

## **Proposal for Guidance Concerning the Application of Economic Substance to Transactions Using Investment Tax Incentives**

### **Introduction**

This proposal is for guidance to clarify application of the recently codified economic substance doctrine to investments in assets entitled to Congressionally approved tax benefits, often made through lease and partnership structures. Over the years, Congress has enacted numerous tax incentives<sup>1</sup> to encourage investment in various categories of property and activities (“Investment Tax Incentives”). Examples include accelerated depreciation,<sup>2</sup> bonus depreciation,<sup>3</sup> current deductions (e.g. film production),<sup>4</sup> production tax credits,<sup>5</sup> investment tax credits<sup>6</sup> and cash grants for renewable energy investment.<sup>7</sup> The level of economic substance historically required to entitle an investor to these Investment Tax Incentives, often reflected in requirements for a minimum equity investment, residual interest and required levels of pre-tax profit, generally have been understood and recognized by the government and the investment community. With respect to investments through leasing and similar structures, many of these accepted standards have been reflected in case law and longstanding guidance promulgated by the Internal Revenue Service, including specifically guidance on required levels of profit and pre-tax cash. In the marketplace, partnership structures to finance assets entitled to Investment Tax Incentives have often applied the pre-tax profit standards of the Leveraged Leasing Guidelines<sup>8</sup> and have also

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<sup>1</sup> Unless otherwise noted, section references are to the Internal Revenue Code of 1986, as amended, or the Treasury regulations promulgated thereunder.

<sup>2</sup> § 168.

<sup>3</sup> § 168(k).

<sup>4</sup> § 181.

<sup>5</sup> § 45.

<sup>6</sup> § 48.

<sup>7</sup> See § 48(d).

<sup>8</sup> See Rev. Proc. 2001-28, 2001-1 C.B. 1156, *modifying and superseding* Rev. Proc. 75-21, 1975-1 C.B. 715 (*which was modified by* Rev. Proc. 81-71, 1981-1 C.B. 496), Rev. Proc. 76-30, 1976-2 C.B. 647, and Rev. Proc. 79-48, 1979-1 C.B. 434. See also See Rev. Proc. 2001-29, 2001-19 C.B. 1160, for the required information and

benefited from general guidance found in the partnership Treasury Regulations<sup>9</sup> and in specific guidance relating to wind energy “flip” partnership structures.<sup>10</sup>

The Joint Committee on Taxation’s Technical Explanation<sup>11</sup> of Section 7701(o) (“Joint Committee Explanation”) indicates that the codification of economic substance is not intended to change the requirements for financing assets for which Congress enacted Investment Tax Incentives. Given the lack of clarity on this issue in the statutory language and the severe strict liability penalties for failure to satisfy these rules, we urge the Treasury Department to promptly issue the guidance described below, which reflects established Internal Revenue Service guidelines on profit and cashflow and established market practices. We believe this guidance can take the form of a Notice or Announcement.

## **I. Leasing – General Rule**

For purposes of Section 7701(o)(1) the economic substance doctrine will not be treated as relevant to a lease of property entitled to one or more Congressionally approved investment tax incentives<sup>12</sup> (“Investment Tax Incentive”) if the transaction (i) is otherwise a true lease of such property for federal income tax purposes based upon the standards established in case law and Internal Revenue Service guidance as applied to all of the facts and circumstances of the transaction, and (ii) satisfies the Profit and Positive Cash Flow requirements of Section 4.06 of Rev. Proc. 2001-28.<sup>13</sup>

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representations necessary for advance rulings on leverage lease transactions qualifying under Rev. Proc. 2001-28, 2001-1 C.B. 1156.

<sup>9</sup> Treas. Reg. §§ 1.701-1 to -2.

<sup>10</sup> See Rev. Proc. 2007-65, 2007-2 C.B. 967, as revised by Ann. 2009-69, 2009-40 I.R.B. 475.

<sup>11</sup> J. Comm. on Taxation, 111<sup>th</sup> Cong., *Technical Explanation of the Revenue Provisions of the “Reconciliation Act of 2010,” as Amended, in Combination with the “Patient Protection and Affordable Care Act,”* at 152-151 (Comm. Print 2010).

<sup>12</sup> Congressionally approved investment tax incentives are tax incentives or benefits enacted to encourage investment in various categories of property and activities. Examples include accelerated depreciation, bonus depreciation, current deductions (e.g. film production), production tax credits, investment tax credits, cash grants and subsidies.

<sup>13</sup> 2001-1 C.B. 1156. These tests would be applied in accordance with Section 4.07 of Rev. Proc. 2001-29, 2001-1 C.B. 1160.

A. Leasing of Investment Tax Credit or Subsidized Property.

In evaluating application of the leasing general rule set forth above to a leasing transaction that includes property entitled to a tax credit, subsidy or grant that is based on the amount invested in such property (“Investment Tax Credit or Direct Subsidy”), satisfaction of the Profit and Positive Cash Flow requirements of Section 4.06 of Rev. Proc. 2001-28<sup>14</sup> will be measured against an investor’s investment in the leased property after reduction by the amount of such Investment Tax Credit or Direct Subsidy.

**II. Direct Investment and Partnership Transactions - General Rule**

For purposes of Section 7701(o)(1) the economic substance doctrine will not be treated as relevant to a transaction to finance property or activities entitled to one or more Investment Tax Incentives directly (including through a disregarded entity) or through an entity that is treated as a partnership for federal income tax purposes if such transaction satisfies (i) all otherwise applicable rules of Subchapter K, (ii) all otherwise applicable rules governing ownership of property for federal income tax purposes, and (iii) as to each investor or partner receiving an Investment Tax Incentive or distributive share thereof, the Profit and Positive Cash Flow requirements of Section 4.06 of Rev. Proc. 2001-28<sup>15</sup> (to the same extent that would have been required if the transaction were a lease).

A. Investment Tax Credit or Subsidized Property Transactions.

The Joint Committee Explanation indicates that codification of economic substance was not intended to disallow an Investment Tax Credit or Subsidy.<sup>16</sup> Accordingly, we recommend that the guidance simply provide that Section 7701(o)(1) is not relevant to a transaction to finance property or activities entitled to an Investment Tax Credit or Subsidy.

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<sup>14</sup> *Id.*

<sup>15</sup> *Id.*

<sup>16</sup> J. Comm. on Taxation, 111<sup>th</sup> Cong., *supra* note 11, at 152 n.344.

Thus, for example it is not intended that a tax credit (e.g., section 42 (low-income housing credit), section 45 (production tax credit), section 45D (new markets tax credit), section 47 (rehabilitation credit), section 48 (energy credit), etc.) be disallowed in a transaction pursuant to which, in form and substance, a taxpayer makes the type of investment or undertakes the type of activity that the credit was intended to encourage.

Alternatively, in evaluating application of the general rule for direct investments and partnership transactions described above to transactions that finance property entitled to an Investment Tax Credit or Subsidy, satisfaction of the Profit and Positive Cash Flow requirements of Section 4.06 of Rev. Proc. 2001-28<sup>17</sup> by each investor or partner, as the case may be, receiving an Investment Tax Incentive or distributive share thereof will be measured against such investor or partner's initial investment reduced by any Investment Tax Credit or Subsidy or distributive share thereof received by or allocated to such investor or partner.

**B. Partnership Realizing Production Tax Credits.**

We recommend that the guidance provide that Section 7701(o)(1) is not relevant to a transaction to finance property or activities entitled to a production tax credit (e.g. Section 45) that satisfies the requirements of Rev. Proc. 2007-65.<sup>18</sup>

Alternatively, in evaluating application of the general rule for direct investment and partnership transactions described above to transactions that finance property entitled to a production tax credit (e.g., Section 45), the amount of such credit or distributive share thereof received by or allocated to an investor or partner shall be treated as cash received by such investor or partner for determining satisfaction of the Profit and Positive Cash Flow requirements of Section 4.06 of Rev. Proc. 2001-28.<sup>19</sup>

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<sup>17</sup> 2001-1 C.B. 1156.

<sup>18</sup> 2007-2 C.B. 967, *as revised by* Ann. 2009-69, 2009-40 I.R.B. 475.

<sup>19</sup> 2001-1 C.B. 1156.