Equipment Leasing Association

True Leases Under Attack: Structuring A True Lease In The Face of New Challenges

Legal Forum
May 2-4, 2004
Presenters

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Program Introduction

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♦ Key topics of panel
♦ Panel approach
<table>
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<td>Handout 4</td>
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- FASB 13

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In re Edison Bros

♦ The facts
♦ The law
♦ The decision
♦ The guidance for structuring true leases
In re Pillowtex

- The facts
- The law
- The decision
- The guidance for structuring true leases
Application of Basic Principles to Fact Scenarios
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- State law cases: a closer look
- Bankruptcy court approach and risks
True Tax Lease

- IRR impact of same deal treated as true lease v. conditional sale
- Fact scenarios – multiple factor tests

<table>
<thead>
<tr>
<th>First</th>
<th>Lease with fixed term, no purchase options, single delivery.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Second</td>
<td>Lease with one EBO and a FMV purchase option.</td>
</tr>
<tr>
<td>Third</td>
<td>Lease with 5 EBOs and a FMV purchase option.</td>
</tr>
<tr>
<td>Fourth</td>
<td>Lease with 5 EBOs, an early termination option, 50% fixed purchase option.</td>
</tr>
<tr>
<td>Fifth</td>
<td>Lease with all that Fourth has, plus auto-renewal lease term at $1 per year.</td>
</tr>
<tr>
<td>Sixth</td>
<td>Lease with all that Fourth has, but fixed purchase option at 8% of equipment cost.</td>
</tr>
</tbody>
</table>
Synthetic Lease

- Troubled but useful structure
- Limitation in use
  - Multi-asset entities
  - SPEs or VIEs
Trac Lease

♦ Security interest or loan
  – Does any court think alike?
  – Do court ever accept a Trac Lease as a true lease?
Conclusions: Putting the Puzzle Pieces Together
Conclusions

1. The law on UCC true leases is shifting to a two-prong test – UCC bright-line and economic realities tests.

2. Proceedings in bankruptcy court have shifted from occasional challenges of "true leases" to nearly routine challenges to every lease as a financing.

3. Lawyers counseling their leasing clients can no longer focus only on drafting and contractual deal structure.
Conclusions (cont.)

4. The courts have issued inconsistent rulings that misapply the basic rules of the UCC, tax and accounting concepts.

5. To structure deals effectively, the leasing lawyer needs to understand the front-end concepts and back-end downside potential.
Questions

Thank you.
**SUMMARY**

Prepared Apr-02-2004 10:57 by your name goes here
Parameter filename 2004 ELA Lease Yield Example1
Parameter path c:\documents and settings\cprince\desktop

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### Cash Flows

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<thead>
<tr>
<th></th>
<th>Cost</th>
<th>Delivery</th>
<th>Funding</th>
<th>Residual</th>
<th>%</th>
<th>Date</th>
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<tr>
<td>Asset Cost</td>
<td>$1,000,000.00</td>
<td>May-01-04</td>
<td>May-01-04</td>
<td>300,000.00</td>
<td>30.0000</td>
<td>May-01-09</td>
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<td>Fees Paid</td>
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<td></td>
<td></td>
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<tr>
<td>Equity</td>
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<td>Rent</td>
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<td></td>
<td>300,000.00</td>
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<tr>
<td>Residual</td>
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<td>Total Cash In</td>
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<tr>
<td>Total Cash Out</td>
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<td>Pre-Tax Cash Flow</td>
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### Statistics

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<th>Parameter</th>
<th>Value</th>
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<tr>
<td>Composite tax rate</td>
<td>37.8000</td>
</tr>
<tr>
<td>IRS true lease tests</td>
<td>passed</td>
</tr>
<tr>
<td>Tax treatment (default)</td>
<td>True tax lease</td>
</tr>
<tr>
<td>FAS 13 for lessor (default)</td>
<td>Capital: single investor (DFL)</td>
</tr>
<tr>
<td>Insured residual</td>
<td>15.8799</td>
</tr>
<tr>
<td>Tax treatment (default)</td>
<td>True tax lease</td>
</tr>
<tr>
<td>Operating</td>
<td></td>
</tr>
</tbody>
</table>

| MISF (per)                        | 8.7090 | 8.5000 | 5.4170 | 5.2870 |
| IRR PTCF (per)                    | 6.9970 | 6.7822 | 4.3521 | 4.2185 |

PV on May-01-04 of Lessee 90%-Test at 7.0000% 786,091.70 78.609170

Payback from May-01-04 5 yrs 0 mos 0 days

### Assets

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<thead>
<tr>
<th>Description</th>
<th>ADR class</th>
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<table>
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<th>Term</th>
<th>Salvage</th>
<th>Convention</th>
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<td>Fed</td>
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<td>Additional first year</td>
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### Residual Guarantee

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<tr>
<td>15.8799</td>
<td>14.1201</td>
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### Fees

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<tr>
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<td>0.396997</td>
<td>May-01-04</td>
<td>Expense</td>
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<tr>
<td></td>
<td>&quot;Residual Insurance Premium&quot;</td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>2</td>
<td>0.00*</td>
<td>0.000000</td>
<td>May-01-04</td>
<td>Expense</td>
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<tr>
<td></td>
<td>&quot;Broker Fee&quot;</td>
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<td>State May-01-04</td>
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<td>3</td>
<td>0.00*</td>
<td>0.000000</td>
<td>May-01-04</td>
<td>Expense</td>
<td>Fed May-01-04</td>
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<tr>
<td></td>
<td>&quot;Other Fee Expense&quot;</td>
<td></td>
<td></td>
<td></td>
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### Amortization

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<tr>
<td>Fed</td>
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<td>Interest, FAS91</td>
<td></td>
</tr>
<tr>
<td>State</td>
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<td>Interest, FAS91</td>
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<td>May-01-04</td>
<td>Interest, FAS91</td>
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SuperTRUMP 8.60 financial model

Page 1

Ivory Consulting Corporation
**SUMMARY**

Prepared Apr-02-2004 10:57 by your name goes here
Parameter filename 2004 ELA Lease Yield Example1
Parameter path c:\documents and settings\cprince\desktop

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### Rents

<table>
<thead>
<tr>
<th>commencment date</th>
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<th>type</th>
<th>amount</th>
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</thead>
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<tr>
<td>May-01-04</td>
<td>1.547529</td>
<td>60</td>
<td>adv</td>
<td>15,475.29</td>
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### Taxes/Lessor

**Federal**
- tax calculation method: Accrual (Arr Only)
- tax estimation method: Level

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<thead>
<tr>
<th>start date</th>
<th>rate</th>
<th>thru</th>
<th>paid</th>
<th>percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan-01-02</td>
<td>35.0000</td>
<td>Mar</td>
<td>Apr</td>
<td>25.0000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Jun</td>
<td>Jun</td>
<td>25.0000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Sep</td>
<td>Sep</td>
<td>25.0000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Dec</td>
<td>Dec</td>
<td>25.0000</td>
</tr>
</tbody>
</table>

**State**
- tax calculation method: Accrual (Arr Only)
- tax estimation method: Level

<table>
<thead>
<tr>
<th>start date</th>
<th>rate</th>
<th>thru</th>
<th>paid</th>
<th>percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan-01-02</td>
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<td>Mar</td>
<td>Apr</td>
<td>25.0000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Jun</td>
<td>Jun</td>
<td>25.0000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Sep</td>
<td>Sep</td>
<td>25.0000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Dec</td>
<td>Dec</td>
<td>25.0000</td>
</tr>
</tbody>
</table>

---

payments: 928,517.12
interest: Actual/360 (Interim Only)
30 = end-of-month

- taxation method: Accrual (Arr Only)
- tax estimation method: Level
- start date and rate:
  - Jan-01-02: 35.0000
  - Jun-01-02: 4.3077

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SuperTRUMP 8.60 financial model
Ivory Consulting Corporation Page 2
TRUE TAX LEASE DETERMINATION
EXAMPLE # 1

• Facts:
  • 5-year lease term
  • End-of-term options-
    • Purchase for FMV,
    • Return assets, or
    • Renew at then FMV lease rate
  • Asset appraisal-
    • 20% expected FMV at the end of year 5
    • 10-year economic useful life

• Proposed Analysis
  • Probably a Tax Lease
  • The facts in this lease are consistent with the “safe harbor” guidelines contained in Rev. Proc. 2001-28, 2001-19 I.R.B. 1156.

---

1 The Proposed Analysis is not intended to be and should not be construed as a legal opinion as to whether this example would be treated as a Tax Lease in all instances.
TRUE TAX LEASE DETERMINATION
EXAMPLE # 2

• **Facts:**
  - 5-year lease term
  - Early Buyout Option (EBO)- Can purchase the assets at the end of year 4 for 25%
  - End-of-term options-
    - Purchase for FMV,
    - Return assets, or
    - Renew at then FMV lease rate
  - Asset appraisal-
    - 25% expected FMV at the end of year 4 (EBO date)
    - 20% expected FMV at the end of year 5 (end of lease)
    - 10-year economic useful life

• **Proposed Analysis**

  - Probably a Tax Lease
  - The issue is whether the EBO fixed purchase price of 25% is representative of the expected FMV of the assets at the end of year 4.

  - In *Cal-Maine Foods v. Commissioner*, 36 TC memo 1977-89, 36 CCH TCM 683 (12977), the Tax Court was “unable to conclude that the [fixed] option price was substantially less than the anticipated value of the property at the end of the primary term” and thus it could not “be considered so insubstantial to raise a presumption of sale.” Consequently, the transaction was upheld as a tax lease. Also see *Frank Lyon Co. v. U.S.*, 435 U.S. 561 (1978) and *Northwest Acceptance Corp. v. Commissioner*, 58 T.C. 836 (1972).

  - The importance of supporting fixed purchase price options with fair market value appraisals was highlighted in Technical Advice Memorandum 200346007 (11/14/2003).

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¹ The Proposed Analysis is not intended to be and should not be construed as a legal opinion as to whether this example would be treated as a Tax Lease in all instances.
TRUE TAX LEASE DETERMINATION
EXAMPLE # 3

• Facts:
  • 6-year lease term
  • EBOs. Can purchase the assets at the end of-
    • Year 1 for 45%
    • Year 2 for 40%
    • Year 3 for 35%
    • Year 4 for 30%
    • Year 5 for 25%
  • End-of-term options-
    • Purchase for FMV,
    • Return assets, or
    • Renew at then FMV lease rate
  • Asset appraisal. Expected FMV at the end of-
    • Year 1 of 45%
    • Year 2 of 40%
    • Year 3 of 35%
    • Year 4 of 30%
    • Year 5 of 25%
    • Year 6 of 20%
    • 10-year economic useful life

• Proposed Analysis
  • Probably not a Tax Lease
  • Even though the EBOs are equal to the expected FMV of the assets, the
    presence of multiple EBOs is a strong indication of the lessee’s intent to
    purchase the assets.
  • What is the business purpose for including annual EBOs?

---

1 The Proposed Analysis is not intended to be and should not be construed as a legal opinion as
to whether this example would be treated as a Tax Lease in all instances.
TRUE TAX LEASE DETERMINATION
EXAMPLE # 4

• Facts:
  • 6-year lease term
  • EBOs. Can purchase the assets at the end of-
    • Year 1 for 45%
    • Year 2 for 40%
    • Year 3 for 35%
    • Year 4 for 30%
    • Year 5 for 25%
  • Early Termination Option (ETO)- Can return the assets at end of year 4
  • End-of-term options-
    • Purchase the assets for 20%,
    • Return assets, or
    • Renew at then FMV lease rate
  • Asset appraisal. Expected FMV at the end of-
    • Year 1 of 45%
    • Year 2 of 40%
    • Year 3 of 35%
    • Year 4 of 30%
    • Year 5 of 25%
    • Year 6 of 20%
    • 10-year economic useful life

• Proposed Analysis
  • Probably not a Tax Lease
  • The issue of multiple EBOs still exists and points strongly to the lessee’s intent to purchase the assets.
  • The ETO should not impact whether this is a tax lease.
  • The 20% end-of-term fixed purchase option should also not impact the determination since it is set at an amount equal to the expected FMV.

1 The Proposed Analysis is not intended to be and should not be construed as a legal opinion as to whether this example would be treated as a Tax Lease in all instances.
TRUE TAX LEASE DETERMINATION
EXAMPLE # 5

• Facts:
  • 6-year lease term
  • EBOs. Can purchase the assets at the end of-
    • Year 1 for 45%
    • Year 2 for 40%
    • Year 3 for 35%
    • Year 4 for 30%
    • Year 5 for 25%
  • Early Termination Option (ETO)- Can return the assets at end of year 4
  • End-of-term options-
    • Purchase the assets for 20%,
    • Return assets, or
    • The lease automatically renews annually for $1
  • Asset appraisal. Expected FMV at the end of-
    • Year 1 of 45%
    • Year 2 of 40%
    • Year 3 of 35%
    • Year 4 of 30%
    • Year 5 of 25%
    • Year 6 of 20%
    • 10-year economic useful life

• Proposed Analysis
  • Probably not a Tax Lease
  • The addition of the $1 dollar automatic renewal provision points further to a non-tax lease.

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1 The Proposed Analysis is not intended to be and should not be construed as a legal opinion as to whether this example would be treated as a Tax Lease in all instances.
TRUE TAX LEASE DETERMINATION
EXAMPLE # 6

• Facts:
  • 6-year lease term
  • EBOs. Can purchase the assets at the end of-
    • Year 1 for 45%
    • Year 2 for 40%
    • Year 3 for 35%
    • Year 4 for 30%
    • Year 5 for 25%
  • Early Termination Option (ETO)- Can return the assets at end of year 4
  • End-of-term options-
    • Purchase the assets for 8%,
    • Return assets, or
    • The lease automatically renews annually for $1
  • Asset appraisal. Expected FMV at the end of-
    • Year 1 of 45%
    • Year 2 of 40%
    • Year 3 of 35%
    • Year 4 of 30%
    • Year 5 of 25%
    • Year 6 of 20%

• Proposed Analysis
  • Probably not a Tax Lease
  • While the end-of-term purchase option is below the expected FMV of the assets, the presence of the $1 dollar automatic renewal provision makes it unlikely that the lessee will exercise the purchase option.

1 The Proposed Analysis is not intended to be and should not be construed as a legal opinion as to whether this example would be treated as a Tax Lease in all instances.
Synthetic Leases Revisited: Are They Dead or Alive?

October, 2003

By David G. Mayer, Partner at Patton Boggs LLP, Dallas Texas

This article is a revised version of an article originally published in the October 2003 edition of Business Leasing News (BLN). See: http://www.pattonboggs.com/Newsletters/Bln/Release/bln_2003_10.htm. BLN is an e-newsletter offering leasing and financing strategies primarily for lessors and lenders, written by David G. Mayer, a business transactions partner at Patton Boggs LLP. To subscribe, e-mail to bln@pattonboggs.com with the word “Subscribe” in the subject line. Business Leasing News can be found online at http://www.pattonboggs.com/Newsletters/Bln.

Synthetic leases seem to have taken a body blow as a result of the completion by the Financial Accounting Standards Board (FASB) of the Guaranty Project (FIN 45) and Consolidation Project (FIN 46). See: Final Off-Balance Sheet Rules Make a Significant Impact on Leasing, Business Leasing News (February 2003). But this operating lease product remains viable and useful despite understandable concern from the market.

A Clear Message

At the recent Accounting Conference of the Equipment Leasing Association held last month in Boston, I spoke on the topic of synthetic leasing and how to restructure these leases affected by FIN 46. I described how synthetic leases still work well for certain types of entities other than variable interest entities (VIEs). However, the response from the attendees seemed consistent: Very few public companies or other lessees want to use synthetic leases except in a select group of business aircraft transactions. In addition, a few real estate transactions may be completed under synthetics, but the negative public reaction to company disclosures of off-balance sheet deals (sometimes referred to as “bad optics”) have practically ended their viability in the current market.

What is a Synthetic Lease?

The synthetic lease acquired its name by "synthesizing" inconsistent provisions of the Financial Accounting Standard No. 13 (FAS 13) and the true lease rules arising under federal income tax law. A synthetic lease is an off-balance sheet "operating lease" under FAS 13 and, concurrently, a conditional sale for federal income tax purposes. As a result, the lessee takes the tax benefits as the tax owner of the leased property under federal

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1 See: http://www.pattonboggs.com/Newsletters/Bln/release/bln_2003_02.htm#1
income tax law while keeping the same lease off its balance sheet as an operating lease under FAS 13.

**The Impact of FIN 46 on Synthetic Lease Structures**

In an effort to correct the alleged wrongs by Enron Corporation, FASB nullified portions of the Emerging Issues Task Force (EITF) Issues No. 90-15 and No. 96-21. EITF 90-15 sanctioned an investment of 3 percent (or more) in a special purpose entity as a sufficient investment to keep the assets and liabilities of a special purpose entity off the books of its investor-sponsor. See: Appendix Paragraphs D(1)(a) and D(2)(b) of FIN 46. FASB also required evidence that a VIE (synthetic lessor) could stand alone and self-finance its existence. To test the ability of any entity to stand on its own, FASB substituted a 10 percent equity requirement for the 3 percent rule; however, FASB did not create a presumption that 10 percent equity would constitute sufficient equity. The acceptable equity level depended on the risk of the transaction. Further, FASB said that an equity investor/lessor must stand to lose the first dollars in a synthetic lease. This change turned the synthetic lease on its head because lessees had previously taken the first loss in the form of an implicit residual guaranty (of up to 89.9 percent of the original equipment cost). So far, according to what I have heard, no lessor has entered into a synthetic lease in which the lessor stands to lose the first 10 percent of its investment.

**Survival of Synthetic Leases**

Did these changes kill synthetic leases? The answer does not seem to conform with the market forces today. The answer, for now, remains clear. Nothing in FIN 45 or FIN 46 precludes a lessor from using a voting interest entity (such as an operating leasing company that it not a VIE) from directly entering into synthetic leases with its lessee-customer. FIN 46 focuses on VIEs. If a lessor uses a voting interest entity, the lessor does not conduct a VIE analysis in a synthetic lease transaction.

Even the Guaranty Project has had little effect in deterring these deals. Under that project, the implicit residual guarantee of the lessee must be disclosed and recognized (that is, booked on a balance sheet) by a lessee at its "fair value." The participants at the Accounting Conference generally indicated that they neither fully understood how to apply the "fair value" calculation nor have any desire to use it. However, in practice, the value booked for the implicit residual guaranty actually seems to be so far below the maximum or face amount of the residual guarantee that it makes this item immaterial to most lessees. Moreover, the extra disclosure required by FIN 45 does not seem to play much, if any, role in a lessee’s decision to use a synthetic lease.

*Prediction:* Many companies have shunned this "operating lease" product due to the public furor over companies allegedly hiding their obligations off-balance sheet. I expect this negative perception to continue to impede widespread use of synthetic leases for the foreseeable future. (This prediction, by the way, is almost a reversal of my earlier views that synthetic leases would spring back faster than they have been.) However, those who know how to properly structure a synthetic lease should achieve full off-balance sheet treatment and favorable lease pricing. Private companies should lead the way in using synthetics because they may not face the ire of their shareholders by using this financing tool. In the long-term, the push toward on-balance sheet accounting may eventually deliver the knockout punch for synthetic leases. For now, however, they remain useful and viable in the contest to offer attractive lease products.
Large Ticket Leveraged Leases:
Sample Tax Indemnity Agreement

TAX INDEMNITY AGREEMENT

Dated as of [_______]

among

[_______]

[_______]

[_______]

[_______] OP, LLC

and

[_______] OL, LLC

[_______]
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TAX INDEMNITY AGREEMENT

This TAX INDEMNITY AGREEMENT dated as of [_______], is entered into by and among [_______] (together with its successors and permitted assigns, “Facility Lessee”), [_______] (together with its successors and permitted assigns), [_______] (together with its successors and permitted assigns), [_______] OP LLC (together with its successors and permitted assigns) and [_______] OL LLC (together with its successors and permitted assigns). Capitalized terms used but not defined in this Agreement shall have the defined meanings set forth in Appendix A to the Participation Agreement dated as of [_______] (the “Participation Agreement”), among the Facility Lessee, [_______], as Lessor Manager, [_______], as Lease Indenture Trustee, [_______], as Pass-Through Trustee, [_______] OL LLC, as Owner Lessor, and [_______] OP LLC, as Owner Participant or (if not defined in the Participation Agreement) in the Facility Lease.

WITNESSETH

WHEREAS, the Periodic Lease Rent, Allocated Rent and Termination Values payable by Facility Lessee under the Facility Lease have been determined in part on the basis of the assumption that as a result of entering into the transactions contemplated by the Operative Documents Equity Investor will be entitled to certain U.S. Federal, state and local income tax benefits identified in Section 1 of this Agreement, and Facility Lessee has agreed to indemnify Equity Investor under certain circumstances for the loss of such benefits;

NOW, THEREFORE, as an inducement to Equity Investor to enter into the transactions contemplated by the Operative Documents and in consideration of the mutual covenants contained in this agreement and in the other Operative Documents, the receipt and sufficiency of which are hereby acknowledged, the parties agree as follows:

SECTION 1. Tax AssumptionsThe Periodic Lease Rent, Allocated Rent and Termination Values have been calculated by Equity Investor, and Owner Participant’s Net Economic Return has been computed, in part, on the basis of the assumptions (it being understood and agreed that, except to the extent provided herein, Facility Lessee has made no representation or warranty with respect to the accuracy of any of such assumptions) that for U.S. Federal, state and local income tax purposes (the "Tax Assumptions"):

(a) On the Closing Date, 100% of the Purchase Price will be allocable to property that constitutes 20-year property under section 168(e) of the Code and the Owner Lessor will be entitled to 20-year, 150% declining balance (switching to the straight line method when most favorable) depreciation deductions with respect to such property, utilizing the half-year convention and a zero salvage value, under MACRS ("Depreciation Deductions").
(b) Transaction Costs paid pursuant to Section 2.4 of the Participation Agreement will be amortizable under Section 162 of the Code on a straight-line basis over the Basic Lease Term (the “Transaction Costs Deductions”).

(c) The Loans will constitute loans made to the Owner Lessor, and all interest accrued with respect to advances thereunder will be deductible, as accrued, pursuant to Section 163 of the Code (the “Interest Deductions”).

(d) The Owner Lessor will be entitled to current deductions of amounts accrued as Lessor Section 467 Interest (the “Section 467 Interest Deductions”).

(e) As a result of entering into the transactions contemplated by the Operative Documents, the Equity Investor will not be required to include any amount in gross income prior to the termination of the Facility Lease other than:

(i) Proportional Rent (and, if the Lease is renewed, Renewal Lease Rent) in the amounts and at the times that such Rent is allocated pursuant to the terms of the Facility Lease; (ii) gain upon the receipt of Termination Value (or other amounts based on Termination Value) in an amount equal to the sum of Termination Value and the balance of any loan arising under and then outstanding under Treas. Reg. § 1.467-4 and at the time that Termination Value is made; (iii) gain upon the sale (direct or indirect) of all or any portion of the Facility or of all or any portion of the Equity Investor’s interest in the Owner Lessor if such sale shall not occur during the continuance of an Event of Default or, if the sale shall occur during the continuance of an Event of Default, (A) in the case of a sale of the Facility, the sales price for the Facility shall be equal to or in excess of Termination Value (or a pro rata portion thereof in the case of a partial sale) or (B) in the case of a sale (direct or indirect) of the Owner Lessor, the sales price shall be equal to or in excess (or a pro rata portion thereof in the case of a partial sale) of the excess of Termination Value over the then outstanding amount of the Loans; (iv) interest income in the amounts accrued as Lessee Section 467 Interest and income upon any cancellation or forgiveness of the balance of any loan arising under Treas. Reg. § 1.467-4; (v) income attributable to any improvement realized upon or after termination of the Facility Lease; (vi) payments being made to the Equity Investor, Owner Participant or Owner Lessor on an After-Tax Basis; (vii) amounts paid to the Equity Investor, Owner Participant or Owner Lessor and identified as interest under the Operative Documents; and (viii) any other amount to the extent such items of income result in an equal and offsetting deduction of the same character in the same taxable year as the inclusion other than the Depreciation Deductions, Interest Deductions, Section 467 Interest Deductions and Transaction Expense Deductions.

(f) Throughout the Basic Lease Term, the marginal U.S. Federal, state and local income tax rate applicable to the Equity Investor will be as set forth in the Pricing Assumptions (the “Assumed Tax Rate”) and the Equity Investor will always have sufficient taxable income for U.S. Federal, state and local income tax purposes to utilize fully the Assumed Deductions (as defined below);
(g) The Facility Lease will be a “true lease” for U.S. Federal, state and local income tax purposes, and the Owner Lessor shall be treated as owner and lessor, and the Facility Lessee shall be treated as lessee, of the Facility for such purposes;

(h) The Equity Investor will compute its U.S. Federal, state and local taxable income on a calendar-year basis using the accrual method of accounting.

(i) The Facility will be treated as placed in service by the Equity Investor on the Closing Date.

(j) The Facility Lease will not be a “disqualified leaseback or long-term agreement” within the meaning of Section 467(b)(4) of the Code and the Equity Investor will not be subject to application of Section 467(b)(2) of the Code with respect to the Periodic Lease Rent provided under the Facility Lease.

(k) The Owner Lessor, Owner Participant and any entity(ies) interposed between the Owner Participant and the Equity Investor (the “Intermediary Entities”) will each be a disregarded entity for U.S. Federal, state and local income tax purposes, and the Equity Investor will be entitled and required to take into account, in computing its U.S. Federal, state and local taxable income, all items of income, gain, loss, deduction and credit with respect to the Owner Lessor’s interest in the Facility.

(l) Periodic Lease Rent, Allocated Rent and all other gains, losses, income, deductions and credits under the Facility Lease or the transactions contemplated by the Operative Documents will be treated as U.S. source pursuant to Sections 861 et seq. of the Code.

(m) For state and local income tax purposes, the Equity Investor will be entitled to depreciation, interest and amortization deductions at the same times and in the same amounts as the Equity Investor is allowed the Depreciation Deductions, the Interest Deductions, the Section 467 Interest Deductions and the Transaction Costs Deductions.

(n) The Equity Investor will be required to include in its gross income for state and local income tax purposes for any taxable year during the Basic Lease Term, with respect to its interest in the Facility, amounts equal to such amounts as are required to be included in its gross income for U.S. Federal income tax purposes.

The Depreciation Deductions, Transaction Costs Deductions, Section 467 Interest Deductions and Interest Deductions are referred to collectively as the “Assumed Deductions.”

In the event that (i) Equity Investor shall suffer a Tax Loss (as such term is hereinafter defined) with respect to which Facility Lessee has paid the required indemnity hereunder or (ii) the percentages for Periodic Lease Rent, Allocated Rent, Proportional Rent,
Section 467 Loan Balance, Section 467 Interest or Termination Values shall be adjusted pursuant to Section 3.5 of the Facility Lease, then the foregoing assumptions shall be amended, if and to the extent appropriate, to reflect such Tax Loss or the events giving rise to such payment or adjustment, respectively.

SECTION 2. Intention of Parties. Equity Investor and Facility Lessee acknowledge that it is intended that Equity Investor will be the owner and lessor of the Facility for all U.S. Federal, state and local income tax purposes, that Facility Lessee will be the lessee of the Facility for such purposes, and that the Facility Lease will be characterized as a true lease for such purposes. Equity Investor and Facility Lessee agree that neither they nor any of their respective Affiliates will file any income tax return or other document for U.S. Federal, state or local income tax purposes that is inconsistent with this intention or inconsistent with the foregoing Tax Assumptions unless and to the extent required by a Final Determination binding on the parties hereto or as contemplated by Section 5 or 6 below.

SECTION 3. Records and Statements. Within 30 days after written request therefor, Facility Lessee shall provide such information (to the extent that such information is regularly maintained by Facility Lessee or any Affiliate in the ordinary course of its business and is reasonably available to any such Person or is required by Applicable Law to be maintained by Facility Lessee or any Affiliate) as Equity Investor may reasonably require to enable Equity Investor to fulfill its tax return filing, audit and litigation requirements (at Facility Lessee’s cost and expense).

SECTION 4. Representations, Warranties and Covenants of Facility Lessee. Facility Lessee represents, warrants and covenants that:

(a) During the Basic Lease Term, no portion of the Facility is or will become tax-exempt use property within the meaning of section 168(h)(1) of the Code, tax-exempt bond financed property within the meaning of section 168(g)(5) or “public utility property” within the meaning of Section 168(i)(10) of the Code (it being understood that this is not a representation as to the “true lease” status of the Lease or the pass-through nature of the Owner Lessor, the Owner Participant or the Intermediary Entities);

(b) All written factual information supplied by or on behalf of the Facility Lessee to the Appraiser or Engineering Consultant and identified in Exhibits A and B hereof as information relied upon by the Appraiser or Engineer, respectively, was accurate at the time given and on the Closing Date, and the Facility Lessee did not omit information available to it which, in light of the circumstances in which the supplied information was provided, rendered the supplied information materially misleading (except that, in the case of information in the nature of forecasts, projections or estimations of the future life, performance, costs, revenues or other future items relating to the Facility, this representation shall instead be that any such information as was supplied by or on behalf of the Facility Lessee was prepared in good faith and on a reasonable basis, determined both at the time given and on the Closing Date);
(c) On the Closing Date, no improvements will be required in order to render the Facility complete for its intended use by the Facility Lessee, other than ancillary items of removable equipment of a kind customarily selected and furnished by lessees of property substantially similar to the Facility;

(d) No Lessee Person (defined for purposes of this Agreement as the Facility Lessee, any sublessee or other user or person in possession of the Facility or any portion thereof or any Affiliate of any of the foregoing, but excluding in all events the Owner Lessor, the Owner Participant, the Equity Investor and each of their respective Affiliates) has taken or will take any position in any filing by it for U.S. Federal, state or local income tax purposes that it is the owner of the Facility or that is otherwise inconsistent with the Tax Assumptions or the allocation of Periodic Lease Rent set forth in Schedule 2-A to the Facility Lease (unless consistent with a contrary Final Determination binding on the Equity Investor or the Facility Lessee with respect to such position);

(e) The Facility was placed in service for U.S. Federal income tax purposes no later than the Closing Date;

(f) The Facility Lessee will not acquire or guarantee (directly or indirectly) any interest in the Lease Debt, the Loans, the Lessor Notes or the Certificates (it being understood that the transactions contemplated by the Operative Documents shall not be considered to constitute such a guarantee and that the Facility Lessee’s exercise of rights or performance of obligations in accordance with or as contemplated under the Operative Documents shall not be deemed to violate this provision); and

(g) On the Closing Date, 100% of the Equity Investor’s basis in the Facility will be allocable to 20-year property described in Section 168(c)(1) of the Code.

The sole remedy for the inaccuracy or breach of any of the foregoing representations, warranties and covenants shall be the Equity Investor’s right to receive payments pursuant to this Agreement.

SECTION 5. Indemnified Losses

(a) If (A) as a result of (i) any act or failure to act by any Lessee Person (other than (w) the execution or the delivery of the Operative Documents, (x) any act or failure to act expressly required by the Operative Documents, (y) any act or failure to act expressly permitted by the Operative Documents, other than any substitution or replacement of all or any portion of the Facility not required by the Operative Documents and the assignment or subleasing of the Facility Lessee’s interest in the Facility or (z) any act or failure to act taken at the express written request of the Owner Participant or the Owner Lessor acting at the direction of the Owner Participant (other than during the continuance of a Lease Event of Default)), (ii) the breach, inaccuracy or incorrectness of any of the Tax
Representations or any of the representations or warranties made by the Facility Lessee in Sections 3.1(a)-(d), (f)(ii), (g), (m), (n), (p), (r), (f), (v), (w) or (y) of the Participation Agreement, (iii) any loss, damage, destruction, casualty, non-use, retirement, removal, replacement, substitution, alteration, modification, addition, improvement, repair, rebuild, theft, taking, confiscation, requisition, seizure or condemnation of all or any portion of the Facility, (iv) the actual receipt of any warranty, damage, refund, insurance, requisition, indemnity or similar payment that is not retained by the Owner Participant or any Related Party, (v) the bankruptcy, insolvency or other proceeding for the relief of debtors involving, or any foreclosure on or against, the Facility Lessee or any Lessee Person, (vi) any foreclosure or pursuit of remedies (whether by the Owner Participant or otherwise) resulting from a Lease Event of Default, (vii) the financing of the Exempt Facilities or the existence of or actions in connection with the Revenue Bonds or the Exempt Facilities Agreement, or (viii) any amendment, modification, supplement or waiver to or in respect of any Operative Document initiated or requested by the Facility Lessee or made during the continuance of a Lease Event of Default, in each case that is made without the written consent of the Owner Participant or the Owner Lessor acting at the direction of the Owner Participant (with (i) through (viii) being hereafter referred to as a "Lessee Action"), the Equity Investor shall suffer a delay in claiming, shall not have the right to claim or shall not claim (in each case, only after receiving a written opinion, delivered to the Facility Lessee as soon as practicable and prior to the date on which the tax return is to be filed on which such claim will not be made, of independent tax counsel selected by the Equity Investor and reasonably acceptable to the Facility Lessee (setting forth in reasonable detail the facts and analysis upon which such opinion is based) to the effect that as a result of a Tax Law Change or change in or discovery of facts subsequent to the Closing Date, other than a Tax Law Change described in Section 5(d)(v) below, there is no Reasonable Basis to make such claim), or shall lose, shall suffer a disallowance of or shall be required to recapture all or any portion of the Assumed Deductions (a "Deduction Loss"); or

(B) as a result of (i) any repair, maintenance, replacement, rebuild or substitution of or any alteration, modification, addition or improvement to, the Facility or any portion thereof, (ii) the actual receipt of any warranty, damage, refund, insurance, requisition, indemnity or similar payment that is not retained by the Owner Participant or a Related Party, (iii) any loss, damage, destruction, casualty, non-use, replacement, removal, rebuild, substitution, theft, taking, confiscation, requisition, seizure or condemnation of all or any portion of the Facility, (iv) a change, adjustment or modification of the schedule of Periodic Lease Rent or Allocated Rent in connection with a Lease Event of Default, (v) the payment by the Facility Lessee of Periodic Lease Rent or Termination Value at times or in amounts inconsistent with the terms of the Facility Lease other than at the express written request of the Owner Participant or the Owner Lessor acting at the direction of the Owner Participant (other than a request made during the continuance of a Lease Event of Default) or, unless required by a Final Determination, the deduction by the Facility Lessee of rental or interest amounts
with respect to the Facility Lease that are inconsistent (either as to timing or amount) with the assumptions set forth in Section 3.2(c) of the Facility Lease, as modified by Section 3.4 of the Facility Lease, (vi) any foreclosure or pursuit of remedies against the Facility Lessee (whether by the Owner Participant or otherwise) during the continuance of an Lease Event of Default, (vii) any refinancing of the Lease Debt or the Loan or financing of improvements, (viii) the bankruptcy, insolvency or other proceeding for the relief of debtors involving, or any foreclosure on or against, the Facility Lessee or any Lessee Person, (ix) any amendment, modification, supplement or waiver ("Amendment") effected after the Closing Date to any Operative Document (A) that is made, initiated or requested by the Facility Lessee unless the Owner Participant or Owner Lessor has consented in writing to such Amendment or (B) that is in connection with a Lease Event of Default, (x) any act or omission of the Facility Lessee that is prohibited by the Operative Documents, (xi) any payment by or on behalf of the Facility Lessee (including, without limitation, indemnities, expenses, fees and compensation) to the Pass Through Trustee or pursuant to the Pass Through Trust Agreement, (xii) the breach, inaccuracy or incorrectness of any of the Tax Representations or any of the representations or warranties made by the Facility Lessee in Sections 3.1(a)-(d), (f)(i), (g), (m), (n), (p), (r), (t), (v), (w) or (y) of the Participation Agreement (or the inaccuracy of any of such listed Participation Agreement representations as incorporated in the Officer's Certificate delivered by the Facility Lessee on the Closing Date) or (xiii) the existence or operation of any provision in the Operative Documents relating to the payment of damages or other amounts to Certificateholders in the event that the Certificates are not registered under the Securities Act of 1933 or otherwise within 240 days of the Closing Date (or in the event that, thereafter, they cease to be so registered), the Equity Investor shall be required for U.S. Federal income tax purposes to include in its gross income an amount not described under the Tax Assumption set forth in Section 1(e) above (an "Inclusion Loss" and, together with the Deduction Loss, a "Tax Loss"),

then, subject in each instance to the exclusions set forth below, Facility Lessee will pay to Equity Investor, at Facility Lessee's election given pursuant to its irrevocable written notice delivered to Equity Investor 10-days before the date on which a payment with respect to such Tax Loss is due and payable to Equity Investor hereunder, either (1) a lump sum amount that on an After-Tax Basis shall be sufficient to preserve Owner Participant's Net Economic Return, after taking into account the amount of all increases and reductions in Equity Investor's U.S. Federal, state and local income taxes in all taxable years that are predicated upon such Tax Loss plus all interest, penalties, fines and additions to tax payable by the Equity Investor as a result of such Tax Loss, (2) unless a Significant Lease Default or a Lease Event of Default shall have occurred and be continuing and so long as the Guarantor's senior unsecured debt obligations are then rated at least investment grade by two nationally recognized rating agencies (or if the Guarantor's obligations are then rated by only one such agency, by such agency), an amount sufficient to reimburse the Equity Investor, on an After-Tax Basis, for
the additional U.S. Federal, state and local income taxes payable by (or not refundable to) the Equity Investor from time to time as a result of such Tax Loss plus all interest, penalties, fines and additions to tax payable by the Equity Investor as a result of such Tax Loss, provided, however, if a Significant Lease Default or a Lease Event of Default shall occur and be continuing or if Facility Lessee no longer meets the rating standard described above, a lump sum amount shall become immediately due under clause (2) to preserve Owner Participant’s Net Economic Return in accordance with the method described in clause (1) above (taking into account, however, any payments previously made by the Facility Lessee pursuant to clause (2)). Amounts payable under this Section 5(a) shall be computed based on the Tax Assumptions set forth in Section 1 hereof (as such Tax Assumptions have been modified in accordance with such Section 1), but assuming in the case of amounts payable due to a Deduction Loss that Equity Investor is subject to U.S. Federal, state and local tax at the Assumed Tax Rate and, with respect to payments due to an Inclusion Loss and with respect to calculating any amounts on an “After-Tax Basis” assuming that Equity Investor is subject to U.S. Federal, state and local income taxes at the highest marginal statutory rates then in effect for corporations for U.S. Federal, state and local income tax purposes (taking into account any deductibility of state and local taxes for U.S. Federal income tax purposes) (the “Effective Rate”) and in either case that Equity Investor can concurrently fully utilize any tax benefits resulting from such Tax Loss against income subject to taxes payable at the Assumed Tax Rate or Effective Rate, whichever is applicable.

(b) Any amount payable by Facility Lessee to Equity Investor pursuant to this Section 5 with respect to a Tax Loss shall be paid upon the occurrence of the latest of the following times as shall be applicable to the circumstances: (i) a determination of independent tax counsel forming the basis for a failure to claim as set forth in Section 5(a), (ii) 30 days after the date of Equity Investor’s notice to Facility Lessee pursuant to Section 7 with respect to such Loss, (iii) if any such indemnity payment relates to a Tax Loss that is being contested pursuant to Section 7, 15 days after the date of a Final Determination with respect to such Loss, and (iv) subject to Section 7(a)(E) hereof, the date Equity Investor shall be required to pay the additional taxes giving rise to such amount payable by Facility Lessee (or would be required to pay such tax pursuant to the assumptions set forth in Section 5(a)); provided, however, that the date required for payment shall be delayed until 15 days after completion of any verification required pursuant to Section 5(c) (with interest accruing from the date such payment would otherwise be due until the date of actual payment at the Overdue Rate).

(c) When requesting payment by Facility Lessee pursuant to this Section 5, Equity Investor shall provide Facility Lessee with a certificate of a Responsible Officer setting forth in reasonable detail the amount payable by Facility Lessee and the computation of such amount, including the amount of any lump sum payment that may be required pursuant to clause (1) of Section 5(a) or the schedule of anticipated payments pursuant to clause (2) of Section 5(a) and Section 6. If Facility Lessee shall disagree with such amount or with an amount
payable by Equity Investor pursuant to Section 6, such amount shall be reviewed and determined on a confidential basis, based on the assumptions and methods required herein, by an independent nationally recognized public accounting or lease advisory firm jointly selected by Equity Investor and the Facility Lessee. The costs of such verification shall be borne by Facility Lessee unless such verification shall result in an adjustment in Facility Lessee’s favor exceeding 5% or more of the net present value (calculated using a discount rate of 6% per annum) of the payment or payments computed by Equity Investor, in which case such costs shall be borne by Equity Investor. Neither the Facility Lessee nor the public accounting or lease advisory firm performing the verification will have any right to examine the tax returns or books of Equity Investor in connection with the verification procedure described in this Section 5(c). Equity Investor agrees to cooperate with the independent firm referred to above and to supply it with all information reasonably necessary to permit it to accomplish such review and determination, provided that such accounting or lease advisory firm shall agree in writing in a manner reasonably satisfactory to the Equity Investor that the information supplied to such firm by Equity Investor shall be solely for its confidential use and solely in connection with such verification. In the event such accounting or lease advisory firm determines that such computations are incorrect, then such firm shall determine what it believes to be the correct computations. Absent manifest error, the computations of the accounting or lease advisory firm shall be final, binding and conclusive upon the Facility Lessee and the Equity Investor. The parties hereto agree that the independent accounting or lease advisory firm’s sole responsibility shall be to verify the computation of any payment hereunder and that matters of interpretation of this Agreement or any other Operative Document are not within the scope of the independent accountant or lease advisory firm’s responsibility. Such accounting or lease advisory firm shall be requested to make its determination within 30 days.

(d) Notwithstanding the foregoing provisions of this Section 5, Facility Lessee shall not have any liability to Equity Investor for indemnification under this Section 5 for any Tax Loss if such Tax Loss results from:

(i) any voluntary sale, transfer or other disposition (direct or indirect) by the Equity Investor, Owner Participant or any Affiliate thereof (each a “Lessor Group Member”), or any involuntary sale, transfer or other disposition (direct or indirect) resulting from any bankruptcy of a Lessor Group Member or the foreclosure by a creditor of a Lessor Group Member, of any interest in or arising under the Operative Documents or of the Facility or of any interest therein or of any interest in Owner Participant or in any Affiliate thereof, unless, in each case, such sale, transfer or other disposition is in connection with a Lease Event of Default that shall theretofore have occurred, an Event of Loss or from the Facility Lessee’s exercise of its rights under the Operative Documents;

(ii) the occurrence of an Event of Loss or an event described in Section 13.1 or 14.1 of the Facility Lease so long as the Facility Lessee has otherwise fulfilled its payment obligations with respect to such event
(and, if such obligation requires the Facility Lessee to make a payment of Termination Value or an amount computed by reference thereto, limited to the extent the amount of such payment accurately reflects the timing of tax consequences arising from the event or occurrence giving rise to such payment) or the occurrence of any other event that requires the Facility Lessee to pay Termination Value or an amount computed by reference thereto to the extent such payment is made and to the extent the amount of such payment accurately reflects the timing of tax consequences arising from the event or occurrence giving rise to such payment;

(iii) failure by a Lessor Group Member timely or properly to claim any Assumed Deduction or to exclude income on its tax return unless the Equity Investor has received a written opinion (that was delivered to the Facility Lessee as soon as practicable and prior to the date on which the tax return was filed on which such failure was reflected) of independent tax counsel selected by the Equity Investor and reasonably acceptable to the Facility Lessee, setting forth in reasonable detail the facts and analysis upon which such opinion is based, to the effect that as a result of a Tax Law Change or change in facts subsequent to the Closing Date, other than a Tax Law Change described in Section 5(d)(v) below, there is no Reasonable Basis to claim such Assumed Deduction or exclusion from income;

(iv) other than as a result of a Lessee Action or the inaccuracy of a Tax Representation, failure of the Owner Lessor’s unadjusted basis in the Facility to equal the Purchase Price;

(v) any enactment, promulgation, release, adoption, amendment or change to the Code or Treasury Regulations (final or temporary), Revenue Rulings, Revenue Procedures or a Treasury Department or IRS notice or announcement that occurs subsequent to the Closing Date (a "Tax Law Change"); provided that this exclusion shall not apply to (a) any change in tax rates applicable to any gross up or Inclusion Loss or (b) any repair, maintenance, replacement, rebuild or substitution of, or any alteration, modification, addition or improvement to, the Facility or any portion thereof;

(vi) the application of Section 59A, 168(d)(3), 168(d)(4)(C), 291 or 467 of the Code except, in the case of Section 467, as a result of (1) the inaccuracy or breach of a Tax Representation, (2) any act of the Facility Lessee that is expressly prohibited by the Operative Documents or any failure by the Facility Lessee to take an act expressly required by the Operative Documents, or (3) any event described in Section 5(a)(B)(i) through (xiii);

(vii) the application of any rules relating to short taxable years, a change in the location, business, tax or other status or tax year of the Equity Investor if and to the extent such application would otherwise result in an increase in Facility Lessee’s indemnity obligations hereunder;
(viii) the failure of the Equity Investor to have sufficient income or tax liability to benefit from the Assumed Deductions, provided that this exclusion shall not affect any indemnification calculated on a hypothetical basis as provided in Section 5(a);

(ix) the failure of the Facility Lease to be treated as a "true lease" for U.S. Federal income tax purposes other than as a result (1) the breach or inaccuracy of a Tax Representation, (2) any act of the Facility Lessee that is expressly prohibited by the Operative Documents or any failure by the Facility Lessee to take an act expressly required by the Operative Documents, or (3) any event described in Section 5(a)(A)(ii) through (viii);

(x) the failure of any of the Owner Participant, Owner Lessor or the Intermediary Entities to be treated as a disregarded entity for U.S. Federal, state or local income tax purposes to the extent of a resulting increase in Facility Lessee's indemnity obligations hereunder;

(xi) the fraud, gross negligence or willful misconduct of a Lessor Group Member, or the breach or inaccuracy of any representation, warranty or covenant of a Lessor Group Member in any of the Operative Documents to the extent of a resulting increase in Facility Lessee's indemnity obligations hereunder;

(xii) any Lessor Group Member being or becoming for U.S. Federal income tax purposes a charitable organization, a tax-exempt entity within the meaning of Section 168(h) of the Code, an agency or instrumentality of the United States, a state or political subdivision thereof or an international organization or the special status of a Lessor Group Member which status causes such member to be subject to the provisions of Section 55, 56, 57, 58, 59, 168(f)(2), 465, 469, 501, 542, 552, 851, 856 or 1361 of the Code in each case to the extent of a resulting increase in Facility Lessee's indemnity obligation hereunder;

(xiii) the failure by the appropriate Lessor Group Member to contest a tax claim in accordance with, and to the extent required by, the applicable contest provisions in Section 7 hereof, if the Facility Lessee's ability to contest the claim is materially adversely affected as a result of such failure, unless such failure is the result of a Lessee Action;

(xiv) the inclusion in income by the Equity Investor upon termination of the Facility Lease and return of the Facility in compliance with the Facility Lease of amounts attributable to improvements, modifications or additions to the Facility not financed by a Lessor Group Member and as to which title vests in a Lessor Group Member;

(xv) an Amendment to any Operative Document to which any Lessor Group Member is a party and to which the Facility Lessee is
not a party and which Amendment is not requested by the Facility Lessee in writing, other than any Amendment (A) that may be necessary as a result of, and is in conformity with, any Amendment to any Operative Document requested by the Facility Lessee in writing or (B) that is required by the terms of the Operative Documents or by applicable law or made during the continuation of a Lease Event of Default;

(xvi) penalties or additions to Tax under Section 6662 or Section 6663 of the Code or relating to estimated Tax, in either case to the extent attributable to matters unrelated to the present transaction;

(xvii) a determination that the transactions contemplated by the Operative Documents are a sham, lack a valid business purpose or have a substance that is different from their form, or a determination that the Equity Investor, Owner Participant or any Related Party is not holding its interest in the Facility in the ordinary course of a trade or business or that the Equity Investor, Owner Participant or any Related Party did not enter into said transactions for profit in each case unless such determination results from (1) the inaccuracy of a Tax Representation, (2) any act of the Facility Lessee that is expressly prohibited by the Operative Documents or any the Facility Lessee’s failure to take any act expressly required by the Operative Documents or (3) any event described in Section 5(a)(A)(ii) through (viii);

(xviii) the failure of the Loan or any loan arising under Section 467 of the Code to constitute qualified nonrecourse financing within the meaning of Treasury Regulation Section 1.861-10T other than as a result of a Lessee Action;

(xix) the existence of, or any consequence of, a deferred equity structure or a deferred or prepaid rent structure, provided that the Facility Lessee makes all payments when due and accrues all rental expense and Section 467 Loan Interest in accordance with the terms of the Facility Lease;

(xx) any tax election made by a Lessor Group Member that is inconsistent with the Tax Assumptions to the extent of an increase in the Facility Lessee’s indemnity obligations hereunder;

(xxi) the term of the Facility Lease (for purposes of Section 467 of the Code) being treated as extending beyond the end of the originally scheduled Basic Lease Term;

(xxii) penalties, additions to tax or interest attributable to a failure to comply with Section 6011, 6111 or 6112 of the Code or the Regulations promulgated thereunder, provided, however, that this exclusion shall not apply to the extent of any penalties, additions to tax or interest that are imposed due to any failure to properly and timely register the transaction
contemplated by the Operative Documents as a confidential tax shelter under and pursuant to Section 6111 of the Code;

(xxiii) a Tax Loss with respect to any period occurring after (and not simultaneously with) (1) the expiration or earlier termination of the Lease Term or (2) the return of the Facility to the Owner Lessor; or

(xxiv) any inaccuracy or the incorrectness of any conclusion reached in the Closing Appraisal, unless as a result of the breach or inaccuracy of a Tax Representation or any of the representations or warranties made by the Facility Lessee in Sections 3.1(a)-(d), (f)(ii), (g), (m), (n), (p), (r), (t), (v), (w) or (y) of the Participation Agreement.

SECTION 6  Tax Savings

(a) Generally. If (i) Facility Lessee shall have elected and paid the indemnity with respect to any Tax Loss pursuant to section 5(a), (ii) the Equity Investor, as the result of the event giving rise to such Tax Loss, shall realize (or, in accordance with paragraph (b) shall be deemed to have realized) with respect to any year U.S. Federal income tax savings that would not have been realized but for such Tax Loss or the event giving rise thereto, and (iii) such savings have not previously been taken into account under this Agreement, then, provided no Significant Lease Default or Lease Event of Default shall have occurred and is continuing, the Equity Investor shall pay to Facility Lessee an amount equal to the sum of (x) such U.S. Federal income tax savings (and, to the extent provided in paragraph (b), state and local income tax savings), and (y) the amount of any U.S. Federal, state or local income tax savings realized as the result of any payment made pursuant to this sentence; provided, however, that such sum shall not exceed the excess of the amounts previously paid by Facility Lessee to the Equity Investor pursuant to Section 5(a)(2) hereof over the amounts previously paid by the Equity Investor to Facility Lessee pursuant to this Section 6 with respect to such Tax Loss with the remainder of such sum to be carried forward and applied pro tanto as an offset against future indemnity payments owed by the Facility Lessee pursuant to Section 5(a)(2).

(b) Assumptions in Calculating Tax Savings. For purposes of calculating in clause (x) of Section 6(a) the income tax savings realized by the Equity Investor, the Equity Investor shall be deemed to have fully utilized any tax benefits resulting from a Tax Loss or the event giving rise thereto against U.S. Federal, state and local income taxes payable at the Assumed Tax Rate, except that, with respect to any tax savings arising as a result of an Inclusion Loss and for purposes of calculating in clause (y) of Section 6(a) the income tax savings realized by the Equity Investor, the Equity Investor will be assumed to be taxable at the Effective Rate.

(c) Timing of Payment and Verification. Any payments due to Facility Lessee pursuant to Section 6(a) shall be paid, provided no Significant Lease
Default or Lease Event of Default has occurred and is continuing, within 30 days after the Equity Investor shall realize (or be deemed to have realized) the tax savings. If Facility Lessee shall disagree with the amounts calculated to be paid to it, such amount shall be reviewed and determined in accordance with Section 5(c) above.

(d) Rent Accruals. If as the result of the inclusion of any provision referenced in Section 5(a)(B)(xiii), (1) the Equity Investor or a Related Party shall be entitled or required pursuant to a Final Determination or an opinion of counsel selected by the Owner Participant and reasonably satisfactory to the Facility Lessee to accrue Rent as taxable income under the Facility Lease at a rate less accelerated than that in the Tax Assumptions, and (2) the Lessee is also accruing its rental expense at a rate less accelerated and, as a result, suffers an adverse U.S. Federal income tax consequence on an actual basis, the Lessee shall be permitted, so long as no Significant Lease Default or Lease Event of Default shall have occurred and be continuing, to defer the Equity Portion of Periodic Lease Rent to such dates (not extending beyond the end of the Basic Lease Term or properly elected Renewal Term) as shall (taking into account the tax benefits arising from such revised accrual of Rent and any tax consequences of such deferral of the Equity Portion of Periodic Lease Rent) preserve the Owner Participant’s Net Economic Return (computed in accordance with the Tax Assumptions, other than the assumptions set forth in Sections 1(d), 1(e)(i), 1(e)(iv) and 1(j), provided, however, that no such deferral of the Equity Portion of Periodic Lease Rent shall require the Owner Participant to record a book loss as of the date such adjustment of Rent is first made and, provided further, that the Facility Lessee will attempt to structure any such deferral of the Equity Portion of Periodic Lease Rent (but only if the same can be accomplished at no cost to the Facility Lessee) in such manner so as to cause the Owner Participant’s book earnings for the year in which the adjustment is first made and the succeeding four years to be neither increased nor decreased by more than five percent (5%). Corresponding adjustments to the schedule of Termination Value to reflect such deferral shall be made. Each Lessor Group Member agrees to use reasonable good faith efforts to file (and reasonably pursue) a protective claim for refund (at the sole cost and expense of Facility Lessee, such costs and expenses to be reimbursed on demand and on an After-Tax Basis by the Facility Lessee) with respect to any open year as to which the Internal Revenue Service has challenged, pursuant to Section 467 of the Code, the rental deductions claimed by the Facility Lessee, if the Facility Lessee shall so request in writing.

(e) Subsequent Loss of Tax Savings. The loss, disallowance or recapture of any tax savings described in this Section 6 subsequent to the year of realization by the Equity Investor shall be treated as a Tax Loss that is indemnifiable pursuant to the provisions of this Agreement without regard to Section 5(d) hereof (other than clause (xi) thereof).

SECTION 7. Contests.
(a) If a written adjustment shall be proposed by the Internal Revenue Service that, if sustained, could result in a Tax Loss for which Facility Lessee and the lessee under the Other Facility Lease might be required to make indemnity payments in an aggregate amount in excess of $100,000 (taking into account similar and logically related claims), Equity Investor agrees (i) to notify Facility Lessee promptly in writing of such proposed adjustment within 15 days of the receipt of such adjustment (including in reasonable detail, the nature, extent and purported basis of such adjustment, to the extent of the Equity Investor’s knowledge thereof) and, in the event that there are less than 30 days to respond to such claim, the Equity Investor agrees to request an extension of time to contest such claim so that the period remaining to initiate such contest is not less than 30 days from the date of the Equity Investor’s notice to the Lessee of such claim, (ii) not to make payment of such proposed adjustment for at least 30 days (or such shorter period as may be required by law) after the giving of such written notice of the proposed adjustment to Facility Lessee and (iii) provided that Equity Investor shall not have received prior to the time before which a response to such claim is due a written opinion, setting forth in reasonable detail the facts and analysis upon which such opinion is based (a copy of such opinion which shall be delivered to the Facility Lessee as soon as practicable after receipt), of independent tax counsel selected by the Equity Investor and reasonably satisfactory to the Facility Lessee, to the effect that, (A) with respect to any initial contest, there is not a Reasonable Basis for such contest and (B) with respect to the appeal of a judicial decision, that it is “more likely than not” that the Equity Investor will not prevail in such appeal, to take such action in contesting such adjustment as Facility Lessee shall request in writing from time to time (it being understood that Equity Investor, in its sole discretion, shall be entitled to pursue or forego any administrative appeals, proceedings, hearings and conferences, provided, that Equity Investor may not forego any administrative process if any other item of the Equity Investor’s tax return for the same taxable year is subject to such administrative process or such process is necessary in order to preserve any judicial remedy) and not to settle any such proposed adjustment without the prior written consent of Facility Lessee (provided, however, that Equity Investor will not be required to pursue an appeal to the United State Supreme Court); subject, however, to the satisfaction of the following conditions: (A) within 30 days after notice by Equity Investor to Facility Lessee of such proposed adjustment (or such shorter period as may be required by law) Facility Lessee shall request that such proposed adjustment be contested; (B) although Equity Investor will keep Facility Lessee reasonably informed as to the progress of such contest (including, subject to the execution of confidentiality agreements reasonably satisfactory to the Equity Investor), will use good faith efforts to provide the Facility Lessee and its counsel with copies of any correspondence (or excerpts thereof relating to the adjustment or the contest of such adjustment) or excerpts of other written materials received by the Equity Investor in connection with the contest and with the opportunity to review and make suggestions on all submissions to the Internal Revenue Service and any court to the extent such documents and submissions relate to the Tax Loss (it being understood that the
Facility Lessee shall not be permitted to review any portions of such documents or submissions that relate to issues unrelated to the transactions contemplated by the Operative Documents) and will, if timely requested, consult in good faith with Facility Lessee’s tax counsel and consider in good faith suggestions by such counsel as to the conduct, including the most appropriate forum, of such contest, nevertheless the conduct of such contest (subject to the requirement that Facility Lessee’s written consent to any settlement of the contest be obtained) shall remain within the sole discretion and control of Equity Investor and its tax counsel, who shall determine the nature of all actions to be taken to contest such proposed adjustment, including, without limitation, (x) whether the contest shall be initially by way of judicial or administrative proceedings, or both, (y) whether the proposed adjustment shall be contested by resisting payment or by paying the tax and seeking a refund thereof and (z) if Equity Investor shall undertake judicial action, the court of competent jurisdiction in which to contest such proposed adjustment; (C) Facility Lessee shall have agreed to pay Equity Investor promptly on an After-Tax Basis all reasonable costs and expenses that Equity Investor shall incur in connection with contesting such proposed adjustment, including, without limitation, reasonable attorneys’, accountants’, experts’ and investigatory fees and disbursements and shall have provided Equity Investor with adequate assurances of the timely payment thereof; (D) such contest involves no material risk of the sale, forfeiture or loss of any portion of the Facility; (E) if Equity Investor shall determine to pay the tax proposed and sue for a refund or shall elect to make a deposit in the nature of a cash bond with respect to any proposed adjustment pursuant to Revenue Procedure 84-58, 1984-2 C.B. 501 (or any similar successor procedure), Facility Lessee shall advance to Equity Investor, on an interest-free basis and with no additional net after-tax cost to Equity Investor, sufficient funds to pay the tax and interest, penalties and additions to tax payable with respect thereto; (F) no Lease Event of Default or Significant Lease Default shall have occurred and be continuing; and (G) the Facility Lessee shall have acknowledged in writing its liability to indemnify the Equity Investor in respect of the claim if the contest is unsuccessful, provided, however, that such acknowledgment of liability will not be binding if the contest is resolved on a basis from which it can be clearly established that the Facility Lessee would not be liable to the Equity Investor in the absence of such acknowledgment.

(b) Nothing contained in this Section 7 shall require Equity Investor to contest a proposed adjustment that it would otherwise be required to contest pursuant to this Section 7 if (A) Equity Investor (i) waives (by written notice to Facility Lessee) the payment by Facility Lessee of any amount that might otherwise be payable by Facility Lessee under this Agreement in respect of such proposed adjustment and any related proposed adjustment with respect to any taxable year, the contest of which is effectively foreclosed by the settlement of such proposed adjustment, and (ii) promptly pays to Facility Lessee any amount previously paid or advanced by Facility Lessee pursuant to clause (E) of Section 7(a) hereof with respect to such proposed adjustment, or (B) the subject of such contest has previously been resolved in a Final Determination for a prior taxable year adversely to the Equity Investor, unless the Facility Lessee shall have
provided the Equity Investor with an opinion of counsel selected by the Equity Investor and reasonably satisfactory to the Facility Lessee that as a result of a Tax Law Change, or change in fact, the prior Final Determination is no longer determinative of the issue.

(c) If Facility Lessee shall have requested Equity Investor to contest such proposed adjustment as above provided and shall have duly complied with all the terms of this Section 7, Facility Lessee’s liability for indemnification under this Agreement with respect to such proposed adjustment shall, unless Facility Lessee and Equity Investor shall otherwise agree, be deferred until a Final Determination of the liability of Equity Investor. At such time, Facility Lessee shall become obligated in accordance with the provisions of this Agreement for the payment of any indemnification under this Agreement resulting from the outcome of such contest, and Equity Investor shall become obligated to repay to Facility Lessee the amount advanced hereunder with respect to such proposed adjustment. Within 30 days following such Final Determination, any amounts then due hereunder shall be paid first by set-off against each other and either (a) Facility Lessee shall pay to Equity Investor any excess of the full amount then due hereunder over the amount of any advances previously made by Facility Lessee and applied against Facility Lessee’s indemnity obligation as aforesaid or (b) Equity Investor shall repay to Facility Lessee any excess of such advances over such full amount then due hereunder, together with any interest (net of taxes payable on the receipt or accrual of such interest) received by Equity Investor that is properly attributable to such excess amount of such advances during the period such advances were outstanding, and, if Facility Lessee shall have paid an indemnity to Equity Investor with respect to the adverse tax consequences of any advances or payments hereunder, the amount of any tax saving resulting from any payment to Facility Lessee pursuant to this sentence.

SECTION 8. Certain Adjustments. Upon the occurrence of a Tax Loss for which Equity Investor has received indemnification hereunder, Equity Investor shall recompute the Termination Values in accordance with the manner in which such Termination Values were originally computed to reflect such Tax Loss. If an event giving rise to the payment of an amount determined by reference to the schedules of Termination Values shall occur and the date as of which Equity Investor shall be affected shall be earlier or later than the date taken into account in computing such schedule, Equity Investor shall increase or decrease appropriately such Termination Values based otherwise on the same assumptions previously used by the Equity Investor in calculating such schedules. A Responsible Officer of Equity Investor shall certify to Facility Lessee in writing either that such Termination Values as set forth in the Facility Lease do not require change or the new Termination Values necessary to reflect the Tax Loss. Such certification shall describe in reasonable detail the basis for computing any such new Termination Values. Upon such certification (and verification in accordance with the procedures set forth in Section 5(c) hereof, if requested by Facility Lessee), any such new Termination Values shall be substituted for the Termination Values in the Facility Lease.

SECTION 9. Definitions. For the purposes of this Agreement:
“Equity Investor.” Any reference to Equity Investor shall mean that corporation(s) which is required to include in its taxable income, for Federal income tax purposes, all or any portion of the Owner Lessor’s income, gain, loss and deduction, as well as any affiliated group of corporations, within the meaning of Section 1504 of the Code, of which such corporation is or becomes a member (or, if the Owner Lessor shall not be or shall cease to be a disregarded or pass-through entity for Federal income tax purposes, shall mean the Owner Lessor as well as any affiliated group of corporations, within the meaning of Section 1504 of the Code, of which the Owner Lessor is or becomes a member).

“Final Determination” shall mean (i) a decision, judgment, decree or other order by any court of competent jurisdiction, which decision, judgment, decree or other order has become final after all allowable appeals by either party to the action have been exhausted or the time for filing such appeals has expired, (ii) a closing agreement entered into (x) under Section 7121 of the Code or any other settlement agreement entered into in connection with an administrative or judicial proceeding and (y) with the consent of Facility Lessee when required, (iii) the expiration of the time for instituting suit with respect to the claimed deficiency, or (iv) the expiration of the time for instituting a claim for refund, or if such a claim was filed, the expiration of the time for instituting suit with respect thereto.

SECTION 10. Survival of Agreement. The obligations and liabilities of the parties arising under this Agreement shall, to the extent arising out of acts or events occurring on or prior to the termination of the Facility Lease, continue in full force and effect, notwithstanding the assignment, expiration, or other termination of the Facility Lease, until all such obligations have been met and such liabilities have been paid in full, whether by expiration of time, by operation of law, or otherwise. The obligations and liabilities of each party arising under this Agreement are expressly made for the benefit of, and shall be enforceable by, the other party and its successors and permitted assigns.

SECTION 11. Payments.

(a) Any payments made pursuant to this Agreement to Equity Investor shall be made directly to Equity Investor, and no such payments shall constitute part of the corpus of the Trust Estate, and any payments made pursuant to this Agreement to Facility Lessee shall be made directly to Facility Lessee. Such payments shall be made by wire transfer of immediately available funds to a bank account of the payee in the continental United States as specified by the payee in written directions to the payor, or if no such direction shall have been given, by check of the payor payable to the order of the payee and mailed to the payee by certified mail, postage prepaid at its address as set forth in the Participation Agreement.

(b) Any amount which is payable to Facility Lessee by Equity Investor pursuant to this Agreement and is not paid because a Significant Lease Default or a Lease Event of Default shall have occurred and be continuing shall be held by Equity Investor as security for Facility Lessee’s obligations to Equity Investor.
hereunder and, if the Owner Lessor declares the Facility Lease to be in default pursuant to Section 16 thereof, shall be applied against Facility Lessee’s obligations hereunder as and when due (and, to the extent Facility Lessee then owes no amounts hereunder to Equity Investor, shall be paid to Facility Lessee). At such time as there shall not be continuing any such Significant Lease Default or Lease Event of Default, such amount shall be paid to Facility Lessee to the extent not previously applied in accordance with the preceding sentence.

SECTION 12. Late Payments. To the extent permitted by applicable law, any late payment by either party of any of its obligations under this Agreement shall result in the obligation on the part of such party promptly to pay an amount equal to interest at the Overdue Rate.

SECTION 13. Miscellaneous.

(a) Amendments and Waivers. No term, covenant, agreement or condition of this Agreement may be terminated, amended or compliance therewith waived (either generally or in a particular instance, retroactively or prospectively) except by an instrument or instruments in writing executed by each party hereto.

(b) Notices. Unless otherwise expressly specified or permitted by the terms hereof, all communications and notices provided for herein shall be in writing or by a telecommunications device capable of creating a written record, and any such notice shall become effective (a) upon personal delivery thereof, including by overnight mail or courier service, (b) in the case of notice by United States mail, certified or registered, postage prepaid, return receipt requested, upon receipt thereof, or (c) in the case of notice by such a telecommunications device, upon transmission thereof, provided such transmission is promptly confirmed by either of the methods set forth in clauses (a) or (b) above, in each case addressed to each party hereto at its address set forth below or, in the case of any such party hereto, at such other address as such party may from time to time designate by written notice to the other parties hereto:

A copy of all notices provided for herein shall be sent by the party giving such notice to each of the other parties hereto.

(c) Successors and Assigns. This Agreement shall be binding upon and shall inure to the benefit of, and shall be enforceable by, the parties hereto and their respective successors and permitted assigns as permitted by and in accordance with the terms hereof.

(d) Governing Law. This Agreement shall be in all respects governed by and construed in accordance with the laws of the State of [ ], including all matters of construction, validity and performance (without giving effect to the conflicts of laws provision thereof, other than [ ]).
(e) **Severability.** Any provision of this Agreement that is prohibited or unenforceable in any jurisdiction shall, as to such jurisdiction, be ineffective to the extent of such prohibition or unenforceability without invalidating the remaining provisions hereof, and any such prohibition or unenforceability in any jurisdiction shall not invalidate or render unenforceable such provision in any other jurisdiction.

(f) **Counterparts.** This Agreement may be executed in separate counterparts, each of which, when so executed and delivered shall be an original, but all such counterparts shall together constitute but one and the same instrument.

(g) **Headings and Table of Contents.** The headings of the sections and the table of contents of this Agreement are inserted for purposes of convenience only and shall not be construed to affect the meaning or construction of any of the provisions hereof.

(h) **Further Assurances.** Each party hereto will promptly and duly execute and deliver such further documents to make such further assurances for and take such further action reasonably requested by the other party, all as may be reasonably necessary to carry out more effectively the intent and purpose of this Agreement.
IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be duly executed, all as of the day and year first above written.

[__________]

By: ____________________________
Name: __________________________
Source Information Provided by the Facility Lessee in Connection with the Closing Appraisal

See attached
Source Information Provided by the Facility Lessee in Connection with the Engineering Report

See attached
BLN Case & Comment: True Lease Case In re: Pillowtex, Inc. Affects Leasing, Energy Services Industries

January, 2004

By David G. Mayer, Partner at Patton Boggs LLP, Dallas Texas

This article is a revised version of an article originally published in the January 2004 edition of Business Leasing News (BLN). See: http://www.pattonboggs.com/Newsletters/Bln/Release/bln_2004_01.htm
BLN is an e-newsletter offering leasing and financing strategies primarily for lessors and lenders, written by David G. Mayer, a business transactions partner at Patton Boggs LLP. To subscribe, e-mail to bln@pattonboggs.com with the word “Subscribe” in the subject line. Business Leasing News can be found online at http://www.pattonboggs.com/Newsletters/Bln.

The Third Circuit Court of Appeals in Delaware rendered a “precedential” decision recently on the question of whether a “Master Energy Service Agreement” (“MESA”) constitutes a lease or a secured financing under New York law. In a 21-page opinion, In re: Pillowtex, Inc. et al., Duke Energy Royal, LLC argued unsuccessfully that the MESA with Pillowtex constituted a lease under common law or Article 2A[1] of the Uniform Commercial Code (“UCC”). See: Duke Energy Royal, LLC v. Pillowtex Corporation[2], Case No. 02-2674 (3d Cir. Ct. of Appeals, Nov. 14, 2003). The Court of Appeals concluded that the MESA was not a lease, and therefore Duke was not entitled to payments under Section 365(d)(10)[3] of the Federal Bankruptcy Code. Instead, it generally agreed with the lower court and ruled that the MESA constituted a secured financing.

*Warning: In any bankruptcy proceeding, lessors should expect their lessees to challenge the lessor’s rights to payment under Section 365(d)(10) if a shred of doubt exists that their transaction is a lease under applicable state law. This predictable challenge merits careful structuring of leases because, unlike secured financings, Section 365(d)(10) requires debtors-in-possession to “timely perform all of the obligations of the debtor…first arising from or after 60 days after the order for relief in a … Chapter 11…

[1] See: http://www2.law.cornell.edu/cgi-bin/foliocgi.exe/UCC2A?


under an unexpired lease of personal property... until such lease is assumed or rejected.” In this case, when Pillowtex successfully challenged the characterization of the MESA as a lease, it escaped the obligation to make payments to Duke and thereby preserved valuable cash for its bankruptcy estate—a powerful incentive to mount a challenge against “lease” transactions.

A Brief Case Review
While a detailed review of the decision is beyond the scope of this article, a summary of the facts and law of the case demonstrates the importance of this decision for the leasing and energy service industries.

Facts: The transaction reviewed by the Court involved the MESA, an eight-year contract in which Duke agreed to acquire, hold title to, and install at its cost approximately $10.41 million of energy savings equipment in nine Pillowtex facilities. The equipment included lamps and electronics ballasts, a waste heat recovery system and various other energy-saving equipment constructed specifically for the Pillowtex facilities. The equipment generally had a useful life of 20-25 years. Pillowtex paid a level amount of compensation to Duke equal to the expected energy savings that Duke expected Pillowtex to obtain from the equipment. Pillowtex accounted for such compensation as utility payments rather than rent. At the end of five years of the eight-year term, Duke expected to recover a “simple payback” of its investment. Duke retained various end of term options—the right to remove the equipment at its cost, abandon the equipment, extend the MESA term or give Pillowtex the option to purchase the equipment at a mutually agreeable price. The cost to remove the equipment was prohibitive for Duke when weighed against the nominal residual value of the equipment as removed at the end of the MESA term.

Law: The Court analyzed these facts primarily against the applicable rules of the UCC and the influential lease characterization case of In re: Edison Bros. Stores, Inc.4, 207 B.R. 801 (Bankr. D. Del. 1997). Specifically, the Court considered whether the MESA constituted a “lease” as defined in Section 2A-103(1)(j). That provision defines a lease as “a transfer of the right to possession and use of goods for a term in return for consideration, but a sale... or retention or creation of a security interest is not a lease.” Noting the bright line between a lease and security interest, the Court also considered the definition of a security interest. As applied to the facts, the Court closely evaluated whether the MESA “created an interest in personal property or fixtures which secures payment or performance of an obligation” within the meaning of Section 1-201(37)5 of the UCC rather than a lease. See: page 10. The Court further reviewed the four elements of the “per se” rule in Section 1-201(37) of the UCC for determining whether the MESA transaction created a security interest as a matter of law.

After extensive discussion, the Court concluded that the transaction did not create a security interest on the per se basis. It then moved, with the concurrence of the parties, to the second level of analysis—the “economic realities” tests as articulated by the lower

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5 See: http://www2.law.cornell.edu/cgi-bin/foliocgi.exe/ucc1/query=*&/doc/{t37}?
court and In re: Edison Brothers, Inc. In doing so, the Court considered whether (a) the purchase option, if any, is for nominal consideration, (b) the lessee is required to make aggregate rental payments with a present value equal or exceeding the original cost of the leased property, and (c) the lease term covers the total useful life of the equipment. See: page 13.

In a detailed analysis of these factors, the Court concluded that, despite the long life of the equipment and the intent of the parties to create a true lease, the MESA was not a lease when considering the economic realities of the transaction. The Court fundamentally based its conclusion on the fact that the rent did exceed the cost of the equipment, which indicated intent on the part of Duke to sell rather than lease the equipment to Pillowtex. See: page 14. The Court found further support in Duke’s own testimony in the lower court proceedings that Duke would likely abandon the equipment because Duke would otherwise face a prohibitively high cost of to remove equipment with nominal residual value upon removal. Further, Pillowtex had control over the purchase option because Pillowtex could refuse to negotiate a price with Duke. This refusal would force Duke to sell the equipment to Pillowtex at a nominal price or abandon the equipment, thus neutralizing the purchase option as a realistic term of the MESA.

*Comments: This case suggests several of the following important points:

The lease versus security interest analysis extends beyond the application of Article 2A and Section 1-201(37) of the UCC to the “economic realities” test which may be determinative of a security interest even though the UCC analysis does not lead to a finding of a security interest;

For the energy service industry, which concentrates its efforts on energy savings arrangements similar to the MESA, the case questions whether the parties can achieve off-balance sheet leasing when using structures similar to the MESA.

The Court specifically confirmed that the UCC does not consider the intent of the parties; the only question is whether the transaction creates a security interest or lease regardless of the name of the document purporting to be a lease. See page 17.

For more information on this important case, please feel free to call me. In any event, watch closely that your leases comply with the economic reality approach enunciated In re: Pillowtex. Don’t constitute a security interest under the “per se” test of 1-201(37) unless you intend to structure your transaction as a secured loan or a financing disguised as a lease.
ECONOMICS OF A TRUE TAX LEASE  
ECONOMIC YIELD - TAX LEASE VS. A LOAN

- **Statistical Yield Terminology:**
  - Internal Rate-of-Return Pre-Tax Cash Flows (IRR PTCF)
    - Similar to the interest rate, or yield, on a loan product
    - It excludes the tax “cash” flow benefits
  - Multiple Investment/Sinking Fund (MISF)
    - Similar to the IRR, but includes the tax “cash” flows
    - It reflects the economic yield of a tax lease

- **Sources of Economic Yield**
  - In a Loan, the yield represented by the IRR PTCF is comprised of:
    - Income based on the stated rate of interest on the note, and
    - Any additional fees collected from the borrower.
  - In a Tax Lease, the yield represented by the MISF is comprised of:
    - Income based on the lease rate factor;
    - Expected residual value of the leased property at the end of the lease;
    - Any additional fees collected from the lessee; and the
    - **Tax deferral benefits.**

- **Quantifying the Tax Deferral Benefits of a Tax Lease**
  - The benefit is generated by calculating the present value of the reduced interest costs generated by deferring the payment of the tax liability until a later date.
  - The excess of the MISF over the IRR PTCF represents the incremental increase in the economic yield of a Tax Lease
“TRUE LEASE”
CHEAT SHEET – COMPARISON OF DEFINITIONS

“Tax Lease”: A tax lease under IRS Rev. Proc. 2001-28 and related cases is a type of “true lease” where the lessor demonstrates that it has assumed the benefits and burdens of ownership of the property so that the lessor is entitled to claim all of the depreciation benefits under federal tax law. Although there is no bright-line test to make this determination, a lease that meets the following four criteria should be treated as a Tax Lease (a true lease for tax-ownership purposes):

- The lessor has a minimum unconditional (“at-risk”) investment of its own funds of at least 20% at the inception, during the term, and at the end of the lease;
- The property has a remaining economic useful life at the end of the lease of at least 20% of its original estimated useful life;
- Any lessee renewal option is set at the expected fair rental value at the time of such renewal; and
- Any lessee purchase option is set at a price which is not less than the expected fair market value at the time of the exercise of such option.

“Operating Lease”: An accounting term under FAS No. 13 for a type of lease that allows “off balance sheet treatment” of the lease by the lessee. If the answer to each question below is “No”, the lease is classified as an Operating Lease: (Any one “Yes” answer means a Direct Finance Lease classification for the Lessor and a Capital Lease classification for the Lessee.)

- Is title to the property automatically transferred to the lessee by the end of the lease?
- Does the lease contain a bargain purchase option?
- Is the lease term equal to or greater than 75% of the estimated economic useful life of the leased property?
- Is the present value of the minimum required lease payments and any other guaranteed lessee payments equal to or greater than 90% of the original fair market value of the leased property?

UCC “Lease”: A “true lease” falls within the scope of Article 2A of the UCC. A “disguised security interest” or a “sale” falls within the scope of Articles 2 and 9. This determination is based upon a “bright line” security interest test as outlined in UCC § 1-201(37) and, in some cases, on the additional “Economic Realities Test.” (See In re Edison and In re Pillowtex.)

- Step One: Bright Line Security Interest Test (objective analysis)
A transaction is a “per se” security interest (not a true lease) if: (1) the lease includes a fixed term, not subject to early termination by “lessee,” and (2) at least one of these four factors applies:
- The original fixed term equals or exceeds the remaining economic life of the goods, or
- The lessee is bound to renew for the remaining economic life of the goods, or is bound to become the owner of the goods, or
- The lessee has an option to renew for the remaining economic life of the goods for no or nominal additional consideration, or
- The lessee has an option to purchase for no or nominal additional consideration.

- Step Two (in some cases): Economic Realities Test (subjective analysis)
A “true lease” does not include: (i) a nominal end-of-term purchase price, (ii) a full present-value pay out of the original cost of the goods, or (iii) a term exceeding the useful life of the goods.
TAX LEASE TERMINOLOGY

- **Tax Lease**: A tax lease under IRS Rev. Proc. 2001-28 and related cases is a type of “true lease” where the lessor demonstrates that it has assumed the benefits and burdens of ownership of the property so that the lessor is entitled to claim all of the depreciation benefits under federal tax law. Although there is no bright-line test to make this determination, a lease that meets the following four criteria should be treated as a Tax Lease:
  
  - The lessor has a minimum unconditional (“at-risk”) investment of its own funds of at least 20% at the inception, during the term, and at the end of the lease;
  - The property has a remaining economic useful life at the end of the lease of at least 20% of its original estimated useful life;
  - Any lessee renewal option is set at the expected fair rental value at the time of such renewal; and
  - Any lessee purchase option is set at a price that is not less than the expected fair market value at the time of the exercise of such option.

- The Internal Revenue Code (“Code”) allows the owner of the property to depreciate it in accordance with the Code.

- The Code does not define which party is the owner of the property. This determination is left to the courts and rulings.

- **Tax Treatment of Tax Lease to:**
  
  - **Lessor**-
    - Is treated as the owner for income tax purposes
    - Depreciates the property
    - Recognizes the lease payments as rental income
  
  - **Lessee**-
    - Does not depreciate the property
    - Deducts the lease payments as rental expense

- **Tax Treatment of Non-Tax Lease to:**
  
  - **Lessor**-
    - Treats the lease as a loan for income tax purposes
    - Does not depreciate the property
    - Allocates the lease payments between principal amortization and interest income.
  
  - **Lessee**-
    - Is treated as the owner for income tax purposes
    - Depreciates the property
    - Treats the lease payments as repayment of a loan
TAX LEASE TERMINOLOGY
REV. PROC. 2001-28

• This revenue procedure updated and superceded Rev Proc 75-21, which was originally published in 1975 to provide taxpayers with a list of guidelines that were necessary in order to apply for an advanced ruling on a leveraged lease transaction.

• Over time, these guidelines have come to be viewed as the IRS’ official, but not final, position for all tax leases and as a type of safe-harbor by taxpayers.

• Subsequent IRS rulings and court decisions have, at times, set aside various aspects of the guidelines.

• **Rev Proc’s Main Guidelines:**
  
  • The lessor has a minimum unconditional (“at-risk”) investment of its own funds of at least 20% at the inception, during the term, and at the end of the lease;
  
  • The property has a remaining economic useful life at the end of the lease of at least 20% of its original estimated useful life;
  
  • Any lessee renewal option is set at the expected fair rental value at the time of such renewal; and
  
  • Any lessee purchase option is set at a price that is not less than the expected fair market value at the time of the exercise of such option.

• **Rev Proc’s Other Provisions:**
  
  • With certain limited exceptions, no part of the cost of the property and any additions/improvements to the property may be furnished by the lessee.
  
  • The lessee may not lend to the lessor any of the funds to acquire the property, or guarantee any of the debt incurred in connection with the acquisition of the property.
  
  • The lessor must demonstrate that it expects to receive a profit from the transaction apart from the value of the tax benefits.
  
  • The property must not be “limited-use property” (property that can only be economically used by the current lessee).
TAX LEASE TERMINOLOGY
TECHNICAL ADVICE MEMORANDUM (TAM) 200346007

• Facts:
  • Sale-leaseback of an office building structured as a leveraged lease.
  • The lease contained a fixed purchase option price (FPPO) at the end of year 26 and fixed early buyout option (EBO) at the end of year 9.
  • The taxpayer (Lessee) and the IRS each provided their own appraisals on FMV at the EBO and FPPO dates.
  • The taxpayer recorded a tax loss on the sale, but not for book purposes since it was treated as a Capital Lease.
  • The primary purpose was to secure long-term financing and offset the interest costs with the tax savings from the tax loss.

• Issues:
  • Were the EBO and FPPO set at the expected FMV of the property?
  • Did the taxpayer (Lessee) intend to repurchase the property?

• Factors Indicating Sale Treatment (i.e., Tax Lease)
  • Legal title passed to the buyer
  • Buyer acquired an equity interest in the property
  • Contract created an obligation on the seller to execute deed and on the buyer to make a purchase payment

• Factors Indicating Financing Treatment (i.e., Non-Tax Lease)
  • Right of possession vests with the buyer
  • Lessee is liable for property taxes (However, net lease is now common)
  • Lessee bears risk of loss damage to the property (Net lease provision)

• TAM Conclusion:
  • IRS National Office could not make a conclusive determination
  • Taxpayer and IRS audit team disagree on FMV at EBO and FPPO dates

• Key Points:
  • Determination is based on all of the attending facts and circumstances
  • Need for FMV appraisals, especially when fixed purchase options are present
ACCOUNTING LEASE TERMINOLOGY
FINANCIAL ACCOUNTING STANDARDS (FAS) NO. 13
ACCOUNTING FOR LEASES

- **Lessor Classification**
  
  - **Direct Finance Lease** classification (often erroneously referred to as a Capital Lease) if at least one of the following criteria are present:
    
    o Title to the property automatically transfers to the Lessee by the end of the lease term;
    o The lease contains a bargain purchase option;
    o The lease term is equal to or greater than 75% of the estimated economic life of the leased property; or
    o The present value of the minimum required lease payments and any other guaranteed lessee payments is equal to or greater than 90% of the fair market value of the property.
  
  - **Sales-Type Lease** classification if:
    
    o The lease meets the definition of a Direct Finance Lease, and
    o The lessor is the manufacturer or a dealer of the property being leased
  
  - **Leveraged Lease** classification if all of the following criteria are present:
    
    o The lease meets the definition of the a Direct Finance Lease;
    o It involves at least three separate parties (a lessee, a long-term creditor and a lessor);
    o The financing provided by the long-term creditor is nonrecourse to the lessor and the amount of the financing is sufficient to provide the lessor with substantial leverage in the transaction; and
    o 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.
  
  - **Operating Lease** classification for all other leases
ACCOUNTING LEASE TERMINOLOGY
FINANCIAL ACCOUNTING STANDARDS (FAS) NO. 13
ACCOUNTING FOR LEASES

• Lessee Classification

  • Capital Lease classification if at least one of the following criteria are present:
    o Title to the property automatically transfers to the Lessee by the end of the lease term;
    o The lease contains a bargain purchase option;
    o The lease term is equal to or greater than 75% of the estimated economic life of the leased property; or
    o The present value of the minimum required lease payments and any other guaranteed lessee payments is equal to or greater than 90% of the fair market value of the property.

  • Operating Lease classification for all other leases
ACCOUNTING LEASE TERMINOLOGY
FINANCIAL ACCOUNTING STANDARDS (FAS) NO. 13
ACCOUNTING FOR LEASES

• Interplay of lease classification test between lessor and lessee

  • While the lease classification test is identical, the lessor and the lessee perform it independently.
  • Consequently, it is common for the application of FAS No. 13 to result in different accounting classification treatment for both parties.
  • For example, the lessor may treat the lease as a Direct Finance Lease and the lessee may treat it as an Operating Lease, with the result that neither party reflects a depreciable asset on its financial statements.
  • In this situation, the lessor records a receivable along with any end-of-term residual value on its balance sheet and the lessee records no asset of its balance sheet (i.e., an Off-balance sheet lease).

• Reason for dissimilar accounting classification:

  • The lessor uses the interest rate implicit in the lease in order to discount the guaranteed minimum lease payments under the 90%-test;
  • The lessee uses its incremental borrowing rate for the 90%-test, unless the implicit interest rate in the lease is known:
    o The lessee cannot derive the implicit rate used by the lessor unless it knows the residual assumption used by the lessor.
    o If the incremental borrowing rate is higher than the implicit rate, the present value can move from greater than 90% of the fair value of the property as calculated by the lessor to less than 90% as calculated by the lessee.
  • In order to increase the amount of guaranteed payments, the lessor can-
    o Purchase 3rd party residual value insurance (RVI), or
    o In the case of a vendor leasing program, obtain a vendor residual guarantee.
ACCOUNTING LEASE TERMINOLOGY
FINANCIAL ACCOUNTING STANDARDS (FAS) NO. 13
ACCOUNTING FOR LEASES

• Financial Statement Reporting for Operating Leases

  • Lessor – The leased property is recorded on the balance sheet as an asset and it is depreciated using the company’s normal depreciation policy—although using the lease term as the depreciable life is quite common. The lease payments are recorded as income over the lease term.

  Balance Sheet (journal entries at inception of lease)

  Dr. Operating Lease Asset xxx
  Cr. Cash xxx

  Income Statement (journal entries over lease term)

  Dr. Cash xxx
  Cr. Rental Income xxx

  Dr. Depreciation Expense xx
  Cr. Operating Lease Asset xx

• Lessee – The lease payments are recorded as an expense. The assets are not recorded on the balance sheet and the future lease obligations are disclosed as a footnote in the financial statements.

  Balance Sheet (journal entries at inception of lease)

  No entries required (which is why this is called an Off-balance sheet lease)

  Income Statement (journal entries over lease term)

  Dr. Rental Expense xxx
  Cr. Cash xxx
ACCOUNTING LEASE TERMINOLOGY
FINANCIAL ACCOUNTING STANDARDS (FAS) NO. 13
ACCOUNTING FOR LEASES

- Financial Statement Reporting for Direct Finance Leases & Capital Leases

  - Lessor – A lease receivable is recorded on the balance sheet for the total amount of the minimum required lease payments. The end-of-term expected residual value of the leased property is also recorded on the balance sheet. Finally, the sum of the (1) lease receivable and the residual asset value less the (2) cost of the equipment is recorded as unearned income. This unearned amount is amortized into income over the lease term so as to produce a constant periodic rate of return on the net investment in the lease, referred to as the effective yield method.

  **Balance Sheet** (journal entries at inception of lease)

  - Dr. Lease Receivable xxxxx
  - Dr. Residual Asset Value xx
  - Cr. Unearned Income xxx
  - Cr. Cash xxx

  **Income Statement** (journal entries over lease term)

  - Dr. Cash xxx
  - Dr. Unearned Income xx
  - Cr. Lease Receivable xxx
  - Cr. Interest Income xx

- Lessee – The leased property is recorded on the balance sheet as an asset and it is depreciated using the company’s normal depreciation policy. A liability is recorded equal to the cost of the leased property.

  **Balance Sheet** (journal entries at inception of lease)

  - Dr. Capital Lease Asset xxxxx
  - Cr. Capital Lease Liability xxxxx

  **Income Statement** (journal entries over lease term)

  - Dr. Capital Lease Liability xx
  - Dr. Interest Expense xx
  - Cr. Cash xxx
  - Dr. Depreciation Expense xx
  - Cr. Capital Lease Asset xx
LEASE TERMINOLOGY
SELECTED INDUSTRY/ MARKETING TERMS

- Capital Lease – The technical accounting classification term for a lessee, but often erroneously used to indicate the lessor’s classification of a Direct Finance Lease.

- Conditional Sales Contract, Money-Over-Money Lease, Non-Tax Lease, Installment Sales Lease, Dollar-Out Lease – Terms that effectively constitute loans, even though they may be documented as leases.

- Early Buyout Option (EBO) – An option that allows the lessee to purchase the leased assets at some point prior to the end of the lease term.

- First Amendment Lease (ABC Lease) – A lease structure that gives the lessee a purchase option, usually for the greater of fair market value or a fixed amount, with a requirement that the lease be automatically renewed for a pre-determined period of time if the purchase option is not exercised.

- Fixed Purchase Option – An option that allows the lessee to purchase the leased assets at a pre-determined price. This may or may not be considered a Tax Lease depending on whether the fixed purchase option is representative of the expected fair market value as of the option date.

- FMV Lease – A Tax Lease that has a fair market value end-of-term purchase option.

- FMV with a CAP – An end-of-term fair market value purchase option that is capped at a certain amount.

- Off-Balance Sheet Lease – An Operating Lease where the lessee does not record the leased property on its financial statements and where tax ownership rests with the lessor.

- Operating Lease – Sometimes used to refer to a Tax Lease, even though it is a technical accounting term used to describe the lessor’s and/or lessee’s lease classification.

LEARN TERMINOLOGY
SELECTED INDUSTRY/ MARKETING TERMS

- Residual Value Insurance (RVI) – 3rd-party insurance acquired by the lessor to increase the guaranteed minimum payments in order to exceed the 90%-present value test and secure Direct Finance Lease accounting classification treatment.

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1 You will note that in certain passages in this Industry/Marketing Terminology section, terms are presented in bold print while at other times the exact terms are not highlighted in this manner. The bold print reflects the proper technical usage of such terms, whereas the terms not highlighted are used out of context.
• Split-TRAC Lease – A variation of a special **Tax Lease** for titled vehicles in which the lessee guarantees a portion of the residual. The reason only a portion of the residual is guaranteed is to allow the lessee to obtain **Operating Lease** accounting classification treatment by keeping the lessee’s calculation of the present value of the minimum required lease payments and other guaranteed payments below the 90% threshold.

• Synthetic Lease or Loan – A lease where the lessee has **Operating Lease** accounting classification treatment but retains tax ownership.

• TRAC Lease - A special **Tax Lease** for titled vehicles in which the lessee guarantees 100% of the lessor’s residual. This results in a **Capital Lease** accounting classification since the present value of the minimum required lease payments and other guaranteed payments are above the 90% threshold.
“FINANCE LEASE”

UCC Article 2A – 103(1)(g)

(g) “Finance lease” means a lease with respect to which:

(i) the lessor does not select, manufacture, or supply the goods;

(ii) the lessor acquires the goods . . . in connection with the lease; and

(iii) one of the following occurs: (lessee has access to the sales contract)

   (A) the lessee receives a copy of the (vendor’s sale contract) . . . before signing the lease; or

   (B) the lessee’s approval of the (vendor’s sale contract) . . . is a condition to the effectiveness of the lease; or

   (C) the lessee, before signing the lease, receives an accurate and complete (summary of the vendor’s sale contract); or

   (D) if the lease is not a consumer lease, the lessor, before the lessee signs the lease, informs the lessee in writing:

       (a) of the identity of the (vendor), unless the lessee has selected the (vendor), and

       (b) that the lessee is entitled to the promises and warranties provided to the lessor by the (vendor), and

       (c) that the lessee may communicate with the (vendor) and receive an accurate and complete statement of those promises and warranties.
# WHAT IS A TRUE LEASE?
A Chronological Review of True-Lease Cases

<table>
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<tr>
<th>#</th>
<th>CASE (NAME, CITATION, DATE &amp; COURT)</th>
<th>HOLDING</th>
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<tbody>
<tr>
<td>1.</td>
<td><em>In the Matter of JEFFREY MARTIN</em>, 64 B.R. 1, (Bankr. S.D.G.A. 1984). Augusta Division.</td>
<td>(old UCC) The Debtor’s right to terminate the agreement at any time by surrender of the property and payment through the date of surrender made this contract a true lease and not a disguised secured transaction.</td>
<td>Lessor entered into a rent-to-own contract with the Debtor and his wife for a nine-foot freezer in the Debtor’s home. The contract called for payments of $10.00 per week. The contract provided that title would remain at all times with the lessor. The contract also allowed the Debtor the option to terminate the contract at any time by returning the freezer to the Lessor together with payment of all rentals due through the date of return. There was also an oral agreement between the parties that the Debtor could acquire title to the freezer by making 78 weekly rental payments. The Debtor originally assumed this contract as an executory contract under his Chapter 13 plan but failed to make the required weekly payments, and tried unsuccessfully to characterize the contract as a disguised secured transaction.</td>
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<td>2.</td>
<td><em>In re NORTH AMERICAN RENTAL</em>, 54 B.R. 574, (Bankr. D. N.H. 1985).</td>
<td>(old UCC) The Court analyzed whether or not the parties “intended to create a security interest” as required under the old Uniform Commercial Code (“UCC”). The Court found the leases to be true leases because: (i) each lease had a FMV purchase option capped at between 21% and 25%; (ii) payments were denominated as “rent”; (iii) the security deposit was less than a down payment; (iv) lessor retained title;</td>
<td>The Debtor entered into eleven leases of heavy machinery, which included end of term purchase options at fair market value with caps that varied from 21-25%. The Court initially distinguished between “operational leases” and “finance leases.” In an “operational lease,” the Lessor maintains the equipment, insures it, and generally just provides the use of the equipment to the lessee on a day-to-day or month-to-month basis. In a “finance lease,” all equipment-related obligations of maintenance and repairs, insurance, etc. are contractually accepted by the lessee. In determining whether the parties intended to create a security interest, the Court balances true</td>
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1 (Note: This summary does not attempt to identify all issues addressed in each case. Also note that while the new UCC Article 2A was being adopted by the various states from 1988 into the late 1990s, many courts have continued until recently to analyze the “true lease” issues under the requirements of the old UCC provisions and cases.)
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<td>(v) equipment return at lease end; and (vi) placing signs of ownership on the equipment.</td>
<td>lease factors vs. secured transaction factors. Factors for a secured transaction included: (i) interest payments; (ii) acceleration clauses; and (iii) whether the lease is originated by a financing or funding source. Factors for a true lease include: (i) a minimal security deposit; (ii) references to “rent” requirements; (iii) equipment-return requirements; and (iv) ownership signs placed on the equipment indicating title.</td>
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<td>3.</td>
<td>In re O.P.M. LEASING SERVICES, 61 B.R. 596, (Bankr. S.D.N.Y. 1986).</td>
<td>(old UCC) The Court analyzed whether or not the parties intended to create a lease. The Court found the transaction to be a true lease based upon: (i) the lease terminology used in the documentation, including “lessor,” “lessee,” “rent,” (ii) the contract verbiage which conveyed only a leasehold interest, (iii) the lessor’s right to assign or encumber its interests without lessee consent, and (iv) the lack of any contract provision for a purchase option (the contract required that the equipment be returned if the lease wasn’t extended at the end of the term).</td>
<td>The lessee and lessor entered into a sale/lease-back arrangement for computer equipment where the lessor assumed the lessee’s obligations under an Equipment Purchase Agreement. The lessor agreed to make a down payment on the equipment and, thereafter, monthly payments to the equipment vendor. The Court found that the transaction gave the lessor title to the equipment but that such title was subject to a lien by the equipment vendor. Subsequently, the lessor’s interest in the lease went through several layers of assignments, ending up again with the original lessor. By then, the original lessor (O.P.M.) had defaulted in its part of the agreement by failing to reimburse the lessee for the original down payment and failing to make the required monthly payments to the equipment vendor. In spite of a hell or high water clause, the lessee sent a notice of default to the lessor and purported to terminate the lease. A successor-in-interest to the original lessor then commenced litigation to quiet title to the lease and to the equipment. Before this action could be resolved, the original lessee settled the claim with the successor-in-interest by paying a sizeable sum for clear title to the equipment. The lessee then sought reimbursement of its damages in bankruptcy court. In part, the court denied the lessee’s claim for reimbursement based upon a finding that the transaction was a true lease, and therefore not subject to the provisions of Article 2 of the UCC.</td>
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<td>4.</td>
<td>In re ACCESS EQUIPMENT, INC., 62 B.R. 642, (Bankr. D. Mass. 1986). (old UCC)</td>
<td>The Court decided not to consider what description the parties gave to the transaction, but rather to look to the “essential character” of the transaction to determine intent. While the Court looked to 15 factors that defined the transaction’s essential character, it focused primarily upon the pre-Article 2A UCC 1-201(37) tests and identified a minimum 25% purchase option price as a requirement for a true lease status. The Court found that there was an 86% purchase option price in this case and that none of the other 201(37) tests had been violated, and therefore judged the transaction to be a true lease.</td>
<td>The lessee and lessor had several different contractual arrangements over the life of their relationship for construction platforms and masts. One of the arrangements was clearly a sale transaction, but the lessee never attempted to take advantage of the terms of that arrangement. In the predominant arrangement used by the parties, there was an Equipment Rental Agreement that was never signed by any of the parties. However, the performance of all of the parties tended to comply with the basic terms and conditions of the rental agreement.</td>
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<td>5.</td>
<td>In re MARVIN NEALE OERKE, 63 B.R. 1, (Bankr. N.D.Tex. 1986). Amarillo Division (old UCC)</td>
<td>The Court decided that it was lacking evidence of the actual intent of the parties, and therefore the Court was required to look to the substance of the underlying documentation to determine if the transaction was a true lease. The court applied the pre-Article 2A UCC 1-201(37) tests. Since there was an FMV purchase option and the lease term was for less than the full useful life of the equipment, the transaction was found to be a true lease.</td>
<td>In 1981, the Debtor entered into three leases for three agricultural sprinkler systems to use on the Debtor’s farm. The leases were for a term of seven years and provided for periodic yearly rentals. The leases also provided that upon the expiration of the initial term, the Debtor could, upon 60 days prior written notice, elect to purchase the sprinkler systems for the then current fair market value of the equipment.</td>
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<td>6.</td>
<td>In re AIRLIFT INTERNATIONAL INC., 70 B.R. 935, (Bankr. S.D.Fla. 1987). (old UCC)</td>
<td>The Court analyzed a series of “secured transaction” factors outlined in the White &amp; Summers’ Handbook of the Law under the Uniform Commercial Code, (2nd ed. 1980), to determine whether the predominate characteristics of the transaction were those of a true lease or those of a secured transaction. Based upon its analysis of those Handbook factors, the Court determined that the transaction was a secured transaction.</td>
<td>The Debtor in this transaction had at least two different agreements with the lessor for the purchase and/or use of two aircraft which were registered with the FAA in the name of the lessor. The final agreement included terms for the Debtor to purchase the aircraft with a balloon payment upon completion of the contract. The agreement also had language that recognized the Debtor’s equity interest in the aircraft. In its analysis, the Court referenced the UCC 9-102 provision specifying that Article 9 applies to any transaction that is “intended to create a security interest,” and then to the pre-Article 2A UCC 1-201(37) secured transaction tests, eventually using the Handbook factors.</td>
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<td>7.</td>
<td><em>In re Eddie F. Armstrong</em>, 84 B.R. 94, (Bankr. W.D.Tex). El Paso Division.</td>
<td>(old UCC) After reviewing the old UCC 1-201(37) tests, the Court decided that before it could even question whether there was a transfer of title for no or nominal consideration, there had to first be a fixed-term, non-cancelable payment obligation to find a secured transaction. Since the Debtor in this case could terminate the lease without penalty at any time, the transaction in this case was a <strong>true lease</strong>.</td>
<td>The Debtor entered into a month-to-month, rent-to-own lease for <strong>household furniture</strong>. The Debtor could return the furniture and cancel the lease at any time or could own the furniture after the payment of a fixed number of payments. This factor tipped the scales to assist the Court in finding this agreement to be a true lease. The fact that the economic incentives in this case did not compel the Debtor to purchase the furniture strengthened this finding.</td>
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<td>8.</td>
<td><em>In re Aspen Impressions, Inc.</em>, 94 B.R. 861, (Bankr. E.D. Pa. 1989).</td>
<td>(NOTE: Now we start to see the impact of the new UCC Article 2A provisions in a few cases. However, most cases continue to apply the old law.) The Court set out the complete text of the newly amended UCC 1-201(37) and found the transaction in this case to be a <strong>true lease</strong>, notwithstanding that it was a fixed-term obligation giving a full pay out plus a 17% interest return on the original cost of the equipment. In its holding, the Court focused, not on the beginning value, but rather on the lessor’s ending value.</td>
<td>The Debtor signed a lease for <strong>printing press</strong> equipment. The lease transaction included no option for the end-of-term purchase of the equipment. The Court did an analysis of the transaction under the newly proposed UCC Article 2A based upon the assumption that “it is generally agreed that, just as the inclusion of a purchase option in a lease does not, of itself, imply a secured installment sale, the exclusion of one does not automatically imply a true lease.” Based upon the American Law Institute’s then recent approval of the new UCC Article 2A for Leases, this Court moved away from the old balancing of lease vs. secured transaction factors, and began to focus on the issue of the lessor’s end-of-lease residual value. The Court found that all of the old factors could legitimately appear in a true lease, and therefore the better indicator was the actual intended ownership as evidenced by the lessor’s anticipated residual value at the end of the lease.</td>
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<td>9.</td>
<td><em>In re Donna G. Thompson</em>, 101 B.R. 658, (Bankr. N.D.Ok. 1989).</td>
<td>(old UCC) – Non-TRAC - Though the new UCC Article 2A had been enacted in Oklahoma at this time, the Court applied the old list of security interest factors. The Court focused on beginning equipment value, rather than lessor’s residual value. The Court went on to hypothesize about post-lease transactions that might be available to a lessor or lessee, and then lumped them all together with the original transaction as if they were all one and the same.</td>
<td>This case involved a set of nine <strong>motor vehicle leases</strong> (not TRACs) with the same leasing company. All leases had very high fixed purchase options (36% to 51%) and left the lessor with a substantial end-of-lease residual interest in the vehicles. These leases are all close-ended leases (not TRAC leases) so all end-of-lease upside value belonged to the lessor. This case appears to ignore basic economic principles in reaching the result.</td>
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<td>transaction. After this discussion, the Court found the leases to be merely a type of <strong>secured transaction</strong>, in spite of the very high fixed purchase options and large end-of-term residual values belonging to the lessor. (Note: Unlike <em>In re OTASCO, INC.</em> (below), these leases were not the TRAC or open-ended type leases which tend to give the lessee the end-of-lease residual value.)</td>
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<td>10</td>
<td><em>In re BRANIFF, INC.</em>, 118 B.R. 819, (Bankr. M.D.Fla. 1990). Orlando Division.</td>
<td>(new UCC) The Court found that a commitment to provide a lease is not itself a true lease, but it is an executory contract, and therefore is subject to 11 U.S.C. 365.</td>
<td>Just hours before the Debtor filed for bankruptcy, the vendor/lessor of <strong>commercial aircraft</strong>, who had inside information, faxed a notice to the Debtor that it was in default under the various purchase and lease agreements. The vendor/lessor asserted unsuccessfully that such agreements were legally terminated before the bankruptcy filing.</td>
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<td>11</td>
<td><em>In re OTASCO, INC.</em>, 111 B.R. 976, (Bankr. N.D.Ok. 1990).</td>
<td>(old UCC) As in <em>In re DONNA G. THOMPSON</em> (cited above), the same judge again refused to use UCC Article 2A principles and analyzed the old security interest factors. Because this case involved a <strong>TRAC or open-ended type lease</strong>, factual support existed for the Court’s finding that this transaction was a disguised secured transaction.</td>
<td>The Debtor entered into a series of <strong>automobile leases</strong> with lessor. These leases contained terminal rental adjustment clauses (TRAC leases) which required that at the end of any lease, which could be terminated by Debtor at any time after the first twelve months, the automobile would be sold and the Debtor would be liable for any deficiency or would be the recipient of any surplus according to the formula set out in the TRAC leases. From the outset the lessor gave up all reversionary interest in the equipment, and except for lessor’s collateral interest, the Debtor assumed all of the economic value, if any, of the ownership benefits and risks. Even in those cases where the Debtor exercised its option to terminate early, all of the economic upside or downside belonged to the Debtor, not to the “lessor.”</td>
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<td>12</td>
<td><em>In re THE ANSWER – THE ELEGANT LARGE SIZE DISCOUNTER, INC.</em>, 115 B.R. 465, (Bankr. S.D.N.Y. 1990).</td>
<td>(old UCC) While acknowledging the new UCC Article 2A principles, the Court relied primarily upon a balancing of the old secured interest vs. true lease factors. The Court stated that a fair market value purchase option is an</td>
<td>The Debtor arranged a two and a half million-dollar line of credit with the lessor. This line of credit was used to purchase high-tech <strong>computer systems</strong> and custom designed trade fixtures for the Debtor’s stores. The lessor purchased the equipment for a series of leases, each of which included a fair market value purchase option.</td>
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<td>important characteristic of a true lease. However, in this case the FMV purchase option was rendered meaningless by the finding that all of the equipment either had short technological life spans or was custom designed for the Debtor’s own stores and would have relatively little value to anyone else. Therefore, the transactions in this case were found to be disguised security agreements and not true leases.</td>
<td>However, at lease end, the equipment was expensive to remove and had relatively little value to anyone other than the Debtor. (See also In re Pillowtex below.)</td>
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<td>13.</td>
<td>In re ZERKLE TRUCKING COMPANY, 132 B.R. 316, (Bankr. S.D. W.V. 1991).</td>
<td>(old and new UCC) The Court acknowledged that through the IRS Code, TRAC leases are true leases for tax ownership purposes, but the Court found that for purposes of enforcement under the Bankruptcy Code, TRAC leases are leases intended for security as a matter of law. The Court made an analysis under both the old UCC “balancing of factors” test as well as under the new Article 2A “lessor residual value” test to conclude that a TRAC lease is never a true lease under the Bankruptcy Code.</td>
<td>The Debtor entered into a series of five year leases for ten tractors and seventy trailers. Title was registered in the name of lessor. All of the leases included terminal rental adjustment clauses (TRAC leases).</td>
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<td>14.</td>
<td>In re MICHAEL V. COLIN, 136 B.R. 856, (Bankr. D. Or. 1991).</td>
<td>(old UCC) --TRAC-- The Court held that before it could make any analysis of the implication of a purchase option, there had to be a fixed term payment obligation. In this case, the Debtor could terminate at any time without penalty, and therefore, this could not be a contract of sale because a month-to-month rental could only be a true lease. Further, the Court held that the price alone cannot render a contract unconscionable under Oregon law without other egregious facts.</td>
<td>The debtor had signed two rent-to-own furniture leases terminable at any time without further obligation. If the debtor made all payments under the leases, the debtor automatically became the owner of the furniture. In bankruptcy, the debtor argued 1) that the debtor was acquiring title without any real purchase option payment at the end of the lease, and 2) that the leases were unconscionable because the furniture was over priced.</td>
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<td>15.</td>
<td>In the Matter of TAK BROADCASTING CORPORATION, 137 B.R. 728, (D. W.D.Wis. 1992).</td>
<td>(parol evidence) The Court found that leases of space on a radio tower were an integral part of a larger sale transaction and could not be interpreted without looking at the larger transaction. Therefore, the transactions were not true.</td>
<td>The Debtor was a successor-in-interest to a series of transactions involving sales of real estate, broadcasting facilities, and leases on an associated radio tower. In bankruptcy, the Debtor unsuccessfully attempted to separate the leases from the sale transactions so that the leases could be rejected as executory.</td>
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<td>16</td>
<td>In re WORCESTER QUALITY FOODS, 140 B.R. 21, (Bankr. D. Mass. 1992). (Federal law)</td>
<td>The Court determined that the UCC test of true lease did not apply to a transaction that is subject to a federal statute governing the rights of the parties, as in connection with the ownership and sale of aircraft.</td>
<td>In this case the Debtor leased an aircraft under an agreement which included a fair market value purchase option, but the option was worded to include a provision that required the lessor to return to the Debtor any amounts received from the sale of the airplane in excess of the contractual Stipulated Loss and Termination Value. The lessor was registered with the FAA as the owner of the aircraft. However, because the Debtor could obtain ownership by payment in full of the fixed term rentals, the transaction was deemed a secured transaction and not a true lease under federal statute. The UCC was deemed to not apply in this case.</td>
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<td>17</td>
<td>In re OPEN DOOR PRESS, INC., 142 B.R. 883, (Bankr. E.D. Mo. 1992). Eastern Division.</td>
<td>After rejecting the position of the state’s supreme court (which was contrary to the majority rule), the Court made a two prong analysis under old UCC 1-201(37) asking whether there were an option to purchase for no additional or nominal consideration, and, if not, for a balancing of the security-interest factors test. Based upon a finding that there was a nominal purchase option, the Court found this transaction to be a secured transaction without going into the second prong of the analysis. Since the lessor did not properly perfect its security interest, it was an unsecured creditor.</td>
<td>In this case, the Debtor leased four pieces of rare laminating equipment under a 60 month lease which allowed the Debtor at lease termination to buy the equipment for one additional lease payment. The lessor, assuming that the transaction was a true lease, filed a notice-only UCC financing statement with the Secretary of State’s office, but did not make the second required filing with the County Recorder of Deeds.</td>
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<td>18</td>
<td>In re DONNY E. BARNHILL, 189 B.R. 611, (Bankr. D.S.C. 1992). (old UCC)</td>
<td>This Court analyzed the old UCC 1-201(37) balancing of factors test. The Court rejected the majority rule that a month-to-month rental agreement that can be terminated leasing.</td>
<td>The Debtor in this case, entered into two rent-to-own furniture leases. The leases provided that the Debtor could terminate the agreements by returning the equipment at any time without penalty. The leases included standard lease language about Debtor leasing.</td>
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<td>at will at any time without penalty is a true lease. Instead, this Court focused on the following factors in concluding that the agreement was a security: (i) full pay out of the original cost; (ii) the title was automatically transferred at lease end; and (iii) the Debtor’s responsibility for risk of loss and insurance.</td>
<td>responsibility for risk of loss, insurance, taxes, etc. Upon payment in full of all rental payments, the leases provided for the transfer of title in the <strong>furniture</strong> to the Debtor.</td>
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<td>19.</td>
<td><strong>In re HOTEL SYRACUSE, INC.,</strong> 155 B.R. 824, (Bankr. N.D.N.Y. 1993).</td>
<td>(old UCC) Applying the old balancing of “secured transactions” factors test, the Court found that this type of transaction was <strong>not a true lease</strong> for purposes of 11 U.S.C. 365(d)(4), which was held to apply only to true leases. In addition, the Court decided that the transaction was not an executory contract within the meaning of 11 U.S.C. 365(a).</td>
<td>This case involved a series of sales and lease-back transactions that eventually came together in a thirty year rental lease to use the real property and associated equipment and <strong>furniture</strong>, with a sixty year renewal option, and with a forced repurchase obligation for $100.00 (upon the full payment of the underlying bonds). The debtor was the operator of an old hotel who arranged for financing in part through a series of sale/lease-back transactions of the hotel property. The debtor successfully kept the hotel property in the bankruptcy estate by overcoming the lessor’s true lease and executory contract arguments.</td>
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<td>20.</td>
<td><strong>In re DWE SCREW PRODUCTS, INC.,</strong> 157 B.R. 326, (Bankr. N.D. Oh. 1993). Western Division.</td>
<td>(old UCC) Without referring to the UCC directly, the Court did the old balancing of factors analysis in order to infer or presume from the parties’ course of dealing what their intent was at the inception of the transaction. The court discounted the Debtor’s sworn statement and found eleven factors on the face of the lease which aptly showed that the parties intended to create a <strong>true lease</strong>.</td>
<td>The Debtor entered into a 10 year lease for <strong>non-residential real property</strong>, with an option to purchase and with the normal shifting of all lease-related risks under the contract to the Debtor. The Debtor submitted a sworn statement that the parties intended to create a financing arrangement and unsuccessfully sought to keep the leased property in the bankruptcy estate by arguing that the transaction was a disguised financing arrangement.</td>
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<td>21.</td>
<td><strong>In re PHOENIX PIPE &amp; TUBE, L.P.,</strong> 154 B.R. 197, (Bankr. E.D. Pa. 1993).</td>
<td>(old UCC) The Court performed the “no or nominal consideration” analysis under old UCC 1-201(37). The Court’s criteria were: i) if the option price at the time of exercise is substantially less than the then-current FMV, the</td>
<td>The Debtor entered into a Master Lease with four Schedules for <strong>band saws, couplings, pumps and valves</strong>. While the Schedule for the couplings had no purchase option, all of the other Schedules had 10% purchase options. In addition to performing the no or nominal consideration analysis,</td>
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<td>22.</td>
<td><em>In re Gordon and Kathy Michaels</em>, 156 B.R. 584, (Bankr. E.D. Wis. 1993). (old UCC)</td>
<td>The Court decided that the new Article 2A provisions did not apply, performing its analysis under old UCC principles. The Court first decided to construe the ambiguous contract against the vendor/lessor, who was its drafter, and next found a few factors in the contract that seemed to indicate that the Debtor had acquired a property interest in the tractor. Therefore, the contract was held to be a <strong>disguised security agreement</strong>, not a true lease.</td>
<td>The Debtor (a farmer) entered into a lease for a <strong>tractor</strong>. Many of the important lease provisions were described in blank fields which were never completed. The lease provided that the Debtor could buy the tractor for the Total Present Value of $_________ (which amount was left blank) and the Debtor could apply to such purchase price ______% (also left blank) of all rentals theretofore paid. The Court bolstered its holding by analyzing the old factors to show that the burden of ownership had been shifted to the Debtor, and also an “economic realities” analysis to show that sensible economics dictated that the Debtor must buy the equipment at the lease’s end.</td>
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<td>23.</td>
<td><em>In re American General Aircraft Corporation</em>, 190 B.R. 275, (Bankr. N.D. Miss. 1995). (old UCC)</td>
<td>Using the old UCC 1-201(37) analysis, the Court found the purchase option to be nominal and hence the agreement was a <strong>lease intended to be security</strong> and not a true lease.</td>
<td>The Debtor entered into a sale/lease-back arrangement with the local Development District to get $2 million worth of <strong>industrial equipment</strong> for the local airport. The lease was a “net lease” for 15 years, included an end-of-term purchase option for $100, and had the normal lease language shifting all risk and responsibility to the lessee. The Development District argued unsuccessfully that it only had legal authority to enter into <strong>true leases</strong>.</td>
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<td>24.</td>
<td><em>In re Kristina Trusty</em>, 189 B.R. 977, (Bankr. N.D. Ala. 1995). Southern Division. (no true lease analysis)</td>
<td>The Court found that under Alabama law a “rent-to-own” agreement is neither a “true lease” nor a “security agreement.” Rather, the “rent-to-own” agreement is a legislatively-created, hybrid commercial device that qualifies under the Bankruptcy Code as an executory contract.</td>
<td>This case involved three separate bankruptcy cases with rent-to-own agreements from three separate merchants. The Debtors argued unsuccessfully that the transactions were sale agreements. The merchants argued unsuccessfully that the transactions were true leases.</td>
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<td><em>In re Edison Brothers Stores, Inc.</em>, 207 B.R. 801, (Bankr. D. Del. 1997).</td>
<td>(both old and new UCC) The Court did its analysis under both old and new UCC principles, citing provisions under each law. The Court did look at certain “disguised financing” factors but decided that such factors are for the most part irrelevant because the factors test tends to contradict long standing leasing industry practices. The Court focused in on a three-prong test to determine true lease status: 1) Is the purchase option price nominal? 2) Does the aggregate rental equal or exceed the original equipment cost? 3) Does the lease term equal or exceed the equipment’s useful life? The Court found a true lease in this case based upon: 1) The Debtor failed to carry its burden of proof to show a nominal purchase option. 2) The Debtor failed to carry its burden of proof to show that the present value of the rentals (using the Debtor’s borrowing rate of 9%) equaled or exceeded the original purchase price. 3) The useful life of the equipment exceeded by several years even the 6 year term (5 original years plus 1 year renewal at $1) of the lease. (See also <em>In re Pillowtex</em> below.)</td>
<td>In this case, the Debtor was a large retail distributor with over 2600 retail stores. The Debtor entered into a series of leases for point-of-sale cash registers for each one of its many stores. The lessor financed the large multi-million dollar transaction by putting up the leases for security for the loans used to purchase the cash registers under the leases. Under the terms of the lease agreements, the Debtor made quarterly rental payments and agreed to accept the risks and responsibilities of the equipment, all taxes, fees, insurance and maintenance, and agreed to indemnify the lessor. The lease further provided that the Debtor had to pay all cost of returning the equipment. The leases continued for a period of five years, at which time the Debtor had a fair market value purchase option or in the alternative could renew the leases for an additional 12 months for rent of one dollar. The Debtor initially booked the leases as operating leases in its financial books and records.</td>
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<p>| 26. | <em>In re Jeffrey Owen d/b/a C &amp; J Express Co.</em>, 221 B.R. 56, (Bankr. N.D.N.Y. 1998). | (new UCC) – TRAC - This Court analyzed the new Article 2A principles. Because New York law expressly provides that in a non-consumer transaction the use of TRAC provisions do not automatically create a conditional sale or secured transaction, the Court analyzed other factors (besides the TRAC provisions) to determine true lease status. The Court finds first that under the new UCC 1-201(37), the annual right to terminate prevents automatic security agreement status. Then the Court goes on to find a true lease in this case by applying an expanded version of the three-prong test as used in the <em>In re Edison Bros.</em> case (see above). The Court finds that: 1) There is no purchase option (nominal or otherwise), 2) The present | This case analyzed two five year leases for refrigerated trailers. Both leases were TRAC leases using normal lease terminology and providing: 1) for retention of title in the lessor, 2) for the shifting of all risks, responsibilities, taxes and fees to the Lessee, 3) for the shifting of the responsibility for insurance and maintenance to the Lessee, 4) for the disclaimer of any representations and warranties from the Lessor, and 5) for the Lessor’s right to assign or encumber without Debtor’s consent or notice. In addition, both leases required that at the end of the lease the trailers would be sold and a final rent adjustment would be made depending upon the amount received for each trailer. Neither lease specifically granted to the Debtor a purchase option. |</p>
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<td>value of rents (at 8.89%) is less than the original purchase price, 3) The lease term is less</td>
<td>1) The Debtor is not left in the position where the only real economic choice is to buy the trucks. 2) The Debtor is at risk for additional consideration if he buys the trucks. 3) The additional consideration (the implied purchase option) doesn’t have to be at least 25%, or any other fixed amount, if it is estimated to be an equivalent of the end-of-term FMV (unless that FMV is negligible). Without analysis, the Court acknowledges to the three-prong test from In re Edison Bros. (see above) and correctly points out that the new “finance leases” under Article 2A are not barred from being true leases just because the lessor is acting only as a financing source.</td>
<td>The Debtor entered into two commercial vehicle agreements. One agreement was for 36 months. The other agreement was for 48 months. Neither agreement allowed for early termination while both agreements included TRAC provisions.</td>
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<td>27</td>
<td>In re JOSEPH E. BECKHAM, 275 B.R. 598, (Bankr. D. Kan. 2002).</td>
<td>(new UCC) – TRAC - The Court applies the new Article 2A principles, finding first that this transaction is not automatically a secured transaction under the new two-part test of UCC 1-201(37). In addition, the Court finds that the new UCC 1-201(37) explicitly moves away from the old use of the “security interest” factors test. Also, under Kansas law, a transaction is not a sale or security agreement solely because it includes TRAC provisions. Even though the leases here are TRAC leases with no express early termination options, the Court finds the leases to be true leases because: 1) The Debtor is not left in the position where the only real economic choice is to buy the trucks. 2) The Debtor is at risk for additional consideration if he buys the trucks. 3) The additional consideration (the implied purchase option) doesn’t have to be at least 25%, or any other fixed amount, if it is estimated to be an equivalent of the end-of-term FMV (unless that FMV is negligible). Without analysis, the Court acknowledges to the three-prong test from In re Edison Bros. (see above) and correctly points out that the new “finance leases” under Article 2A are not barred from being true leases just because the lessor is acting only as a financing source.</td>
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<td>In re ROBERT FRITZ CHARLES, 278 B.R. 216, (Bankr. D. Kan. 2002).</td>
<td>(new UCC) – TRAC - The Court held that the new UCC 1-201(37) no longer required a search for the parties’ intent and that the old</td>
<td>In this case, the Debtor’s entered into a Master Lease for five Kenworth truck tractors. The Master Lease was composed of an Equipment Schedule for five years, a delivery and acceptance process.</td>
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<td>balancing of factors was no longer relevant. The Court found that while this TRAC lease was non-terminable, it didn’t fail any of the four residual-value tests in the second part of the new UCC 1-201(37) two-part security interest per se test. Further, Kansas law expressly states that a transaction is not a sale or security interest solely because of a TRAC provision. The Court rejected various old cases as no longer applicable under new the Article 2A principles. The Court held this transaction to be a true lease, and found that: 1) The Debtor’s option price was not nominal, 2) The lessor retained a significant reversionary interest, and 3) The Debtor obtained no meaningful equity in the vehicles unless they were purchased (which would be a separate transaction).</td>
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<td>29. In re CIRCUIT-WISE, INC., 277 B.R. 460, (Bankr. D. Conn. 2002).</td>
<td>(burden of proof) The Court found that a lessor was not entitled to 11 U.S.C. 365 protections as a matter of law, unless and until the Court determined that the transaction was a true lease. The practical effect of this case is to switch the burden of proof to the lessor to prove a true lease. This case is contrary to the majority rule that the Debtor bears the burden of proof to show that a lease is other than what it purports to be.</td>
<td>Nearly a year after filing bankruptcy, the Debtor had not made any payments to the Lessor under the lease. The Lessor filed a motion under 11 U.S.C 365 seeking payment of all amounts due under the lease. The Debtor argued successfully that the Lessor was not entitled to payments unless the court determined that the transaction was in fact a true lease. The Lessor argued unsuccessfully that the transaction was a “presumptive” or “punitive” lease until ruled otherwise by the court and that the Debtor should have the burden of proof.</td>
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<td>30. In re PALACE QUALITY SERVICES INDUSTRIES, INC., 283 B.R. 868, (Bankr. E.D. Mich. 2002).</td>
<td>(no true lease analysis) Without analyzing the nature of the transaction, the Court assumed that there was a true lease in this case and stated that the Debtor’s and Trustee’s failure to pay Section 365(d)(10) rents to lessor allowed the lessor to seek relief from the automatic stay only. It did not allow for a monetary claim against the bankruptcy estate. Any claim for rent not covered by Section 503 was to be treated as an unsecured, non-priority claim. The Court found the lessor was entitled to its entire claim of unpaid post-petition rents and late fees because of an certificate, and a TRAC Addendum. Under the lease agreement the Debtor had the option: 1) to purchase the trucks for the amount of the residual value plus a $500 termination fee, or 2) to sell the trucks to the highest bidder, or 3) the Debtor could extend the lease for an additional 6 months. If extended, the lease payment would remain the same and such holdover rents would not be credited towards the purchase option or residual value amounts. On a separate note, the Court in this case held that even if this were a secured transaction, registration of the lessor as “owner” (not just as “lienholder”) on the Certificate of Title was a proper way to perfect a security interest.</td>
<td>The Debtor leased two large commercial washing machines from the Lessor for use in the Debtor’s business. The Lessor sought payment of all rent and late fees under the lease from the date of the Chapter 11 filing to the date the lease was deemed rejected pursuant to 11 U.S.C. 365(d)(1). The Debtor had continued using the leased equipment after filing bankruptcy until it ceased doing business. Five months after ceasing business operations, it converted to a Chapter 7 bankruptcy. The Trustee objected to the payment of any amounts due the lessor after the Debtor ceased doing business.</td>
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279038v1 Washburn/KeyBank & D. Mayer Patton/Boggs LLP
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<tr>
<th>#</th>
<th>CASE (NAME, CITATION, DATE &amp; COURT)</th>
<th>HOLDING</th>
<th>FACTS &amp; FACTORS</th>
</tr>
</thead>
<tbody>
<tr>
<td>31.</td>
<td><em>In re QDS COMPONENTS, INC.,</em> 292 B.R.313, (Bankr. S.D.O.H. 2002). Western Division at Dayton.</td>
<td>administrative priority under 11 U.S.C. 503(b)(1)(A), and not because of any administrative claim under 11 U.S.C. 365.</td>
<td>In this case the Debtor entered into two lease agreements for lathes purchased from a third party vendor. Both agreements required large advance payments. Each lease agreement was written for five years and included an end of term purchase option for $9,065.00. The leases also included an early termination provision that allowed the Debtor to terminate upon payment in full of the net present value of the lease plus the present value of the purchase option, plus any other amounts due and owing under the lease. The leases also shifted all risks of insurance, loss, taxes, fees, maintenance, etc. to the Debtor. While the leases reserved title to the lessor, the lessor filed a precautionary financing statement and when the leases were sold to two separate funding sources, a third party funding source gave lien subordination agreements to the new lessors.</td>
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<td>#</td>
<td>CASE (NAME, CITATION, DATE &amp; COURT)</td>
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<tr>
<td>32.</td>
<td><em>In re METAL TRANSPORTATION SYSTEMS, INC,</em> (new UCC) – TRAC - (Bankr. N.D.N.Y. 2003).</td>
<td>The Court limited its true-lease analysis to the required elements of the new UCC 1-201(37) Bright Line Test. Because this lease provided for a fixed, non-cancelable term, the Court focused on the second part (the four residual value elements) of the test. Finding that the Debtor failed to carry its burden of proof in showing: 1) the lease term exceeded the equipment’s economic life, or 2) the purchase option was nominal (and the other two elements having been stipulated by the parties) the Court found this transaction to be a true lease. However, the original lessor financed the lease with a bank loan and allowed the Bank to take a security interest in the lease. The Court found that the Bank was not a party to the lease, and hence, was not protected by 11 U.S.C. 365.</td>
<td>The Debtor entered into a lease for ten 1998 Ravens Eclipse Flatbed Trailers. The lessor paid a total price of $350,000.00 for the trailers. The lease provided for 59 monthly payments of $6,430.00 and the final payment of $10,185.00 for a total of rental payments equal to $385,800.00. The lease stipulated that lessor retained full legal title, that it was a “true lease”, that the Debtor was responsible for all maintenance, taxes, losses, insurance, etc. Under the lease the Debtor was required to pay a security deposit equal to one months rent and the lessor was entitled to take all federal income tax deductions. Finally, the lease included a TRAC provision that allowed the Debtor to purchase the equipment at the expiration of the lease for 20% of the original equipment cost or $70,000.00. If the Debtor did not purchase the equipment, the equipment was to be sold and the Debtor would receive any surplus or be charged for any deficiency in the lessor’s effort to recover the estimated residual value.</td>
</tr>
<tr>
<td>33.</td>
<td><em>In re REBEL RENTS, INC,</em> 291 B.R. 520, (Bankr. C.D. C.A. 2003).</td>
<td>(new UCC) The Court limited its true-lease analysis to the required elements of the new UCC 1-201(37) Bright Line Test, rejecting any analysis under the old comparison of factors test. While this agreement was a fixed-term obligation, with no early termination rights, the Debtor had failed to carry its burden of proof to establish the presence of any one of the four residual-value elements, at least one of which is necessary to show that the lessor has given up all residual interest rights. The lack of all four of these elements weighed against any finding that this lease was anything other than a true lease. However, because the leased equipment was necessary to the operation of the Debtor’s business, the court did not allow lessor to repossess its equipment even though it had not been paid for more than a six months and the equipment value was depreciating quickly.</td>
<td>The Debtor in this case entered into a sale/lease back transaction with the lessor. The Debtor sold 55 construction vehicles to the lessor for nearly $4,000,000.00. The Debtor then leased back those same 55 construction vehicles on a three year lease with monthly payments of approximately $90,000.00 per month, and with a total rental payment under the lease of $3,500,000.00. The Debtor had a fair market value purchase option under the lease. During the initial year of the lease, nearly half of the 55 vehicles were sold and the sale proceeds were paid to the lessor and deducted from the lease.</td>
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<tr>
<td>#</td>
<td>CASE (NAME, CITATION, DATE &amp; COURT)</td>
<td>HOLDING</td>
<td>FACTS &amp; FACTORS</td>
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<td>34.</td>
<td><em>In re PILLOWTEX INC</em>, 349 F.3d 711 (3d Cir. 2003).</td>
<td>(new UCC) The Court first analyzed the transaction under the UCC 1-201(37) Bright Line Test, and after finding that the transaction was not a “per se” disguised security agreement, then went on to look at the facts of the case to determine whether the economic reality of the transaction suggested a security agreement. To determine economic reality, the Court used the same three factors as were used in <em>In re Edison Bros.</em> cited above. Because the equipment would be very expensive to remove and the resale value, once removed, was very minimal, the Court found that the value of any purported purchase option or of any remaining economic life (apart from the Debtor’s usage) lacked real economic substance and were not important true lease factors in this case. On the other hand, the fact that the present value of the rent payments significantly exceeded the cost of the energy fixtures (not including labor) tended to indicate that the lessor was receiving more than a payment for just the use of the equipment and the loss of its value. Under the facts of this case, indicating that the lessor had no meaningful residual value, the Court found that a sale transaction was the only economic reality possible. The lessor also tried to raise some old UCC criteria, like evidence of intent, but the Court rejected all of the other suggested factors as either inapplicable or misapplied.</td>
<td>In this case, the Debtor entered into a Master Energy Services Agreement (“MESA”) wherein the vendor provided certain <strong>lighting fixtures</strong> and a new wastewater <strong>heat recovery system</strong>. More than half the value of the MESA was for labor in removing old fixtures and installing the new fixtures. The MESA did not use any lease terminology and provided that the energy savings to the Debtor would equal the monthly payment. The Debtor booked the monthly payments as a “utility expenses.” The MESA provided for a fixed term of 8 years after which time the vendor had the option to 1) remove the equipment and replace it with like equipment, or 2) abandon the equipment in place, or 3) continue the MESA as mutually agreed by the parties, or 4) give the debtor the option of purchasing all but not less than all of the equipment at a mutually agreed upon price. The MESA is not labeled a lease and does not refer to the parties as Lessee or Lessor. Under the agreement, the parties agreed that monthly payments would be set so the vendor would recuperate its investment in the first five years of the 8 year term. The parties agreed that the useful life of the energy fixtures was 20 – 25 years. Representatives of the vendor made statements to the Debtor that the equipment would in fact be abandoned at the end of the 8 year term. Certain schedules under the MESA went through a series of assignments so that by the time of bankruptcy, the original vendor held some schedules, and successors in interest held others.</td>
</tr>
</tbody>
</table>

SEC. 2. BACKGROUND

01. Section 911(a) of the Code allows a “qualified individual,” as defined in § 911(d)(1), to exclude foreign earned income and housing cost amounts from gross income. Section 911(c)(3) of the Code allows a qualified individual to deduct housing cost amounts from gross income.

02. Section 911(d)(1) of the Code defines the term “qualified individual” as an individual whose tax home is in a foreign country and who is (A) a citizen of the United States and establishes to the satisfaction of the Secretary of the Treasury that the individual has been a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire taxable year, or (B) a citizen or resident of the United States who, during any period of 12 consecutive months, is present in a foreign country or countries during at least 330 full days.

03. Section 911(d)(4) of the Code provides an exception to the eligibility requirements of § 911(d)(1). An individual will be treated as a qualified individual with respect to a period in which the individual was a bona fide resident of, or was present in, a foreign country if the individual left the country during a period for which the Secretary of the Treasury, after consultation with the Secretary of State, determines that individuals were required to leave because of war, civil unrest, or similar adverse conditions that precluded the normal conduct of business. An individual must establish that but for those conditions the individual could reasonably have been expected to meet the eligibility requirements.

04. For 2000, the Secretary of the Treasury in consultation with the Secretary of State, has determined that war, civil unrest, or similar adverse conditions that precluded the normal conduct of business existed in the following country beginning on or after the specified date:

<table>
<thead>
<tr>
<th>Country</th>
<th>Date of Departure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eritrea</td>
<td>May 19, 2000</td>
</tr>
</tbody>
</table>

05. Accordingly, for purposes of § 911 of the Code, an individual who left the foregoing country on or after the specified departure date shall be treated as a qualified individual with respect to the period during which that individual was present in, or was a bona fide resident of, such foreign country if the individual establishes a reasonable expectation of meeting the requirements of § 911(d) but for those conditions.

06. To qualify for relief under § 911(d)(4) of the Code, an individual must have established residency or have been physically present in the foreign country on or prior to the date that the Secretary of the Treasury determines that individuals were required to leave the foreign country. Individuals who establish residency or are first physically present in the foreign country after the date that the Secretary prescribes, shall not be treated as qualified individuals under § 911(d)(4) of the Code pursuant to § 911(d)(4)(C). For example, individuals who are first physically present in Eritrea after May 19, 2000, are not eligible to qualify for the exemption prescribed in § 911(d)(4) of the Code for taxable year 2000.

07. In order to assist those individuals who are filing prior year or amended tax returns, the Internal Revenue Service is republishing the countries listed for tax years 1997, 1998, and 1999, for which the eligibility requirements of § 911(d)(1) of the Code are waived under §911(d)(4):

<table>
<thead>
<tr>
<th>Country</th>
<th>Date of Departure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Albania</td>
<td>March 12, 1997</td>
</tr>
<tr>
<td>Cambodia</td>
<td>July 9, 1997</td>
</tr>
<tr>
<td>Central African</td>
<td>March 28, 1997</td>
</tr>
<tr>
<td>Republic</td>
<td></td>
</tr>
<tr>
<td>Democratic</td>
<td>May 3, 1997</td>
</tr>
<tr>
<td>Republic of the</td>
<td></td>
</tr>
<tr>
<td>Congo</td>
<td>June 7, 1997</td>
</tr>
<tr>
<td>Sierra Leone</td>
<td>May 28, 1997</td>
</tr>
<tr>
<td>Tajikistan</td>
<td>November 26, 1997</td>
</tr>
</tbody>
</table>

Tax Year 1998–2000

<table>
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<tr>
<th>Country</th>
<th>Date of Departure</th>
</tr>
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<tbody>
<tr>
<td>Albania</td>
<td>August 14, 1998</td>
</tr>
<tr>
<td>Democratic</td>
<td>August 5, 1998</td>
</tr>
<tr>
<td>Republic of the</td>
<td></td>
</tr>
<tr>
<td>Congo</td>
<td>June 5, 1998</td>
</tr>
<tr>
<td>Eritrea</td>
<td>June 10, 1998</td>
</tr>
<tr>
<td>Guinea-Bissau</td>
<td>May 15, 1998</td>
</tr>
<tr>
<td>Pakistan</td>
<td>August 16, 1998</td>
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<tr>
<td>Sierra Leone</td>
<td>December 23, 1998</td>
</tr>
<tr>
<td>Serbia-Montenegro</td>
<td>October 11, 1998</td>
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</tbody>
</table>

SEC. 3. INQUIRIES

A taxpayer who needs assistance on how to claim this exclusion, or on how to file an amended return, should contact a local IRS Office or, for a taxpayer residing or traveling outside the United States, the nearest overseas IRS office.

SEC. 4. EFFECT ON OTHER DOCUMENTS


DRAFTING INFORMATION

The principal author of this revenue procedure is Kate Y. Hwa of the Office of Associate Chief Counsel (International). For further information regarding this revenue procedure, contact Ms. Hwa at (202) 622-3840 (not a toll-free call).

26 CFR 601.201: Rulings and determination letters. (Also Part I, sections 38, 61, 162, 167, 467; 1.61–1, 1.162–1, 1.167(a)–1, 1.467–3.)


SECTION 1. PURPOSE

This revenue procedure provides guidelines that the Internal Revenue Ser-
vice will use for advance ruling purposes in determining whether certain transactions purporting to be leases of property are, in fact, leases for federal income tax purposes. This revenue procedure modifies and supersedes Rev. Proc. 75–21, 1975–1 C.B. 715. Rev. Proc. 2001–29, 2001–19 I.R.B. 1160, sets forth the information and representations required to be furnished by taxpayers in requests for advance rulings on leveraged lease transactions within the meaning of this revenue procedure.

SECTION 2. BACKGROUND


SECTION 3. SCOPE

This revenue procedure applies in the case of transactions commonly called "leveraged leases." Such leases generally involve 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.

The guidelines set forth in this revenue procedure clarify the circumstances in which an advance ruling recognizing the existence of a lease ordinarily will be issued solely to assist taxpayers in preparing ruling requests and the Service in issuing advance ruling letters as promptly as practicable. These guidelines do not define, as a matter of law, whether a transaction is or is not a lease for federal income tax purposes and are not intended to be used for audit purposes.

SECTION 4. GUIDELINES

Unless other facts and circumstances indicate a contrary intent, for advance ruling purposes only, the Service will consider the lessor in a leveraged lease transaction to be the owner of the property and the transaction a valid lease if all the guidelines described below are met. If all of these guidelines are not met, the Service nevertheless will consider ruling in appropriate cases on the basis of all the facts and circumstances.

0.1 Minimum unconditional "at risk" investment

The lessor must have made a minimum unconditional "at risk" investment in the property (the "Minimum Investment") when the lease begins, must maintain such Minimum Investment throughout the entire lease term, and such Minimum Investment must remain at the end of the lease term. The Minimum Investment must be an equity investment (the "Equity Investment") that, for purposes of this revenue procedure, includes only consideration paid, and personal liability incurred, by the lessor to purchase the property. The net worth of the lessor must be sufficient to satisfy any such personal liability. In determining the lessor's Minimum Investment, the following rules will be applied:

1. Initial Minimum Investment. When the property is first placed in service or use by the lessee, the Minimum Investment must be equal to at least 20 percent of the cost of the property. The Minimum Investment must be unconditional. That is, after the property is first placed in service or use by the lessee, the lessor must not be entitled to a return of any portion of the Minimum Investment through any arrangement, directly or indirectly, with the lessee, a shareholder of the lessee, or any party related to the lessee (within the meaning of § 318 of the Internal Revenue Code) (the "Lessee Group"). The lease transaction may include an arrangement with someone other than the foregoing parties that provides for such a return to the lessor if the property fails to satisfy written specifications for the supply, construction, or manufacture of the property.

2. Maintenance of Minimum Investment. The Minimum Investment must remain equal to at least 20 percent of the cost of the property at all times throughout the entire lease term. That is, the excess of the cumulative payments required to have been paid by the lessee to or for the lessor over the cumulative disbursements required to have been paid by or for the lessor in connection with the ownership of the property must never exceed the sum of (i) any excess of the lessor's initial Equity Investment over 20 percent of the cost of the property plus (ii) the cumulative pro rata portion of the projected profit from the transaction (exclusive of tax benefits).

3. Residual Investment. The lessor must represent and demonstrate that an amount equal to at least 20 percent of the original cost of the property is a reasonable estimate of what the fair market value of the property will be at the end of the lease term. For this purpose, fair market value must be determined (i) without including in such value any increase or decrease for inflation or deflation during the lease term, and (ii) after subtracting from such value any cost to the lessor for removal and delivery of possession of the property to the lessor at the end of the lease term. In addition, the lessor must represent and demonstrate that a remaining useful life of the longer of one year or 20 percent of the originally estimated useful life of the property is a reasonable estimate of what the remaining useful life of the property will be at the end of the lease term.

0.2 Lease Term and Renewal Options

For purposes of this revenue procedure, the lease term includes all renewal or extension periods except renewals or extensions at the option of the lessee at fair rental value at the time of such renewal or extension.

0.3 Purchase and Sale Rights

No member of the Lessee Group may have a contractual right to purchase the property from the lessor at a price less than its fair market value at the time the right is exercised. When the property is first placed in service or use by the lessee, the lessor may not have a contractual right (except as provided in section 4.01(1) above) to cause any party to purchase the property. The lessor must also represent that it does not have any present intention to acquire such a contractual right. The effect of any such right acquired at a sub-
sequent time will be determined at that time based on all the facts and circumstances. A provision that permits the lessor to abandon the property to any party will be treated as a contractual right of the lessor to cause such party to purchase the property.

.04 Investment by Lessee

(1) Permitted Investments. Except as otherwise specifically provided in paragraphs (2) and (3) below, no part of the cost of the property or the cost of improvements, modifications, or additions to the property ("Improvements"), may be furnished by any member of the Lessee Group. Property that could itself be separately leased in a transaction eligible for an advance ruling under this revenue procedure does not constitute an Improvement. For example, assume X leases a chemical plant from Y. Assume further, that after the plant is placed in service, X wishes to erect and own additional tanks that will be used to store the output of the plant. Although the tanks will be used in conjunction with X's plant, they constitute separate items of property that could be used in conjunction with other facilities and therefore do not constitute limited use property under section 5.02 of this revenue procedure. If a third party owned the tanks, it could lease them to X in a transaction eligible for an advance ruling. Thus, the tanks do not constitute an Improvement.

(2) Severable Improvements. A member of the Lessee Group may furnish amounts to pay for the cost of an Improvement that is owned by a member of the Lessee Group, and is readily removable without causing material damage to the leased property ("Severable Improvement"), provided that such Improvement is not subject to a contract or option for purchase or sale between the lessor and any member of the Lessee Group at a price other than fair market value at the time of such purchase or sale. At the commencement of the term of the lease, a Severable Improvement to the leased property must not be required in order to render the leased property complete for its intended use by the lessee. However, property will be considered to be complete even though the lessee may add as Severable Improvements ancillary items of equipment of a kind that customarily are selected and furnished by purchasers or lessees of property of the kind subject to the lease. Thus, for example, to the extent an item of equipment such as the boiler for a leased, steam powered vessel otherwise constituted a Severable Improvement, the vessel would not, for purposes of this section, be considered complete without the boiler. On the other hand, a leased airplane would be considered complete without items of equipment such as aviation electronics and a leased vessel would be considered complete without such ancillary items such as radar, lines, or readily removable fittings, and will be eligible for an advance ruling even though such items of equipment are to be added by the lessee.

(3) Nonseverable Improvements. A member of the Lessee Group may furnish amounts to pay for the cost of Improvements that are not readily removable without causing material damage to the property ("Nonseverable Improvements") if they are described in subparagraph (a) below and the conditions of subparagraph (b) are met.

(a) A Nonseverable Improvement is described in this subparagraph if either:

(i) it is furnished in order to comply with health, safety, or environmental standards of any government or governmental authority having relevant jurisdiction (or any industry-wide standard recognized by such government or governmental authority);

(ii) it does not increase the productivity (or capacity) of the leased property to more than 125 percent of its productivity (or capacity) when first placed in service, or modify the leased property for a materially different use. For this purpose, separate units that are subject to one lease (e.g., ten boxcars subject to one lease) are each considered "the leased property;" or

(iii) the cost of the Nonseverable Improvement, when added to the cost of Nonseverable Improvements that previously have been made to the property (other than those described in subparagraph (i) above) does not exceed 10 percent of the cost of the property. For purposes of this subparagraph, the cost of a Nonseverable Improvement will be considered to be the actual cost multiplied by a fraction, the numerator of which is the Implicit Price Deflator for Fixed Nonsidential Investment (published by the Department of Commerce in the Survey of Current Business) for the year in which the property was placed in service, and the denominator of which is the Implicit Price Deflator for Fixed Nonsidential Investment for the year in which the Improvement is made. As indicated in section 4.04(5) of this revenue procedure, ordinary maintenance and repair does not constitute an Improvement.

(b) The following conditions must be satisfied:

(i) At the commencement of the term of the lease, a Nonseverable Improvement must not be required in order to complete the property for its intended use by the lessee;

(ii) The Nonseverable Improvement must not cause the leased property to become limited use property within the meaning of section 5.02 of this revenue procedure; and

(iii) The furnishing of the cost of the Nonseverable Improvement does not constitute an equity investment by a member of the Lessee Group in the property. For this purpose, the lessee's right to use the Improvement during the lease term in which such improvement is made does not constitute an equity investment in the property. The furnishing of such cost will be considered an equity investment in the property if a member of the Lessee Group may receive compensation, directly or indirectly, for its interest in such Nonseverable Improvement. A member of the Lessee Group will be regarded as having made an equity investment in the property if, for example:

- the lessee is obligated to purchase the Nonseverable Improvement or reimburse a member of the Lessee Group for the cost of the market value of the Nonseverable Improvement;

- any option price or renewal rental rate to a member of the Lessee Group is adjusted downward to reflect any portion of the cost or fair market value of the Nonseverable Improvement; or

- the lessee is obligated to share with a member of the Lessee Group a portion of the proceeds of any sale or lease of the property to a third party.

(4) Cost Overruns and Modifications. If the cost of property exceeds the
estimate on which the lease was based, the lease may provide for adjustments of rent to compensate the lessor for such additional cost.

(5) Maintenance and Repair. If the lease requires the lessee to maintain and keep the property in good repair during the term of the lease, ordinary maintenance and repairs performed by a member of the Lessee Group will not constitute an Improvement.

.05 No Lessee Loans or Guarantees

No member of the Lessee Group may lend to the lessee any of the funds necessary to acquire the property, or guarantee any indebtedness created in connection with the acquisition of the property by the lessor. A guarantee by any member of the Lessee Group of the lessee’s obligation to pay rent, properly maintain the property, or pay insurance premiums or other similar conventional obligations of a net lease does not constitute a guarantee of the indebtedness of the lessor.

.06 Profit Requirement

The lessor must represent and demonstrate that it expects to receive a profit from the transaction, apart from the value or benefits obtained from the tax deductions, allowances, credits, and other tax attributes arising from such transaction. This requirement is met if:

(1) Overall Profit. The aggregate amount required to be paid by the lessee to or for the lessor over the lease term plus the value of the residual investment referred to in section 4.01(3) of this revenue procedure exceed an amount equal to the sum of the aggregate disbursements required to be paid by or for the lessor in connection with the ownership of the property and the lessor’s Equity Investment in the property, including any direct costs to finance the Equity Investment; and

(2) Positive Cash Flow. The aggregate amount required to be paid to or for the lessor over the lease term exceeds by a reasonable amount the aggregate disbursements required to be paid by or for the lessor in connection with the ownership of the property.

SECTION 5. OTHER CONSIDERATIONS

.01 Uneven Rent Test. Leveraged lease transactions that satisfy the guidelines set forth in section 4 of this revenue procedure and that contain uneven rent pay-ments may be subject to § 467 and the regulations thereunder relating to the accounting treatment for certain leases with prepaid or deferred rent. In addition, § 1.467–3(c)(4) of the Income Tax Regulations provides an uneven rent test. A lease meeting this uneven rent test will not be treated as a disqualified leaseback or long-term agreement for purposes of § 467. How the lease is treated under § 467, including whether or not the uneven rent test of § 1.467–3(c)(4) is met, will not affect the ability of a taxpayer to obtain an advance ruling under this revenue procedure.

.02 Limited Use Property.

(1) In General. Section 4.01(3) of this revenue procedure requires the lessor to represent and demonstrate certain facts relating to the estimated fair market value and estimated remaining useful life of the property at the end of the lease term. This requirement is intended, in part, to assure that the purported lessor has not transferred the use of the property to the purported lessee for substantially its entire useful life. In the case of such “limited use” property, at the end of the lease term there will probably be no potential lessees or buyers other than members of the Lessee Group. As a result, the lessor of limited use property will probably sell or rent the property to a member of the Lessee Group, thus enabling the Lessee Group to enjoy the benefits of the use or ownership of the property for substantially its entire useful life. See Rev. Rul. 55–541, 1955–2 C.B. 19, for an example of a transaction in which property was determined to be leased for substantially its entire useful life and the conclusion that such a transaction transfers equitable ownership. Accordingly, the Service will not issue advance rulings concerning whether certain transactions purporting to be leases of property are, in fact, leases for federal income tax purposes when the property is limited use property.

(2) Examples. The following examples illustrate the types of property the Service considers to be limited use property, and the types of property the Service does not consider to be limited use property.

(a) X builds a masonry smokestack attached to a masonry warehouse building owned by Y, and leases the smokestack to Y for use as an addition to the heating system of the warehouse. The lease term is 15 years; the smokestack has a useful life of 25 years, and the warehouse has a remaining useful life of 25 years. It would not be commercially feasible to disassemble the smokestack at the end of the lease term and reconstruct it at a new location. The smokestack is considered to be limited use property.

(b) X builds a complete chemical production facility on land owned by Y and leases the facility to Y, a manufacturer of chemicals. The lease term is 24 years, and the facility has a useful life of 30 years. The land is leased to X pursuant to a ground lease for a term of 30 years. The technical “know-how” and trade secrets Y possesses are necessary elements in the commercial operation of the facility. At the time the lease is entered into, no person who is not a member of the lessee group possesses the technical “know-how” and trade secrets necessary for the commercial operation of the facility. The taxpayers submit to the Service the written opinion of a qualified expert stating it is probable that by the expiration of the lease term of the facility third parties who are potential purchasers or lessees of the facility will have independently developed such “know-how” and trade secrets. The facility is considered to be limited use property. In reaching this conclusion, the Service will not take into account such expert opinion because such opinions are too speculative for advance ruling purposes.

(c) The facts are the same as in example (b) except X has an option, exercisable at the end of the lease term of the facility, to purchase from Y the “know-how” and trade secrets necessary for the commercial operation of the facility, and it would be commercially feasible at the end of such lease term for X to exercise the option and operate the facility itself. The facility is not considered to be limited use property.

(d) The facts are the same as in example (b) except it would be commercially feasible for the lessor at the end of the lease term to make certain structural modifications of the facility that would make the facility capable of being used by persons not possessing any special technical “know-how” or trade secrets. Furthermore, if such modifications were made, it would be commercially feasible, at the end...
of the lease term, for a person who is not a member of the lessee group to purchase or lease the facility from X. The facility is not considered to be limited use property.

(e) X builds an electrical generating plant on land owned by Y and leases the plant to Y. The lease term is 40 years, and the plant has an estimated useful life of 50 years. The land is leased to X pursuant to a ground lease for a term of 50 years. The plant is adjacent to a fuel source that it is estimated will last for at least 50 years. Access to this fuel source is necessary for the commercial operation of the plant, and Y has recently obtained the contractual right to acquire all fuel produced from the source for 50 years. Y will use the plant to produce and generate electrical power for sale to a city located 500 miles away. The plant is synchronized into a power grid that makes the sale of electrical power to a number of potential markets feasible. It would not be commercially feasible to disassemble the plant and reconstruct it at a new location. The electrical generating plant is considered to be limited use property because access to the fuel source held exclusively by Y is necessary for the commercial operation of the plant.

(f) The facts are the same as in example (e) except X has an option, exercisable at the end of the lease term of the plant, to acquire from Y the contractual right to acquire all fuel produced from the fuel source for the 10-year period commencing at the end of such lease term. It would be commercially feasible at the end of such lease term for X to exercise this option. Furthermore, it would be commercially feasible at the end of such lease term, for a person who is not a member of the lessee group to purchase the contractual right to the fuel from X for an amount equal to the option price and purchase or lease the plant from X. The plant is not considered to be limited use property.

SECTION 6. EFFECT ON OTHER DOCUMENTS


SECTION 7. EFFECTIVE DATE

This revenue procedure is effective May 7, 2001.

SECTION 8. DRAFTING INFORMATION

The principal author of this revenue procedure is Edward Schwartz of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Mr. Schwartz at (202) 622-4960 (not a toll-free call).

26 CFR 601.201: Rulings and determination letters
(Also Part I, sections 38, 61, 162, 167, 467; 1.61–1, 1.162–1, 1.167(a–1), 1.467–3.)


SECTION 1. PURPOSE

This revenue procedure sets forth the information and representations required to be furnished by taxpayers in requests for advance rulings on leveraged lease transactions within the meaning of Rev. Proc. 2001–28, 2001–19 I.R.B. 1156. Rev. Proc. 2001–28 provides guidelines to be used for advance ruling purposes in determining whether such a transaction is, in fact, a valid lease for federal income tax purposes. The specific terms used in this revenue procedure are defined in Rev. Proc. 2001–28.

SECTION 2. BACKGROUND

.01 The checklist set forth in this revenue procedure is designed to ensure the inclusion and order of presentation of necessary information in the initial ruling request so that the Internal Revenue Service can more promptly and efficiently process the request. However, since the information necessary for the issuance of a ruling with regard to any particular transaction depends upon all the facts and circumstances of that case, information in addition to that outlined in the checklist may be required with respect to that transaction.

.02 In view of the complexity of a typical leveraged lease transaction and the voluminous nature of the related documentation, the Service cannot accept the responsibility for raising or considering issues arising out of such provisions that are not specifically brought to its attention.

SECTION 3. GENERAL REQUIREMENTS

.01 The lessor, the lessee, and any other party with an interest in the leasing transaction for which a specific ruling is requested must join in the ruling request.

.02 The ruling request must include a summary statement of the facts as described in section 8 of Rev. Proc. 2001–1, 2001–1 I.R.B. 1 (or its successor).

.03 In addition to the information and documents required by section 8 of Rev. Proc. 2001–1, the ruling request must include detailed information required by section 4 of this revenue procedure. If the information requested is not applicable to the parties or to the transaction, an express statement to that effect is required. The response to each item of information requested must include a reference to the page number of any relevant document containing the information that supports the response. Furthermore, portions of the relevant documents supporting a particular response should be underscored or otherwise highlighted and cross-referenced to the appropriate subsection of section 4 of this revenue procedure. All parties joining in the request for ruling are jointly responsible for responses to each item of information requested by section 4 of this revenue procedure, with the exception of section 4.02 for which only the lessor is responsible.

.04 The lessor must also submit copies of any offering circular, prospectus, economic analysis, or other document used to induce the lessor’s investment in the leased property (the “Property”). These documents must include an analysis of the projected cash flow to the lessor from the lease transaction including the projected benefits from the tax attributes thereof.

SECTION 4. SPECIFIC INFORMATION REQUIRED

.01 In general

(1) Describe in detail the type and quantity of the Property.

(2) Identify and describe all parties to the leveraged lease transaction, their respective interests in such transaction, and the relationships that exist between or among such parties.

(3) Submit a diagram of the transaction showing (a) the parties to the transaction, (b) the succession of ownership to
the Property, and (c) the source, amounts, and flow of the funds used to acquire the Property (total acquisition cost within the meaning of § 1012 of the Internal Revenue Code).

(4) Indicate whether the Property is to be temporarily or permanently affixed to or installed on or in land, buildings, or other property. If so, indicate who will own such land, buildings, or other property.

(5) Indicate whether the Property is new, reconstructed, used, or rebuilt. (See §§ 1.48–2 and 1.48–3 of the Income Tax Regulations; Rev. Rul. 68–111, 1968–1 C.B. 29; and Rev. Rul. 70–135, 1970–1 C.B. 10.)

(6) Indicate when, where, and how the Property will be, or has been, first placed in service or use.

.02 Minimum Unconditional At Risk Investment

The lessee must:

(1) Indicate the total acquisition cost (within the meaning of § 1012) of the Property.

(2) Indicate when and in what amounts the lessee did or will make its Equity Investment or incur personal liability for such Equity Investment.

(3) Indicate the conditions under which the lessee would be entitled to a return of any portion of its Equity Investment or would be released from any personal liability for such Equity Investment.

(4) Submit a representation of the net worth of the lessee and financial data to support the representation, including, for example, audited balance sheets or unaudited balance sheets with a representation that the latter are prepared in accordance with generally accepted accounting principles.

(5) Submit an analysis demonstrating that the lessee’s Equity Investment will remain equal to at least 20 percent of the cost of the Property at all times throughout the lease term. This analysis must demonstrate that throughout the lease term the items designated as (a), (b), (c), and (d) below solve the formula “(a)–(b) never exceeds (c) + (d).”

(a) The projected cumulative payments required to be paid by the lessee to or for the lessor.

(b) The projected cumulative disbursements required to be paid by or for the lessor in connection with the ownership of the Property, excluding the lessor’s initial Equity Investment, but including any direct costs to finance the Equity Investment.

(c) The excess of the lessor’s initial Equity Investment over 20 percent of the cost of the Property.

(d) A cumulative pro rata portion of the projected profits from the transaction (exclusive of tax benefits). Profit for this purpose is the excess of the sum of (i) the amounts required to be paid by the lessee to or for the lessor over the lease term plus (ii) the value of the residual investment referred to in section 4.01(3) of Rev. Proc. 2001–28, over the aggregate disbursements required to be paid by or for the lessor in connection with the ownership of the Property, including the lessor’s initial Equity Investment and any direct costs to finance the Equity Investment.

(6) Furnish an opinion, from a qualified expert who has professional knowledge of the type of property subject to the lease, regarding:

(a) the fair market value of the Property at the end of the lease term, determined in accordance with section 4.01(3) of Rev. Proc. 2001–28, and the manner in which such fair market value was determined;

(b) the cost to the lessor, if any, of the removal and delivery of possession of the Property to the lessee at the end of the lease term; and

(c) the remaining useful life of the Property at the end of the lease term, and the manner in which such useful life was determined.

.03 Lease Term and Renewal Options

Indicate the period for which the Property will be leased initially, if there are any provisions for the renewal or extension of such period, and, if so, on what terms.

.04 Purchase and Sale Rights

(1) Indicate whether any member of the Lessee Group or any other party has a contractual obligation or right to purchase all or any part of the Property at any time, and, if so, when, under what conditions, and at what price.

(2) Indicate whether the lessee or any other party has a contractual right to cause any party to purchase the Property, and if so, when and under what conditions.

(3) Indicate whether the lessor, a shareholder of the lessor, or a party related to the lessor (within the meaning of § 318), or any other party who has joined in the request for a ruling has any present intention to acquire a contractual right to cause any party to purchase or sell the Property, and, if so, when and under what conditions.

(4) Indicate whether the lessee may abandon the Property to any party at any time, and if so, when, to whom, and under what conditions.

.05 No Investment by Lessee

(1) Indicate whether any member of the Lessee Group may be required to furnish any part of the cost of the Property, and if so, when and under what conditions.

(2) Submit a representation that at the commencement of the term of the lease neither a Nonseverable Improvement, nor a Severable Improvement (other than a Severable Improvement of a kind customarily furnished by purchasers or lessees of property of the kind subject to the lease) is required in order to complete the property for its intended use by the lessee.

(3) If Severable Improvements may be made to the Property, indicate who will own the Severable Improvements and identify the parties who will provide the funds necessary to purchase them.

(4) Indicate whether any Severable Improvement is to be the subject of a contract or option for purchase or sale, and if so, describe the contract or option terms.

(5) If Nonseverable Improvements may be made to the Property, identify the parties who will provide the funds necessary to purchase them.

(6) Indicate whether a member of the Lessee Group may receive compensation, directly or indirectly, for its interest in any Nonseverable Improvement.

(7) Indicate whether the lease states that the addition of any Nonseverable Improvement will not cause the Property to become limited use property.

(8) Indicate whether a member of the Lessee Group may provide the cost of a Nonseverable Improvement that is not described in one of the subparagraphs of section 4.04(3)(a) of Rev. Proc. 2001–28.
(9) Indicate whether the lease (or any document or other agreement) requires a member of the Lessee Group either to make a specific Nonseverable Improvement, or to make Nonseverable Improvements of a specific value or minimum value.

(10) Indicate whether the transaction contains any cost overrun provisions, who must pay the cost overrun, and whether the lease provides for an adjustment to rents to compensate the lessee for any additional cost incurred because of cost overruns.

(11) If a member of the Lessee Group may furnish amounts to pay for the cost of a Nonseverable Improvement, indicate which subparagraph of section 4.04(3)(a) of Rev. Proc. 2001–28 describes the Nonseverable Improvement.

.06 No Lessee Loans or Guarantees

(1) Indicate whether any member of the Lessee Group will guarantee an indebtedness incurred in connection with the acquisition of the Property by the lessee and, if so, under what terms and conditions.

(2) Indicate whether any member of the Lessee Group directly or indirectly made or will make any other guarantees as a part or result of the lease transaction. If so, describe such guarantees.

.07 Profit Requirement

(1) Submit an analysis demonstrating that the lessor will receive a profit from the transaction exclusive of benefits from the tax attributes thereof. This analysis should demonstrate that the items identified as (a), (b), and (c) below will solve the formula “(a) + (b) exceed (c).”

(a) The projected aggregate payments required to be paid by the lessee to or for the lessor over the lease term.

(b) The value of the residual investment described in section 4.01(3) of Rev. Proc. 2001–28.

(c) The projected sum of the aggregate disbursements required to be paid by or for the lessor in connection with the ownership of the Property, including the lessor’s initial Equity Investment, and any direct costs to finance the Equity Investment.

(2) Submit an analysis demonstrating that the lessor will have a projected positive cash flow from the lease transaction. This analysis must contain the following information in order to demonstrate that the items identified as (a) and (b) will solve the formula “(a) exceeds (b) by a reasonable minimum amount.”

(a) The projected aggregate payments required to be paid by the lessee to or for the lessor over the lease term.

(b) The projected aggregate disbursements required to be paid by or for the lessor in connection with the ownership of the Property, excluding the lessor’s initial Equity Investment, but including any direct costs to finance the Equity Investment.

.08 Other Considerations: Limited Use Property

(1) Indicate whether the Property is expected to be useful or usable by the lessor at the end of the lease term and capable of continued leasing or transfer to any party. If such a representation is made, demonstrate its commercial feasibility.

(2) Indicate whether the Property would be useful or usable at the end of the lease term by a party other than a member of the Lessee Group, and if so, describe such use.

(3) Indicate whether the Property needs to be dismantled, disconnected, or removed from any site on which it was placed or installed in order for possession thereof to be returned to the lessor at the end of the lease term. If so:

(a) Indicate whether and how such dismantling, disconnection, or removal will affect the value of the Property for the purpose for which it was originally intended to be used, and

(b) Demonstrate the commercial feasibility of reassembling, reconnecting, or installing the Property at another location.

.09 Other

(1) Set forth the details of the repayment of the portion of the total acquisition cost borrowed by the lessor (debt service), including an analysis of the anticipated repayment of principal and interest on such debt by the lessor.

(2) List and explain all provisions of the lease transaction relating to indemnities, termination, obsolescence, casualty, stipulated casualty value, and insurance.

(3) State that if the Service rules that the lessor is the owner of the Property for federal income tax purposes at the time that the Property is first placed in service or use, the lessee will not claim that it is such an owner at such time.

SECTION 5. OTHER INSTRUCTIONS

Documents that have been submitted with the request for an advance ruling may, as indicated below, be amended by the parties, prior to the date on which the Property is first placed in service or use. A complete explanation of the changes must be submitted together with specific references to both the original and amended documents. If, as a result of the amended documents, the responses required by section 4 of this revenue procedure are modified, the revised responses must be brought to the attention of the Service in such a fashion as to be readily understandable. In situations where the transaction is materially revised by the amendments, the original request for advance ruling, together with all submissions including the amended documents, will be considered by the Service to be a new request for advance ruling received on the date that it receives the amended documents. The Service ordinarily will not rule on the consequences of a proposed amendment that purports to relate back to the time when the Property was first placed in service, or purports to affect the issue of the ownership of the Property at that time.

SECTION 6. EFFECT ON OTHER DOCUMENTS


SECTION 7. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget (OMB) in accordance with the Paperwork Reduction Act (44 U.S.C. § 3507) under control number 1545–1738.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

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2001–19 I.R.B.
The collection of information is contained in section 4 of this revenue procedure. This information is required to establish the economic substance of the transaction and its bona fides as a true lease. The likely respondents are individual taxpayers and corporations.

The estimated total annual burden is 800 hours.

The estimated annual burden per respondent will vary from 60 hours to 100 hours, depending on individual circumstances, with an estimated average of 80 hours. The estimated number of respondents is 10.

The estimated annual frequency of responses is on occasion.

Books and records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and return information are confidential, as required by § 6103.

SECTION 8. EFFECTIVE DATE

This revenue procedure is effective May 7, 2001.

SECTION 9. DRAFTING INFORMATION

The principal author of this revenue procedure is Edward Schwartz of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Mr. Schwartz at (202) 622-4960 (not a toll-free call).

26 CFR 601.201: Rulings and determination letters.
(Also Part 1, § 29.)


SECTION 1. PURPOSE

This revenue procedure informs the public of the Internal Revenue Service’s decision to issue private letter rulings regarding whether a solid fuel produced from coal is a qualified fuel under § 29(c)(1)(C) of the Internal Revenue Code under the circumstances described in section 3 of this revenue procedure.

SECTION 2. BACKGROUND

Section 2.01 of Rev. Proc. 2001–3, 2001–1 I.R.B. 111, provides that whenever appropriate in the interest of sound tax administration, it is the policy of the Service to answer inquiries of individuals and organizations regarding their status for tax purposes and the tax effects of their acts or transactions, prior to the filing of returns or reports that are required by the revenue laws. There are, however, certain areas in which, because of the inherently factual nature of the problems involved, or for other reasons, the Service will not issue rulings or determination letters.

Section 4 of Rev. Proc. 2001–3 sets forth those areas in which rulings or determination letters will not ordinarily be issued. “Not ordinarily” means that unique and compelling reasons must be demonstrated to justify the issuance of a ruling or determination letter. Section 2.01 of Rev. Proc. 2001–3.

Section 4.02(1) of Rev. Proc. 2001–3 provides that the Service will not ordinarily issue rulings or determination letters regarding any matter in which the determination requested is primarily one of fact, for example, market value of property, or whether an interest in a corporation is to be treated as stock or indebtedness.

Section 5 of Rev. Proc. 2001–3 sets forth those areas under extensive study in which rulings or determination letters will not be issued until the Service resolves the issue through publication of a revenue ruling, revenue procedure, regulations, or otherwise.

Section 5.01 of Rev. Proc. 2001–3 provides that the Service will not issue rulings or determination letters on whether a solid fuel other than coke or a fuel produced from waste coal is a qualified fuel under § 29(c)(1)(C). Waste coal for this purpose is limited to waste coal fines from normal mining and crushing operations and does not include fines produced (for example, by crushing run-of-mine coal) for the purpose of claiming the credit.

Section 5.01 of Rev. Proc. 2001–3 supersedes Rev. Proc. 2000–47, 2000–46 I.R.B. 482. Rev. Proc. 2000–47 was published because concern had been raised that taxpayers were claiming the § 29 credit for processing coal in ways that may not have been intended by the Congress. Rev. Proc. 2000–47 requested comments concerning the standard to be applied in determining whether fuel produced from coal is a solid synthetic fuel. The Service received extensive comments.

Section 29 provides a credit against income tax for the production and sale of “qualified fuels” produced from a non-conventional source. Section 29(c)(1)(C) provides that qualified fuels include liquid, gaseous, or solid synthetic fuels produced from coal (including lignite).

Rev. Rul. 86–100, 1986–2 C.B. 3, adopts for purposes of § 29(c)(1)(C) the definition of synthetic fuel in § 1.48–9(c)(5) of the Income Tax Regulations. Section 1.48–9(c)(5)(ii) provides that, to be “synthetic,” a fuel must differ significantly in chemical composition, as opposed to physical composition, from the substance used to produce it. Rev. Rul. 86–100 describes favorably processes such as gasification, liquefaction, and production of solvent refined coal that result in substantial chemical changes to the entire coal feedstock rather than changes that affect only the surface of the coal.

Section 29(f) provides that § 29 applies to qualified fuels that are produced in a facility placed in service after December 31, 1979, and before January 1, 1993, and that are sold before January 1, 2003. Section 29(g)(1)(A) provides that a facility for producing qualified fuels described in § 29(c)(1)(C) is treated for this purpose as being placed in service before January 1, 1993, if the facility is placed in service before July 1, 1998, pursuant to a binding written contract in effect before January 1, 1997. For a facility that meets this condition and is originally placed in service after December 31, 1992, § 29(g)(1)(B) provides that the § 29 credit applies to qualified fuels that are sold before January 1, 2008.

Property is “placed in service” in the taxable year the property is placed in a condition or state of readiness and availability for a specifically assigned function. See, for example, § 1.167(a)–11(e)(1)(i). Thus, the § 29 credit is not allowed for fuel produced in a facility that was originally placed in service for a function other than producing qualified fuel under § 29(c)(1)(C) and was not con-
Lease Accounting Classifications

From: Business Leasing For Dummies

By: David G. Mayer

Wiley Publishing, Inc.