G. Reform the Tax Treatment of Leasing Transactions with Tax-Indifferent Parties

Present Law

Overview of depreciation

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system ("MACRS"). Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods based on such property's class life. The recovery periods applicable to most tangible personal property (generally tangible property other than residential rental property and nonresidential real property) range from 3 to 25 years and are significantly shorter than the property's class life which is intended to approximate the economic useful life of the property. In addition, the depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized.

Characterization of leases for tax purposes

In general, a taxpayer is treated as the tax owner and is entitled to depreciate property leased to another party if the taxpayer acquires and retains significant and genuine attributes of a traditional owner of the property, including the benefits and burdens of ownership. No single factor is determinative of whether a lessor will be treated as the owner of the property. Rather, the determination is based on all the facts and circumstances surrounding the leasing transaction.

A sale-leaseback transaction is respected for Federal tax purposes if "there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached."[440]

Recovery period for tax-exempt use property

Under present law, "tax-exempt use property" must be depreciated on a straight-line basis over a recovery period equal to the longer of the property's class life or 125 percent of the lease term.[441] For purposes of this rule, "tax-exempt use property" is tangible property that is leased (other than under a short-term lease) to a tax-exempt entity.[442] For this purpose, the term "tax-

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[440] *Frank Lyon Co. v. United States*, 435 U.S. 561, 583-84 (1978).

[441] Sec. 168(g)(3)(A). Under present law, section 168(g)(3)(C) states that the recovery period of "qualified technological equipment" is five years.

[442] Sec. 168(h)(1).

exempt entity" includes Federal, State and local governmental units, charities, and, foreign entities or persons.[443]

In determining the length of the lease term for purposes of the 125-percent calculation, several special rules apply. In addition to the stated term of the lease, the lease term includes options to renew the lease or other periods of time during which the lessee could be obligated to make rent payments or assume a risk of loss related to the leased property.

Tax-exempt use property does not include property that is used by a taxpayer to provide a service to a tax-exempt entity. So long as the relationship between the parties is a bona fide service contract, the taxpayer will be allowed to depreciate the property used in satisfying the contract under normal MACRS rules, rather than the rules applicable to tax-exempt use property.[444] In addition, property is not treated as tax-exempt use property merely by reason of a short-term lease. In general, a short-term lease means any lease the term of which is less than three years and less than the greater of one year or 30 percent of the property's class life.[445] Also, tax-exempt use property generally does not include any qualified technological equipment if the lease to the tax-exempt entity has a lease term of five years or less.[446] The term "qualified technological equipment" is defined as computers and related peripheral equipment, high technology telephone station equipment installed on a customer's premises, and high technology medical equipment.[447] Finally, tax-exempt use property does not include computer software because it is intangible property.

Description of Proposal

Overview

The Administration's proposal modifies the recovery period of certain property leased to a tax-exempt entity, alters the definition of lease term for all property leased to a tax-exempt

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[443] Sec. 168(h)(2).

[444] Sec. 7701(e) provides that a service contract will not be respected, and instead will be treated as a lease of property, if such contract is properly treated as a lease taking into account all relevant factors. The relevant factors include, among others, the service recipient controls the property, the service recipient is in physical possession of the property, the service provider does not bear significant risk of diminished receipts or increased costs if there is nonperformance, the property is not used to concurrently provide services to other entities, and the contract price does not substantially exceed the rental value of the property.

[445] Sec. 168(h)(1)(C).

[446] Sec. 168(h)(3). However, the exception does not apply if part or all of the qualified technological equipment is financed by a tax-exempt obligation, is sold by the tax-exempt entity (or related party) and leased back to the tax-exempt entity (or related party), or the tax-exempt entity is the United States or any agency or instrumentality of the United States.

[447] Sec. 168(i)(2).

entity, and establishes rules to limit deductions associated with leases to tax-exempt entities unless such lease satisfies specified criteria.

Modify the recovery period of certain property leased to a tax-exempt entity

The proposal modifies the recovery period for qualified technological equipment and computer software leased to a tax-exempt entity[448] to be the longer of the property's assigned class life or 125 percent of the lease term. The proposal does not apply to short-term leases as defined under present law section 168(h)(1)(C) and section 168(h)(3).

Modify definition of lease term

In determining the length of the lease term for purposes of the 125-percent calculation, the proposal requires that the lease term include all service contracts and other similar arrangements following a lease of property to a tax-exempt party. This requirement applies to all leases of property to a tax-exempt entity.

Limit deductions for leases of property to tax-exempt parties

The proposal also provides that if a taxpayer leases property to a tax-exempt entity, the taxpayer may not claim deductions from each lease transaction in excess of the taxpayer's gross income from the lease for that taxable year. This limit applies to deductions or losses related to a lease to a tax-exempt party and the leased property. Any disallowed deductions are carried forward and treated as deductions related to the lease in the next taxable year subject to the same limitations. A taxpayer is permitted to deduct previously disallowed deductions and losses when the taxpayer completely disposes of its interest in the property.

A lease of property to a tax-exempt party is not subject to the deduction limitations described in the preceding paragraph if the lease satisfies all of the following five requirements.

(1) Property is not financed with tax-exempt bonds

The leased property is not financed with tax-exempt bonds. For example, a lease of rolling stock to a municipality would be subject to the proposal if the proceeds of the municipality's general obligation bond were used to finance the acquisition of the rolling stock (in whole or part).

(2) Tax-exempt entity does not monetize its lease obligation

The tax-exempt party does not enter into an arrangement to monetize its lease obligations, including any purchase option, in an amount that exceeds 20 percent of the taxpayer's cost of the leased property. Arrangements to monetize lease obligations include a defeasance arrangement, a loan by the tax-exempt party (or an affiliate) to the taxpayer (or an affiliate), a deposit agreement, a letter of credit collateralized with cash or cash equivalents, a

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[448] The proposal defines a tax-exempt entity as under present law. Thus, it includes Federal, State, local, and foreign governmental units, charities, foreign entities or persons.

payment undertaking agreement, a lease prepayment, a sinking fund arrangement, any similar arrangement, and any other arrangement identified by the Secretary in regulations. The Secretary is authorized to promulgate regulations providing that this requirement is satisfied even if a tax-exempt party provides cash-equivalent credit support in excess of 20 percent of the taxpayer's cost of the leased property if the creditworthiness of the tax-exempt party would not otherwise satisfy the lessor's customary underwriting standards. Such credit support would not be permitted to exceed 50 percent of the taxpayer's cost of the property. In addition, on the purchase option exercise date, if any, such credit support would not be permitted to exceed 50 percent of the lessee's purchase option price.

(3) Lessor maintains a substantial equity investment in property

The lessor must make and maintain a substantial equity investment in the leased property. For this purpose, a lessor would not have made or maintained a substantial equity investment unless the lessor makes an unconditional initial equity investment in the property of at least 20 percent of the cost of the leased property and such equity investment continues throughout the lease term.

(4) Tax-exempt entity does not retain more than minimal risk of loss

The tax-exempt party must not assume or retain more than a minimal risk of loss (other than the obligation to pay rent and insurance premiums, to maintain the property or other similar conventional obligations of a net lease) through a put option, a residual value guarantee, residual value insurance, any similar agreement (such as a service contract), or any other arrangement identified by the Secretary in regulations. For this purpose, a tax-exempt party would have assumed or retained more than a minimal risk of loss if: (1) as a result of obligations assumed or retained by, on behalf of, or pursuant to an agreement with the tax-exempt party, the taxpayer is insulated from any portion of the loss that would occur if the value of the leased property were 25 percent less than the leased property's projected fair market value at lease termination; (2) as a result of obligations assumed or retained by, on behalf of, or pursuant to an agreement with the tax-exempt party, the taxpayer is insulated from a risk of loss in the aggregate that is greater than 50 percent of the loss that would occur if the value of the leased property were zero at lease termination; or (3) the tax-exempt party assumes or retains a risk of loss described by the Secretary in regulations.

(5) Secretary does not otherwise describe the lease

The Secretary in regulations does not otherwise describe the lease.

Effective date.–The proposal is effective for leases entered into after December 31, 2003. No inference should be drawn regarding the appropriate tax treatment of similar transactions entered into prior to January 1, 2004.

Analysis

Complexity issues

Under the proposal, taxpayers would be required to perform additional analysis with respect to leasing transactions with tax-exempt entities. For leases subject to the proposal, businesses would have to perform additional computations and keep additional records. In addition, regulatory guidance likely would be necessary to clarify certain aspects of the proposal. However, it is likely that the proposal will significantly reduce the amount of tax-advantaged leasing to tax exempt entities, thus limiting the number of taxpayers affected by the complexity of the proposal. Additionally, taxpayers engaging in the types of transactions subject to the proposal generally are sophisticated corporate taxpayers with the expertise and resources to comply with the additional requirements.

Policy issues

Background

The recent focus on certain leasing transactions with tax-exempt entities raises a number of significant tax policy issues. The relative importance of these issues varies according to whether the lessee is a Federal agency, a State or local governmental agency, a nonprofit organization, or a foreign government or person. Congress analyzed many of these issues in the early to mid-1980s and enacted significant reforms with respect to the leasing of property by tax-exempt entities. However, taxpayers have been able to structure leasing transactions with tax-exempt entities that circumvent the present-law rules, often through the unanticipated exploitation of certain exceptions to the rules. Before reviewing the specific policy issues of the proposal, it is useful to review some of the general tax policy issues that are relevant to tax-exempt leasing transactions. These tax policy issues were relevant over 20 years ago and remain relevant today to determine the merits of updating and altering the present-law rules to address leasing transactions with tax-exempt entities.

Efficiency.–The first issue is whether leasing arrangements are an efficient way to provide Federal assistance to tax-exempt entities. The dollar value of the tax benefits from such transactions is shared by the tax-exempt entity, the lessor (a taxable entity), and the lawyers, investment bankers, leasing companies, and other agents or investors that are involved in the transaction. Because the benefits to the tax-exempt entity are only a portion of the total benefits derived from the transaction, the cost to the Federal government is greater than the benefits provided to the tax-exempt entity. For example, a review of over 30 transactions approved by the Federal Transit Authority[449] indicated that, on average, fees paid to lawyers, investment bankers, leasing companies, and other agents advising or assisting tax-exempt entities equaled approximately 24 percent of the benefits received by the tax-exempt entities. With respect to the sharing of the benefits between the lessor and a tax-exempt entity, promotional materials describing long-term lease/leaseback arrangements indicate that the tax-exempt entity is entitled

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[449] The Federal Transit Authority is an agency within the U. S. Department of Transportation.

to an upfront payment equal to three to four percent of the market value of the property. The lessor's benefit is more complicated, but is generally equal to 35 percent of the market value of the leased property reduced by taxable gain on the sale of the property back to the tax-exempt entity at the end of the lease term. Because the lessor's tax benefit (and subsequent additional taxable income) is recognized over a number of years, the tax benefits (and tax costs) must be discounted (present valued) to accurately compare such benefit to the tax-exempt entity's benefit from the transaction.

To the extent that the significant benefits of the leasing transaction are transferred to taxable entities, corporate taxpayers, and advisors of tax-exempt entities, leasing is an inefficient way of providing assistance to tax-exempt entities. A more efficient and direct approach to assisting tax-exempt entities might include direct spending programs. However, this approach also may incur additional costs that reduce the benefits to the tax-exempt entity (e.g., additional costs to effectuate the program). Alternatively, allowing tax-exempt entities to sell tax benefits (e.g., depreciation) may allow a broader group of tax-exempt entities to benefit. Currently, the benefits generally are limited to tax-exempt entities with significant assets that satisfy certain specific characteristics (e.g., railcars, large number of buses, etc.). This results in a disproportionate portion of the benefits being allocated to a narrow group of tax-exempt entities.[450] Providing a direct ability to transfer the tax benefits would allow other assets, and lower value assets, to qualify that are precluded today because any tax benefits are offset by the significant costs of engaging in these transactions. However, previous proposals that sanctioned the transfer of tax benefits resulted in significant revenue loss and were quickly repealed (e.g., safe harbor leasing). These proposals also resulted in a sharing of benefits between tax-exempt entities, taxable entities, and other parties involved in the transaction.

Budget oversight.–A second issue is the impact of governmental leasing on the budget process. In the case of a lease to a governmental agency, leasing can distort the appropriations process by shifting capital acquisition costs from the agency's budget to the U.S. Treasury in the form of reduced tax revenues. Thus, leasing reduces the oversight over spending normally exercised by the appropriations process by converting direct outlays, which require appropriations, into tax benefits, which do not.

In addition, leasing by Federal, State, and local agencies can distort the actual level of financial support provided to a governmental agency. As mentioned above, these transactions shift costs from agencies' budgets to the U.S. Treasury, making it difficult to determine how much Federal assistance is being provided and to whom or for what purposes it is being provided. For example, a U.S. municipality that leases its subway railcars effectively transfers the local operating costs of its subway system to all taxpayers without regard to use and without any consideration by Congress of whether such cost transfer is appropriate. Removing the tax

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[450] For example, eight cities (Atlanta, Chicago, Los Angeles, New York, Newark, Philadelphia, San Francisco, and Washington DC) comprise approximately 75 percent of the lease transactions (by value of assets) reviewed by the Federal Transit Authority since 1988. Further, four of these eight cities (Atlanta, Chicago, New York, Newark) comprise approximately 50 percent of the transactions (by value of assets) reviewed.

incentives for government agencies to lease rather than purchase property reduces distortions in the budget process and enables Congress to more effectively oversee the appropriation of funds.

Public perception.–A third issue relates to whether the use of tax-motivated arrangements by tax-exempt entities creates perceptions that the tax system is unfair or dysfunctional. This possibility seems especially likely when highly visible assets, such as municipal buildings or transportation assets, are offered in sale-leaseback transactions, or when U.S. tax benefits are allowed for assets that are neither produced nor used domestically. With regard to certain cross-border leasing transactions, the U.S. taxpayers essentially are subsidizing the purchase of property for a foreign government or business for which the U.S. taxpayers obtain no benefit.[451]

Neutrality.–A fourth issue is the extent to which the ability of a tax-exempt entity to transfer depreciation and interest expense deductions through a lease with a taxable entity economically distorts the decision of the tax-exempt entity between purchasing and leasing property. Many believe that the tax system should not influence a tax-exempt entity's decision to purchase an asset (e.g., in the case of a State or local government through the proceeds of tax-exempt bonds) or lease the asset. In accordance with this view, prior tax legislation (generally the approach taken by Congress in 1984) attempted to minimize the potential distortion of depreciation on the decision by decelerating the depreciation deductions associated with property leased to tax-exempt entities. However, the effectiveness of this legislation has been questioned as new and innovative structures have been designed to minimize or circumvent such restrictions.

According to another view, tax subsidies should be made equally available to both taxable and tax-exempt entities. Under this view, it is inappropriate to prevent tax-exempt entities from receiving the benefits of tax incentives through leasing. For example, if Congress wants to subsidize certain types of investments, Congress should not care who is making the investment. Under this concept, there should be neutrality regardless of whether the investor is a tax-exempt entity or a taxable entity.

However, critics of this view cite at least two problems with this analysis. First, the notion that taxable and tax-exempt entities should be given equal incentives ultimately leads to the conclusion that these entities should be treated equally in all respects (i.e., tax-exempt status should be repealed). Second, providing tax-exempt entities with additional financial benefits through leasing could result in tax-exempt entities leasing, rather than owning, most or all of their buildings and equipment.

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[451] For example, in discussing the benefits of certain U.S./German leasing transactions a leasing industry trade publication stated "inaccurate reporting [by the German press] has created a wave of anti-leasing sentiment that is both unwarranted and the public purse equivalent of looking a gift horse in the mouth." It went on to state "part of the problem rests with the failure of the [leasing] industry to sell itself clearly and loudly. Lease product needs to be clearly marked -- a gift from the U.S." *See "The Lease Experience,"* Asset Finance International, May 2003.

Others argue that it is not necessary to have the leasing of property and the ownership of property treated alike for tax purposes because a "true lease" is different from outright ownership. However, if the leasing arrangement has factors that indicate it is economically equivalent to ownership by the lessee then the investments should be similarly taxed. Otherwise the tax system has influenced the investment decision between leasing property and owning property.

Privatization.–A fifth issue has been raised by some who contend that private parties can provide public services more economically than can governments. It is argued that leasing is a mechanism for promoting the "privatization" of public services and should be encouraged. The greater expertise of private providers, as well as their ability to bypass negotiations with public labor unions, Federal and State mandates, facility design or other criteria specified by public agencies, and delays in obtaining financing through public budgeting processes (e.g., debt ceilings and balanced budget requirements) are among the sources of the advantages cited for privatization. However, critics argue that the tax rules should not be used to supersede laws and procedures that the public itself, through its representatives in Congress and other governmental agencies, has imposed and can amend directly upon a full consideration and public debate of their merits. In addition, others highlight that many of the leasing transactions have not altered the party responsible for providing the services, or anything else, but, rather, have only altered who is considered the tax owner of the property. Critics also highlight that if there are economic advantages to privatizing certain governmental services, such advantages are separate, and occur apart from, any tax incentives.

Policy issues pertaining to leases with certain tax-exempt entities

As mentioned above, the relative importance of these policy issues varies according to whether the lessee is a Federal agency, a State or local governmental agency, a nonprofit organization, or a foreign government or person. The following discussion addresses the relative importance of these issues to each of these types of entities.

Federal government.–The main issues involved in leasing by Federal government agencies appear to be the distortion of the appropriations process, the inefficiency of tax-motivated leases, and the public's perception of the integrity of the Federal tax system. Leasing by a Federal agency distorts the appropriations process by shifting capital acquisition costs from the agency's budget to the U.S. Treasury in the form of reduced tax revenues. Thus, it reduces the control over spending normally exercised by the appropriations process by converting direct outlays, which require appropriations, into tax benefits, which do not. Leasing also shifts the disbursement of funds from the agency's procurement account to a possibly less scrutinized part of the agency's budget, such as an operations and maintenance account. When a Federal agency leases property, the cost of the property tends to be obscured in the agency's budget because the cost is reflected in the budget as ongoing rental payments rather than a more conspicuous authorization or annual outlay in the procurement section of the budget. In addition, leasing is inefficient and likely raises the total government cost of acquiring property. Finally, the sale of tax benefits by a Federal government agency may contribute to a public perception of inequity in the Federal income tax system.

State and local governments.–The main tax issues involved in State and local governmental leasing appear to be whether leasing is an appropriate mechanism to provide State and local government assistance and whether certain leasing transactions provide a double tax benefit to State and local governments.

Congress already provides targeted assistance to States through the appropriations process and also provides assistance through the tax system to State and local governments by means of the exclusion from Federal tax of interest paid on municipal bonds and the itemized deduction for certain State and local taxes. In addition, Congress has provided direct funding to States.[452] In these situations, Congress generally either directs the funds to specific activities (e.g., by direct appropriation) or limits the benefits by imposing rules that require the State and local governments to follow certain rules (e.g., tax-exempt bond limitations). In contrast, the benefits provided by leasing transactions are not subject to Congressional review or oversight.

Proponents of leasing claim that it is a mechanism to increase funding to maintain or provide public services that could not be offered because bond issues have been rejected or limits on indebtedness have been reached. However, critics argue that the federal tax Code ought not be used to supersede laws and procedures that the local residents have imposed and can amend directly upon a full consideration of their merits.

In some instances, State and local governments may be combining the benefits of leasing with Federal financial assistance by leasing assets that previously have been funded with tax-exempt obligations and grants by the Federal government. The proceeds of the sale may then be invested by the State or local government in investments, the interest on which is used to cover rental payments, meet other current operating expenses, and provide a sinking fund for repurchasing the property at the end of the lease term. Some have argued that this produces two financial benefits provided by the Federal government on the same asset, one enjoyed by the governmental entity (through the Federal financial assistance) and another enjoyed by the tax-exempt entity and the lessor (the tax benefits of depreciating the property).

Nonprofit organizations.–Leasing by nonprofit organizations generally raises similar tax policy issues as State and local governmental leasing. Congress currently provides other assistance to nonprofit organizations through the tax system (e.g., tax-exemption and deductibility of charitable contributions of property donated to such organizations).

Foreign governments and persons.–As is the case with any other lessee, a foreign person leasing property from a U.S. lessor may receive an indirect subsidy from the U.S. Treasury. If the foreign person is taxable by the United States on all the income generated by that property, the subsidy may be as justifiable as that provided to any other taxable user. However, if only a small portion of the income is taxable by the United States, or if the foreigner is not subject to U.S. tax because it is a foreign government or a foreign entity not doing business in the United States, then many of the same issues as those described above are raised. For example, information provided for leases that have been registered as tax shelters with the IRS highlights

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[452] *See e.g.,* Pub. L. 108-27, sec. 401, which provided $20 billion in direct funding to States to provide funding for essential government services, and for Medicaid.

that the vast majority of the value of qualified technological equipment is foreign use property that, absent the sale-leaseback transaction, would not be eligible for U.S. tax benefits. The types of assets that have been used in foreign qualified technological equipment leasing transactions include, among others, telecom equipment, baggage handling equipment, flight simulators, mail sorting equipment, automatic train control systems, air traffic control systems, electronic toll systems, automated food production lines, and automated fare collection systems.[453]

For U.S. produced goods, the subsidy for foreign investment might be justified as an export incentive. However, no similar justification exists where foreign produced goods are leased or where previously acquired goods (regardless of where produced) are sold and leased back. A related issue is the potential revenue cost if foreigners are able to take unrestricted advantage of U.S. tax subsidies by leasing property from U.S. lessors.

Specific policy issues with respect to the proposal

Inclusion of all service contracts in lease term.–The present-law depreciation rules applicable to tax-exempt use property subject to a lease were enacted to prevent tax-exempt entities from transferring to a taxable entity the tax benefits of accelerated depreciation on property used by the tax-exempt entity. These rules require that the leased property be depreciated on a straight-line basis over a recovery period equal to the longer of the property's class life or 125 percent of the lease term. The policy requiring the recovery period be no less than 125 percent of the lease term was intended to ensure that the recovery period would more accurately reflect the economic life of the property.[454] To avoid the impact of these rules, a taxpayer leasing tax-exempt use property may seek to shorten the depreciable life of the asset by combining a shorter lease term with a subsequent service contract that would not be treated as part of the lease term.[455] Thus, the taxpayer is able to accelerate tax depreciation deductions and circumvent the tax policy rationale of the 125 percent rule. Including the service contract in the term of the lease for depreciation purposes will prevent this technique.

On the other hand, there are bona fide reasons for service contracts between taxable and tax-exempt entities. However, it is difficult to envision a non-tax business reason for a tax-exempt entity structuring a transaction that converts a 20, 30, or 40-year lease into a service

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[453] These transactions have included property from, among other countries, Australia, Austria, Canada, China, France, Germany, Netherlands, Portugal, Sweden, Switzerland, and the United Kingdom.

[454] In general, a taxpayer is not considered the owner of property if the lease extends beyond 80 percent of the useful life of the asset. Thus, property subject to a lease term that is for 80 percent of the property's useful life would be recovered over its economic life under this rule (80% x 125% = 1).

[455] Effectively, a service contract arrangement provides a relatively assured means of achieving a minimum investment expectation by the lessor without requiring such contract term to be included in the lease term. Removal of this feature would in some cases subject the lessor to additional economic risk unless the lease term is extended.

contract. Further, tax-exempt entities engaged in leasing transactions have indicated in internal correspondence that the service contracts are used to avoid Federal income tax issues, and that they never expect to ever take any other action than pay the buyout option and terminate the transaction, irrespective that such buyout is above projected fair market value.

Limitation on tax benefits from certain tax-exempt leases.–The proposal is intended to ensure that certain leasing transactions with tax-exempt entities not create a significant mismatch in the timing of income and deductions. The proposal generally is intended to be limited to leasing transactions in which the substance of the arrangement is the payment of a fee to the tax-exempt entity in exchange for the transfer of tax benefits to a taxable entity that can use such benefits. In these types of leasing arrangements, the arrangement is economically equivalent to ownership by the tax-exempt entity (lessee), and thus the investment should be taxed as such (i.e., the tax benefits of depreciation and other costs should be removed). In order to accomplish this result and deter such activity, the proposal adopts an approach that is similar to the rules addressing passive activity losses for individuals in that, like passive activity losses, recognition of net losses from the early years are deferred until corresponding net income (if any) is recognized by the taxpayer in later years (or upon termination of the leasing transaction). Advocates of the proposal argue that taxable U.S. corporations should not be permitted to take advantage of the special tax status of tax-exempt entities participating in a lease in order to generate U.S. tax benefits that can be used to shelter other unrelated income. Advocates of the proposal also argue that the mechanics of the passive activity loss rules provide an appropriate model for addressing the timing issues presented by certain leasing transactions with tax-exempt entities. Further, they argue that by incorporating exceptions for certain leases from the broad scope of this proposal it is appropriately targeted. Lastly, the proponents highlight that the leasing transactions are an inefficient mechanism for providing funds and do not afford Congress any oversight on the use of the subsidy provided.

Critics of the loss deferral proposal argue it is overly broad and could inappropriately affect leasing transactions with tax-exempt entities that are not primarily engaged in to shelter taxable income.[456] In addition, it can be argued that an alternative approach for addressing certain specific income and deduction mismatching problems could be achieved more effectively by modifying the class lives of property so that they more accurately reflect the economic useful life of such property, thus minimizing the ability to obtain significant tax benefits through mismatching of income and deductions.

Critics also may argue that, irrespective of arrangements (e.g., defeasance of lease obligations) that limit the risk of the parties involved, such arrangements are not legally binding and, similar to other non-binding business arrangements, should not impact the tax treatment of

[456] On the other hand, some may argue that the proposal is not broad enough because it does not include lease transactions with U.S. corporations that have expiring net operating losses. In such situations, such corporations may be considered effectively tax-exempt to the same degree as State and local governments, nonprofit organizations, and foreign governments and persons. Thus, it could be argued that the proposal does not comprehensively preclude abusive lease transactions with tax-exempt entities because it does not apply to transactions with such corporations.

the transaction.[457] Critics may argue further that the abusive characteristics of the targeted leasing transactions are not merely a function of the presence of a tax-exempt accommodating party but, rather, are related to the absence of economic substance in the transaction and should be challenged on such basis. Lastly, critics may argue the transactions are no less efficient than other forms of Federal assistance.

Prior Action

Proposals to limit deductions associated with tax-exempt leasing and include all service contracts in the lease term were included in S. 1637, the "Jumpstart Our Business Strength (JOBS) Act," as passed by the Senate Committee on Finance on November 7, 2003. In addition, a proposal to limit deductions associated with tax-exempt leasing was included in the President's fiscal year 2000 budget proposal. A proposal to include all service contracts in the lease term was included in the President's fiscal year 2001 budget proposal.

[457] However, it should be noted, Treas. Reg. sec. 1.148-1(c)(2) states that if an issuer of tax-exempt bonds voluntarily sets up a sinking fund that it reasonably expects to use to pay debt service on the bonds, the amounts deposited in the sinking fund will be subject to the arbitrage rules.