drafted specifically to protect lessors’ interests in the event that tax legislation negatively affecting leasing transactions is passed. Such provisions could be detrimental to the exempt lessee if they allow the lessor to unwind the transaction or shift the cost of any lost tax benefits to the exempt lessee.

Although both the Senate and House proposals contain provisions that would negatively impact tax-exempt leasing transactions, the proposals included in the House bill (H.R. 4520), which revised a prior House version in several important respects, represent a significant improvement over the Senate proposal. GCD will continue to monitor this rapidly developing issue.

Endnotes

\(^1\) See Department of the Treasury, General Explanations of the Administration’s Fiscal Year 2005 Revenue Proposals, February 2004, p. 124 (Reform the Tax Treatment for Leasing Transactions with Tax-Indifferent Parties); S. 1637 (Jumpstart Our Business Strength Act); and H.R. 4520 (American Jobs Creation Act of 2004).
See IRC Section 168(i)(2). Section 1-168(j)-1T of the Treasury Regulations further defines “high-technology medical equipment” to include CAT scanners, MRI machines, drug monitors, ultrasound scanners, bedside monitors, nuclear cameras, and other computer-based equipment used in the screening, diagnosis and treatment of human patients in laboratories, hospitals and medical centers.

Under current law, an option to renew is included in the term of a lease for purposes of determining a lease term. Thus, a QTE lease of five years that includes an option to renew would not qualify for favorable depreciation treatment.

The prior version of the House proposal (H.R. 3967) included this condition using even broader language than the Senate bill.

Although the effective date included in the House version is a significant improvement over the Senate’s, the possibility of a retroactive application of subsequent legislation is unfair.

See Notice 2003-76, 2003-49 I.R.B. 1181 (LILOs were identified as listed transactions on February 28, 2000). Recently, the Senate Finance Committee staff proposed revocation of exempt status for any tax-exempt organization that accommodates parties to a “listed transaction” tax shelter.

For more information on these Tax Code proposals, please contact the authors, Kathleen Nilles or Francisca Mordi, or any other member of our Tax-Exempt and Governmental Entities practice group. Alternatively, please contact the GCD attorney who serves as your regular contact.