Federal Taxation Workshop
Taxation of Leases, Loans & Services Contracts
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Objectives

• To understand the federal tax guidance which determines whether a transaction will be treated as a lease, a loan or a service contract for tax purposes

• To understand other specific federal income tax rules that affect transactions
  – Revenue Procedure 2001 – 28/29 Leasing
  – IRC 7701(e) Service Contract rules
  – IRC Section 467 level rent rules
  – IRC Section 1031 like-kind exchange rules

• Tax Accounting
  – How to account for taxes under US GAAP
Understanding Taxation of Leases
Lease vs Loan

• Tax treatment of a lease versus a loan

• Understanding Tax Benefits

• IRS Guidelines & Tax Lease Issues

• Level rent rules

• Quick Reference Chart
Tax Treatment of a Lease versus Loan

- For **accounting purposes**, leases are currently characterized either as operating leases or financings (direct finance leases) under ASC 840 (“Leases”) (previously FAS 13 (U.S.) or IASB 17 (International))
  - Operating lease – fixed asset / rental revenue / depreciation
  - Direct finance lease – finance income
- For **tax purposes**, a lease is characterized as either a “true (tax) lease” or as a financing
  - Book mostly follows tax; operating lease = true lease; direct finance lease = loan
  - Under a tax lease the lessor is considered the owner of the asset for **income tax purposes**
  - Legal title sometimes resides with the lessee while the lessor has tax ownership or vice versa
- As asset owner, on its tax return the lessor includes:
  - Tax depreciation (usually MACRS, bonus depreciation if applicable)
  - Rental income (subject to tax reporting guidance for level rents)
  - Interest expense deductions (if the transaction is leveraged with debt)
  - Residual income on disposition of the asset (sales value less tax basis)

If a lease fails the guidance for tax lease characterization, the IRS can re-characterize the lease as a loan, thus changing the economics of the transaction
The tax characterization of a lease financing transaction is dependent on multiple factors including:

Who bears the substantial risks and rewards of ownership of the asset (lessor - tax lease, lessee - loan)

Form of documentation; is it documented as a loan or lease? (a loan usually includes a stated interest rate)

The nature of the asset; can the asset realistically be used by another user?

The facts and circumstance of the deal and terms and conditions of the transaction:

• Is legal title held by the lessor?
• Does legal title automatically transfer to the lessee at any time?
• Does the lessee have any rights to the residual value of the asset?
• Does the lessor assume substantially all of the risks and rewards of ownership of the asset?
• Can the lessee implicitly claim a right in the asset because they contributed towards its initial purchase?
• Is the lessee guaranteeing any of the future value of the residual value?
• Can the lessee buy the asset from the lessor for a value which is substantially less than the fair market value of the asset at that time?
• Is the lease of such a long term that the asset has only a trivial future economic useful life or residual value?
Timing differences

• Accelerated Depreciation is a major tax benefit; usually DDB using a half year first year convention regardless of in-service date
  • MACRS provides for accelerated tax depreciation; Asset written off for taxes over a much shorter term than their useful life
    • MRIs/ CTs – 5 yr MACRS vs 8-9 years EUL
    • Rail cars – 7 yr MACRS vs 30 years EUL
    • Corporate aircraft – 5 yr MACRS vs 25-30 years EUL
    • Construction equipment – 5 yr MACRS vs 12 years EUL
  • Bonus (accelerated) depreciation (currently 50%)
    • 50% x basis + MACRS x adjusted basis (basis – bonus to be claimed); 60% for 5 year MACRS assets!
    • Phasing out; down to 40% in 2018 and 30% in 2019
  • Qualified Technological equipment (including high tech Medical assets such as MRIs and CTs)
    • MACRS even when lessee is tax-exempt provided lease is 60 mos or less
• Rent is only taxed based on contract structure; thus a lease starting Dec 31 only reports 1 day of rent expense
  • Rent holidays available – 3 months at beginning of lease
  • Low – high rent structures
    • Rents must be between 90% and 110% of the average rents during the lease
    • Amounts that fall outside the 90%- 110% window can be subject to Sec 467 “rent leveling” rules
• Like-kind exchange (deferral of end-of-lease gain into basis of new asset)
• Deferral of gross profit on sales - Manufacturer-lessors have the additional benefit of tax deferral of the sales profit; if the lease is a tax lease, profit on initial sale is not recognized for taxes however is taken in over the lease term because rents are based on the retail price of the asset
Understanding Tax Benefits

**Permanent differences**
- 30% investment tax credits for certain alternative energy projects; phasing out through 2019
  - Based on start of construction date
  - Solar, Wind, Biomass, Qualified fuel cell, Geothermal
- Production Tax Credits
  - Wind energy credit based on a rate x kilowatt hours of electricity produced for 10 years
  - Phasing out through 2019 also based on start of construction
- Tax exempt interest income
  - Interest income is non-taxable but interest expense used to fund the loan is deductible
- State income taxes increase tax deferral rate; the more one can defer paying taxes, the better the economic benefit (and lower the rate that can be charged)

**Limitations & Adjustment**
- Maximum tax benefit items (bonus depreciation and tax credits) may only be available to the initial owner/lessor (or if acquired within 90 days from original owner under special leasing sale-leaseback rules)
- Tax basis of asset is adjusted for ½ of ITCs claimed
IRS Guidelines and Tax Lease Issues
Internal Revenue Service Guidances

• The IRS has not issued any Revenue Procedures (Rev. Proc’s) specifically pertaining to single-investor leases (without non-recourse third-party debt), however has issued strict guidance pertaining to tax-leveraged leases (leveraged with third-party non-recourse debt)

• Rev. Proc. 2001-28 and 2001-29 superseded Rev. Proc. 75-21 (which superseded Revenue Ruling 55-540) and established guidance which is used by the leasing industry as a “safe-harbor” for single-investor leases (non-tax leveraged leases) in the leasing industry

• Case law has driven several industry approaches and some latitude is available, but Rev. Proc. 2001-28/29 still represents the “gold standard” to avoid IRS challenges to tax lease characterization

• Recent tax shelter cases – LILO/SILO leases might allow IRS to narrow true lease definition where purchase option is expected to be exercised

• Additional interpretations affect how net income is taxed (Sec 467 level rents) or whether specific exceptions are available (Sec 7701(h) TRAC leases or 7701(e) service contracts)

• The basis of Rev. Proc 2001 – 28 guidance, plus specific case law and industry practice still suggest that the lessor must be able to demonstrate that they retain the majority of the risks and rewards of owning the asset and that the transaction is not simply a “disguised” financing of the “sale” of tax benefits
In Revenue Procedures 2001-28/29, the IRS stated that to be respected as a tax lease, at inception a lease must adhere to the following guidelines:

- The asset being leased cannot be “limited as to its use” only by the lessee
- The lessee cannot furnish any part of the cost of the property or improvements or additions (unless such items can be readily removed without causing material damage)
- The lessor must maintain a minimum unconditional “at risk” investment (the residual value) in the property at all times throughout the entire lease term
- The lease term, including all the renewal and extension periods expected to be exercised (bargain renewals), must not be greater than 80% of the asset’s economic useful life
- The lessee must not have a contractual right to buy the asset at a price which is less than its fair market value at the time of exercise
- The lessee may not lend any of the funds necessary to acquire the property
- The lessor must expect to receive a profit apart from the value of or benefits derived from tax deductions

NOTE – These rules appear very similar to the US lease accounting rules!
Limited Use Test

**The asset cannot be “limited as to its use” only by the lessee**

Examples of generic assets usable by other than the original user:
- Railcar
- Trucks, tractor trailers
- Corporate Aircraft
- MRI
- CT Scan machine

Examples of potential limited use property:
- Water treatment facility permanently installed and usable only by the lessee
- Equipment usable only by the lessee either in actuality (e.g. single use satellite, specific scientific research equipment) or by agreement (lessee remarketing restrictions)

Rollover charges, termination fees, extended maintenance contract costs and software licenses do not represent depreciable assets or expenses; the amount financed is considered a loan for tax purposes.
Leasable or Not?
Lessee Investment test

The lessee has not furnished any part of the cost of the property or improvements or additions (unless such items can be readily removed without causing material damage) or made an investment in the asset

The issue is whether the lessee has a legal interest in the asset because of their investment in the asset OR creates a “preponderance to exercise a buyout” (economic compulsion) to acquire the asset because of this investment

Examples of lessee furnishing part of the cost of the asset:
- Lessee makes a down payment on the asset and finances the balance via a lease (10% guideline)
- Lessee trades in another asset and receives a credit against the purchase price of the new asset (10% guideline)
- Lessee puts up so much money in the form of either security deposits or advance rents that a preponderance towards ownership is created which also minimizes the lessor’s risk (total of 20%)
- Lessee sells the asset to the lessor for less than the asset’s fair market value (by assigning their purchase option from an existing lease to the lessor)

Result of lessee making an investment in the asset:
- Lease may be recharacterized by the IRS as a loan or
- Lessor is forced to record the down payment/trade-in as a first payment (also see Sec 467)
Lessor at-risk test

**At all times the lessor has an initial and ongoing minimum “at risk” investment in the asset**

The unguaranteed residual value is considered the “at risk” investment
- “at risk” investment is measured using the appraised future retail residual value of the asset
- the orderly liquidation value of the asset which is used for pricing, can be less than the appraised retail value
- the residual value cannot be guaranteed by the lessee (7701(h) TRAC lease exception)

The future return on the investment should not be capped as a result of purchase options which are less than the projected fair market value of the asset or it would be likely the lessee would simply exercise their purchase option to acquire the asset

**Preferred**
Even if the lease is priced using a 10% residual value while the projected residual value is 20%, the lease should have a FMV purchase option or a cap equal to or greater than 20%

**Not preferred**
- Lease is priced using a 10% residual value and lessee has a 15% capped purchase option; lessor rewards are thus limited to the 15%
- Lessee has a 20% capped purchase option while the stipulated loss value indicates a 25% value at the same time; purchase option appears to be a bargain
- Lessee is guaranteeing the first loss on the residual value; i.e. the first 15% of a 30% residual value
TRAC lease exception

**Terminal Rent Adjustment Clause (TRAC) lease “at risk” exception**

Special provision under Sec 7701(h) of the Internal Revenue Code
The lease must otherwise pass the tax lease test (minimum at risk rule, etc.);

Applicable for qualified motor vehicles, generally subject to registration and licensing, including:
- Automobiles
- Trucks, Tractors (Class 8 tractor/trailers), Trailers
- Utility trucks (with buckets)
- Certain farm vehicles subject to licensing/registration
- Certain construction vehicles subject to registration which can driven on roads
- Certain transportable mobile medical vehicles

Total cost of the asset including components;
- Additions such as bucket lifts or reefer units are included as part of the leasable asset

Lessor must pledge unrelated property or be personally liable for all of the debt used to acquire the property subject to the TRAC lease; lessors cannot leverage the investment with non-recourse debt

Lease should contain an affirmative statement making the Section 7701(h) election that the lessor is the owner of the asset for tax purposes
- Vehicle can be titled and registered in lessee’s name while the lessor claims tax benefits
The lease term, including all renewals and extensions expected to be exercised (bargain renewals) must not be greater than 80% of the economic useful life of the asset.

Lease term is consistent with the minimum at risk investment guideline.

Economic useful life is generally defined as the life during which the asset is used for its original intended purposes.

- A ship cannot be considered to have a 100 year economic useful life because it can be used as a reef after its use as a ship.

Certain assets’ economic useful lives may be affected by governing agencies.

- Some rail cars or locomotives have lives limited by the Surface Transportation Board.
- Aircraft have lives subject to Federal Aviation Authority maintenance rules.

Certain assets’ economic useful lives may be affected by other factors:

- Satellites have a 12 – 15 year economic useful life because of their power sources.
The lessee cannot have a contractual right to buy the asset at a price which is less than its fair market value

Fixed price purchase options (FPPOs) (including early Buyout Options (EBOs)) may contractually be offered, provided:

They are at an amount reasonably projected to be at least equal to the fair market value of the asset at the time of exercise

The FPPO should be greater than the “stipulated loss value” at that time or else the IRS may question whether the FPPO is a bargain

No more than 2 FPPOs should be provided; industry practice believes that the IRS will conclude that the lessee has too many opportunities to acquire the asset

FPPOs should not be offered within the first 12 -18 months of the lease, otherwise the IRS may believe the asset was held for a nominal period to “borrow” tax benefits

Best practices

FPPOs should be priced above an SLV curve or a FMV curve at all times
If a separate appraisal is available, the FPPO price should be based on the retail value curve
Comparison of FMV versus Net Investment

- Investment higher than FMV
- PO must be at FMV to retain tax treatment
- 20% Value for IRS test
- Pricing RV

Optimum PO point
Renewals should be at fair market value (not a bargain) or they will act to extend the lease term and stress the minimum investment requirement

Leasing industry tax attorneys will require that appraisers test to determine that a bargain renewal does not exist; i.e. that the present value of the total of the fixed price renewals plus the projected residual value at the end of the renewal period is less than the projected original residual value

Example
- Projected residual value at month 72 = $5.0 million
- Present value of 2 year fixed price renewal = $3.0
- Present value of residual at 96 months = $1.5
- Present value of renewal assumptions = $4.5 million
- Conclusion – appears to be a bargain

The lease must generate a profit exclusive of the tax benefits

Total of rents plus expected residual value (or capped buyout or FPPO) is greater than the equipment cost plus expenses incurred

The lessee does not have rights to share in the upside of the residual value

Lessee sharing in profits could be construed to form a de facto partnership and taint the true lease characterization
Examples of Acceptable Tax Lease Structures

• Fair market value purchase options (determined at the end of the lease)

• Fixed price purchase option (FPPO) which is fixed at the beginning of the lease and set at the projected future fair value of the asset (at least 20%)

• Early Buyout Option (“EBO”) during the base term, provided that the purchase option is set at the projected fair market value at that time

• Capped purchase option (not to exceed XX%), provided that the cap is at least equal to the projected fair market value and at least 20%

• Early-termination option while guaranteeing the sales price of the asset by way of a cancellation/termination payment (lessee may terminate lease early by paying a penalty)

• Guarantee by lessee of a portion of the residual value provided that the lessor has the majority of the risks subject to the 20% rule (subject to F&C interpretation)

• Lease priced using a lower residual value but where the projected residual value is 20%

• Guarantee by lessee of 100% of the residual value provided the lease is a Terminal Rent Adjustment Clause (“TRAC”) lease of a registered vehicle, subject to IRC Sec. 7701(h) rules
Examples of terms and conditions which will characterize a lease as a loan

- Bargain Purchase options
  
  Price set at less than retail fair market value / 5% is often used
  
  $1 buyout
  
  $101 buyout
  
  Capped buyout set below fair market value (i.e. capped at 12%)

- Conditional sales agreements; automatic title transfers

- Lessor put options – lessor can contractually force the lessee to buy the asset

- Lessee requirements to find replacement lessee – if lessee cannot find replacement lessee, then the lease remains in place

- The asset is a limited-use asset (i.e. specialized asset or software license) which can only be used by that lessee
Examples of terms and conditions which may characterize a lease as a loan

- Lessee guarantees a material portion of the first loss on residual value
  - At an amount greater than the lessor’s at risk amount; likely characterized as a loan
    - Lessee guarantees first 40% of a 60% residual (forecasted FMV)
  - At an amount less than the lessor’s at risk amount; it depends on facts & circumstances; guarantee may simply be treated as a final lease payment
    - Lessee guarantees first 10% of a 60% residual (forecasted FMV); may simply be considered the final payment

- Lessee has multiple early buyout options or combinations of rights to buy the asset

- Lessee has an economic compulsion to buy the asset because it is dependent on the asset for a particular contract and the asset cannot easily be replaced by another
How will ASC 842 affect tax leases?

- May drive shorter term leases so that lessee’s capitalize less; lessors may have to assume a higher residual risk
- May drive more leases with fixed price renewal options
- May drive various forms of residual value guarantees whereby the lessee may agreement to provide limited guarantees of residual values so that a shorter lease can be written while removing some of the risk from the lessor
  - Example – Lease aircraft for 5 years to a 75% residual value
  - Lessee guarantees the first 25% of the 75% residual
  - Lessee capitalizes only the portion of the guarantee they believe they will have to pay; possibly zero
  - Lessor must determine whether the 25% lessee first loss invalidates the lease as a true tax lease under Rev Proc 2001-28
    - Lessor still has a 50% residual value risk
    - Lessor still has the greater share of the risk associated with the asset
  - Does the first loss risk have to be included in the rental stream during the lease term when measuring uneven rents?
Taxable Revenue and Depreciation Fundamentals
Rental income or finance income from a lease may be taxable or non-taxable

**Characterization** of the income is dependent on the tax characterization of the lease

- Tax lease – rental income
- Loan for tax purposes – finance income

**Taxable transactions**

- **Rental income** from leases to all corporations, not-for-profit entities (501c3), municipalities, state and local governments and agencies is generally taxable

- Depreciation deductions for corporations usually follows MACRS but may be limited to straight-line if the lessee is a Sec 501(c)(3) tax exempt entity (Qualified Technological Equipment 5-year lease exception) or if the asset is located outside of US

**Tax Exempt**

- **Finance income** from a state or local government or agency, municipality or federal government agency is generally tax exempt if proper evidence is provided

- Finance income from a not-for-profit entity that has been processed using a “conduit” such as a State Dormitory Agency

- Lessee provides an IRS Form 8038 or 8038g and a bond counsel’s opinion

- No depreciation deduction is available because the transaction is a financing for tax
Depreciation method (Modified Accelerated Cost Recovery System (MACRS) vs Alternative Depreciation System (ADS)) and life/schedule depends on:

- **Type of equipment**
  - MRI, Aircraft, Vessel, Manufacturing Equipment, Truck

- **Use of the equipment by lessee**
  - If used as part of a manufacturing process, will be depreciated based on the method followed for that process

- **When installed**
  - Bonus depreciation phases down through 12/31/19; 40% in 2018; 30% in 2019

- **Location of the equipment**
  - US versus non-US

- **Nature of Lessee**
  - Taxpayer versus non-taxpayer (taxable, foreign lessee, tax-exempt)

Depreciation amount that can be deducted over the asset life (asset tax basis)
- Also dependent on other credits (alternative energy ITC reduces basis by half)

General – If the lessee cannot deduct depreciation, the lessor will be required to use a depreciation method that is slower than MACRS i.e. MACRS / ADS (SL)
Tax Benefits – Qualitative Aspects

- Items affecting the **timing** of tax benefits
  - If the lessee is a Tax Exempt entity, they cannot use the tax depreciation, so the IRC limits the lessee to claiming **ADS** depreciation
    - ADS for leases to tax exempts is the **longer** of the (i) class life or (ii) 125% of the lease term
  - “Tax exempt” generally includes:
    - Federal, state and local government (including agencies and instrumentalities), 501(c)(3) companies and most foreign entities
    - Not for Profit does not mean Tax Exempt! Check IRS tax exempt website to verify
  - Exceptions
    - If the lease **term** (including options to renew) is three-years or less
    - If the leased asset is Qualified Technological Equipment (QTE) and the lease term is five-years or less and the lessee is NOT the federal government and is not subject to a sale-leaseback (unless completed within 3 months of the initial acquisition of the asset by the lessee), the lessor can claim MACRS accelerated depreciation
    - If the QTE lease term exceeds five years, ADS depreciation is claimed with a 5-year recovery period
    - Medical equipment (MRIs, CT Scans, etc) is generally considered to be Qualified Technological Equipment
PATH Act
Protecting Americans from Tax Hikes
Passed Dec 31, 2015
Tax Extenders
Bonus Depreciation

Bonus depreciation
Based on placed in service date
• 50% bonus depreciation retroactive from 1/1/15 to 12/31/17
• 40% bonus depreciation from 1/1/18 - 12/31/18
• 30% bonus depreciation from 1/1/19 - 12/31/19
• Special rules for long production period assets (over 1 year to build & costing over $1 million)

Calculated as follows:
• Bonus percentage x Asset Basis
• Plus standard MACRS x (Asset Basis – bonus depreciation claimed)
• i.e. 5 yr MACRS asset using ½ convention and 40% bonus
  – Bonus depreciation = 40.00%
  – Plus 32% x (100% - 40%) = 19.20%
  – First year depreciation = 59.20%
  – Second year – 19.2% x 60% = 11.52%
Energy Investment Tax Credit

Converting to a “start of qualified construction” test from the “placed in-service” date test; generally claimed when placed in service

- 30% extended for projects starting construction by 12/31/19
- 26% for projects starting construction from 1/1/20 – 12/31/20
- 22% for projects starting construction from 1/1/21 – 12/31/21 with a required placed in service deadline of 12/31/23, or else the percentage will drop to 10%
- 10% for projects starting after 12/31/21

Investment Tax Credit claim in lieu of PTC

Based on qualified start of construction date and continuous construction rules; generally claimed when placed in service

Retroactive to 1/1/15 and extended through 2019 subject to a phase-down as follows:

- Rate remains 30% for start of construction from 1/1/15 - 12/31/16
- Rate drops to 24% for start of construction from 1/1/17 – 12/31/17
- Rate drops to 18% for start of construction from 1/1/18 – 12/31/18
- Rate drops to 12% for start of construction from 1/1/19 – 12/31/19
Based on qualified start of construction date and continuous construction rules; commences at commercial operation date

Retroactive to 1/1/15 and extended through 2019 subject to a phase-down as follows:

– Rate is 100% of current rate for start of construction from 1/1/15 - 12/31/16
– Rate drops to 80% of current rate for start of construction from 1/1/17 – 12/31/17
– Rate drops to 60% of current rate for start of construction from 1/1/18 – 12/31/18
– Rate drops to 40% of current rate for start of construction from 1/1/19 – 12/31/19
Income Recognition Issues
Internal Revenue Code Section 467 limitations
Taxable Rental Income – Section 467 Limitations

• Rental income should be approximately level over the term of the lease.
  • IRS measures allocated rents or cash rents if rents are not allocated
  • Deferred and prepaid rents (>1 year) are subject to deemed interest charge (cash versus allocated rents)

• Some forms of “uneven rent” are acceptable
  • Rents that vary:
    • With asset use
    • Due to third party costs
    • With an underlying index such as cost of funds
    • Vary by an acceptable amount (90/110% rule)
    • Leases with rents equal to or less than $250,000 in total
    • Uneven rents that are not tax motivated

• Rents that vary with asset use or results
  • Variation with output of a leased equipment; per MRI scan
  • Mileage on a vehicle
  • With sales (retail store)
  • Variation with profitability (retail store)
• Rents that vary due to third party costs
  • Property taxes
  • Utility costs
  • Insurance costs
  • Maintenance costs

• Rents that vary with an index
  • Consumers Price Index
  • Producers Price Index
  • Regional Price Index
  • Commodity Index (fuel or food prices)
  • Financial Index
• Rents that vary by an acceptable amount
  
  • Lessors will seek to lower the lessee’s rent by structuring leases so that as much rental income is “pushed” to be taxed at end of the lease thus maximizing tax timing cash flows
  
• The “90-110 test” was established by case law
  
  • Rents may vary by +/- 10% from the average rents
  • Any amounts below 90% are treated as a loan TO the lessee and interest income must be imputed by the lessor
  • Any amounts above the 110% are treated as a loan FROM the lessee and an interest expense income must be imputed by the lessor
  • Leases of assets considered Real Estate allows for a 15% variation (“85-115 Test”)

• Leases not subject to rent leveling
  
  • Aggregate rents from lease and other leases in related transactions between same lessee and lessor are $250,000 or less
  • Lease is not a leaseback and term is 75% or less of statutory recovery period
  • Uneven rent not tax motivated
# Lease Tax Tests – Quick Reference Chart

The following chart contains a list of factors that can be used as a basis in your planning of either lease or financing transactions. The factors are based on guidelines that have been published by the IRS for purposes of determining the existence of a lease and are often more strict than actual standards imposed by the courts.

<table>
<thead>
<tr>
<th>Factors</th>
<th>Lease</th>
<th>Loan</th>
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<tbody>
<tr>
<td>1. Lessor has minimum investment of at least 20% in leased property[^1]</td>
<td>✔</td>
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<tr>
<td>2. Lessor’s minimum investment in leased property is at risk[^2]</td>
<td>✔</td>
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<td>3. Lessee (or affiliate) guarantees Lessor’s indebtedness created in connection with the acquisition of the leased property[^3]</td>
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<tr>
<td>4. Residual value of leased property is at least 20% at the end of lease term[^4]</td>
<td>✔</td>
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<td>5. Remaining useful life of leased property is at least 20% at end of lease term[^5]</td>
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<td>7. Lessor has expectation of profit[^7]</td>
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<tr>
<td>8. Portion of the rental payments are applied to equity</td>
<td>✔</td>
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<td>9. Lessee acquires title after payment of stated rentals</td>
<td>✔</td>
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<td>10. Total rents paid for short period of use constitutes large portion of purchase price of property if Lessee acquired the property by purchase</td>
<td>✔</td>
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<tr>
<td>11. Rental payments exceed current fair rental value</td>
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<tr>
<td>12. Portion of the rental payments are specifically designated as interest</td>
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[^1]: Courts have recognized the lessor as the owner even where the minimum equity investment is lower than 20% (as low as 1%).
[^2]: Courts, however, have permitted lease characterization in cases where the lessee has assumed the risks of casualties, obsolescence or burdensome governmental regulations.
[^3]: Courts have not placed significance on lease debt guarantees as long as the lessor is the true borrower in the acquisition of the property.
[^4]: Courts have held that residual values representing less than 10% of the original cost were sufficient.
[^5]: There have been no court decisions in this area, however, the IRS has privately ruled that a remaining useful life of 16.7% was sufficient.
[^6]: Courts have respected lease characterization as long as the lessee’s purchase option is not “nominal” nor clearly a bargain.
[^7]: Courts have focused more on the economic viability of the transaction to determine that the lease was not entirely tax motivated.
Questions
Taxation of Service Contracts
Taxation of Service Contracts

• A service contract is typically used when an entity is buying output (power, services, etc) from a facility or asset rather than controlling and operating the asset themselves.

• Leasing provides for the right of “quiet enjoyment” which means the lessee has the right to use the asset without interference by the lessor.

• Under a service contract the lessor is “operating” the asset, producing output and selling that output to the “off-taker”:
  • If qualified, the service provider owns the asset and claims tax depreciation deductions usually following MACRS regardless of who the user is; i.e. tax-exempt user.

• In the past, some leases were “represented” to be service contracts so that the owner could claim the accelerated tax benefits to lower the rate charged and enhance the yield to the asset owner (i.e. when lessee was tax-exempt).
Uses of Service Contracts

• Solar energy agreements
  • Off-taker agrees to buy all the electrical production output of a solar installation installed on its property (roof, land, etc)
• Wind energy agreements
  • Off-taker agrees to buy all the electrical production output of a wind farm
• Energy Sales Agreement (ESA) / Energy Savings Performance Contract (ESPC)
  • Provider installs improvements (often Federal/ S&L) and is paid from savings
• Processing services
  • Off-taker agrees to process a stipulated volume of product (grain, dairy, oil) through a facility owned by a service provider
• Water treatment facilities
  • Off-taker sends contaminated water to service provider who cleans it and returns it to them for production or subsequent disposition
• Qualified solid waste disposal
  • Agency sends solid waste to a processor which may sort it, recycle some, treat some and dispose of balance, sometimes on facility on agency’s land
• Operating a low-income housing project
  • Operator runs project for benefit of an agency
Why a Service Contract?

• Sometimes it is just because the service recipient does not want to operate the asset or facility because;
  • they do not want to add employees,
  • do not have a need for the total output (and be responsible to sell the balance),
  • do not have the expertise to provide the service themselves,
  • cannot buy such a facility due to their own budgetary constraints or public approval process and/or
  • desire of service recipient to avoid risk of ownership

• Service provider can claim tax benefits (accelerated depreciation and investment, energy or production tax credits) that a tax-exempt off-taker/service recipient could not otherwise utilize
  • By monetizing otherwise unusable tax-benefits, the service provider can charge a lower rate to the off-taker
Governed under IRC Section 7701(e)(1) – (For all service contracts)

“A contract which purports to be a service contract shall be treated as a lease of property if such contract is properly treated as a lease of property, taking into account all relevant factors”

Statute lists six non-exclusive “relevant” factors indicative of a lease:

1. Physical possession
2. Control of property
3. Significant economic or possessory interest in the property
4. Lack of service provider risk if there is non-performance
5. Dedicated use to one off-taker
6. Total contract price is less than rental value for contract period
Service Contract Tax Code rules explained

1. **Physical possession**
   a. Is the asset is located on the service recipient’s site and access is controlled by or limited by the service recipient?
   b. Can be overcome with contractual terms and conditions.

2. **Control of property**
   a. Service recipient controls the property’s operation, maintenance or improvements to the property.
   b. Are operational management decisions are made by the service recipient or by the provider?

3. **Service recipient has significant economic or possessory interest** – may be established by facts such as
   a. property’s use is dedicated to the service recipient for a substantial portion of its life,
   b. service recipient shares in the decline or appreciation in value of the property,
   c. service recipient shares in savings in operating costs or
   d. service recipient bears risk of damage to or loss of the property.
Service Contract Tax Code rules explained

4. Service provider does not bear risks of diminished receipts or increased expenditures
   a. Service provider bears the risks of non-production; if the sun doesn’t shine or the wind doesn’t blow, they don’t get paid
   b. Can receive payments when temporarily out of service provided there is a “catch-up”

5. Service is not provided concurrently to another service recipient
   a. Dedicated assets may sometimes require the right to provide services to other parties (whether they actually do or not)

6. Contract price does not exceed comparable rental price
   a. Compare PV of rentals vs PV of contract prices
   b. Contract price can assume tax credits as cash payments since tax incentives are meant to create the benefit

Note – Legislative history states that “the presence or absence of any single factor may not be dispositive in every case”
Service Contract Tax Code rules explained

Tax counsels often **use leasing rules as a “proxy”** when examining service contracts to opine on the tax treatment

1. Minimum forecasted residual value test  
   a. 20% calculated by an appraiser; can use various appraisal techniques and assumptions
2. Economic useful life test – contract term should be less than 80% of EUL
3. Residual profit /loss sharing – none should be provided in the agreement
4. Purchase options  
   a. No automatic title transfer  
   b. Should be at FMV (including a stated FMV)  
   c. Limited to two purchase options  
   d. Economic compulsion test to be performed for any early buyout
5. No guaranteed yields (i.e. no guaranteed residual values or contingent payments)
6. No quiet enjoyment; recipient should not be operator  
   a. Operator / service provider should have rights to access property at any (reasonable) time
7. Minimum 2% pre-tax profit test exclusive of tax benefits (but inclusive of tax credits)
Service Contract - Specified Facility Tax Code exceptions

IRC Sec 7701(e)(3) exceptions for:

1. Qualified solid waste disposal facilities,
2. Cogeneration or alternative energy facilities,
3. Water treatment works facilities, and
4. Low-income housing projects

Agreements that purport to be treated as service contracts for the above properties will be respected as a service contract (and not treated as a lease) UNLESS the service recipient:

1. Operates the facility
2. Bears any significant financial burden if there is nonperformance under the agreement unless such nonperformance is beyond provider’s control
3. Receives any significant financial benefits if facility's operating costs are less than anticipated under the agreement. A decrease in payments because of increased production or efficient or recovery of energy is not counted for these purposes.
4. Has the right to buy at a price other than fair market value
Revenue Procedure 2017-19 background

• An Energy Sales Agreement included within an Energy Service Performance Contract may include alternative energy assets (such as a solar farm) and would normally be eligible for the investment tax credit

• OMB previously required that the offtaker must “retain title to the asset” at the end of the contract

• Requirement to purchase often ‘voided’ claiming ITC because the contract was not deemed to be a service agreement for tax purposes

• IRC Sec 7701(3)(e) provided that to remain qualified, the offtaker may “have an option or obligation to purchase all or part of the facility” but only at the fair market value of the facility

• Contradiction between IRC Sec 7701(3)(e) and OMB contract requirements

• Dept of Energy, IRS and OMB met and compromised; IRS issued Rev Proc 2017-19 which (in theory) resolved the difference and allows federal agency to purchase the asset at the then determined FMV and to escrow funds with the ESPC provider periodically to pay for such future purchase!
1. Service contracts or agreements that purport to be service contracts may become prevalent as the new lease accounting rules are implemented

2. Determine what type of property will be providing the services
   a. Specified facilities or general facilities or assets

3. Determine if the risks and rewards of ownership are being transferred to the purported service recipient
   a. Examine the terms and conditions of the arrangement almost as if you were examining the arrangement under accounting for a Variable Interest Entity

4. Consider obtaining tax opinions for such transactions
Questions
Understanding Section 1031 Like Kind Exchanges
Like Kind Exchange ("LKE") - Background

• Gain on sale of leased assets is typically taxed at a combined Federal and State tax rate of 38% or more

• IRC Section 1031 allows taxpayers to defer paying tax on the disposition of business assets where:
  • The taxpayer receives “like kind” replacement assets in exchange for the taxpayer’s old assets
    (generally recognized by States also)

• Tax rationale ("continuity of investment"):
  • Taxpayer has not profited from the replacement of an old asset with a new asset
  • Taxpayer remains in business and has simply exchanged one business asset for another
  • Taxpayer has not cashed out of its investment in business assets
Like Kind Exchange Uses

- Alternative uses of LKE by lessors
  - One off or limited big ticket asset exchanges
    - Each transaction usually stands on its own and is separately documented/executed
    - Aircraft, barges, and other big ticket asset classes
  - Comprehensive LKE Program
    - Recurring exchanges of most if not all asset classes
    - Exchange process institutionalized as part of the daily origination and termination activities

- In either case LKE can increase margins and enhance profitability of the tax lease portfolio
  - Lease pricing and tax benefits
    - Individual transaction margins are typically enhanced by tax losses generated from the use of MACRS in the early years of a lease
    - LKE can enhance these benefits
  - Deferred taxes reduce portfolio funding cost
    - Balance sheet deferred tax liabilities provide an alternative source of capital/funding
    - This can result in reduced outside borrowings or an internal funding credit improving business unit profits
    - LKE increases deferred tax balances
Like Kind Exchange Example

Lease Pricing
Enhancing Margins & Rental Rates With LKE

Assumptions

<table>
<thead>
<tr>
<th>Cost of Construction Equipment</th>
<th>$ 141,148</th>
</tr>
</thead>
<tbody>
<tr>
<td>Monthly Rent</td>
<td>$ 2,360</td>
</tr>
<tr>
<td>MACRS Class - No Bonus</td>
<td>5 year</td>
</tr>
<tr>
<td>Combined St. &amp; Fed Tax Rate</td>
<td>38%</td>
</tr>
<tr>
<td>Lease Term</td>
<td>36 months</td>
</tr>
<tr>
<td>Sales price</td>
<td>$ 76,219</td>
</tr>
</tbody>
</table>
## Like Kind Exchange Example

### Example: LKE Cash Savings

#### Utilizing a Like Kind Exchange

<table>
<thead>
<tr>
<th></th>
<th>Without LKE</th>
<th>With LKE</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sale of Heavy Construction Equipment</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Proceeds</td>
<td>$ 76,219</td>
<td>$ 76,219</td>
</tr>
<tr>
<td>Tax Basis</td>
<td>$ 32,520</td>
<td>$ 32,520</td>
</tr>
<tr>
<td>Gain</td>
<td>$ 43,699</td>
<td>$ 43,699</td>
</tr>
<tr>
<td>Less Federal &amp; State Taxes Due</td>
<td>$(16,605)</td>
<td>$ -</td>
</tr>
<tr>
<td>Cash available to acquire new Equip.</td>
<td>$ 59,614</td>
<td>$ 76,219</td>
</tr>
</tbody>
</table>

**LKE Advantage**  $ 16,605
## Like Kind Exchange Example

### Lease Pricing – Enhancing Margins With LKE

**Heavy Construction Equipment**

<table>
<thead>
<tr>
<th>Illustration of LKE Yield Advantage</th>
<th>With and Without LKE After Tax Cashflows</th>
</tr>
</thead>
<tbody>
<tr>
<td>Month</td>
<td>Purchase</td>
</tr>
<tr>
<td>-------------------------------</td>
<td>-----------</td>
</tr>
<tr>
<td>Year 1</td>
<td>$ (141,148.00)</td>
</tr>
<tr>
<td>Year 2</td>
<td>$ -</td>
</tr>
<tr>
<td>Year 3</td>
<td>$ -</td>
</tr>
<tr>
<td>Total</td>
<td>$ (141,148.00)</td>
</tr>
</tbody>
</table>

**Annual IRR**

- **Without LKE**: 4.408%
- **With LKE**: 5.598%

**LKE v No LKE Yield advantage** (119 bps)

- **Without LKE**: 1.190%
## Like Kind Exchange Example

### Lease Pricing – Using LKE to Reduce Monthly Lease Payments

#### Heavy Construction Equipment

**Illustration of LKE Yield Advantage**

**With and Without LKE After Tax Cashflows**

<table>
<thead>
<tr>
<th>Month</th>
<th>Purchase Price</th>
<th>Rent Receipt</th>
<th>Sales Proceeds</th>
<th>Aftertax Cashflow With LKE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>$ (141,148.00)</td>
<td>$ 26,892.00</td>
<td>$</td>
<td>$ (82,281.26)</td>
</tr>
<tr>
<td>Year 2</td>
<td>$</td>
<td>$ 26,892.00</td>
<td>$</td>
<td>$ 25,254.94</td>
</tr>
<tr>
<td>Year 3</td>
<td>$</td>
<td>$ 26,892.00</td>
<td>$ 76,219.00</td>
<td>$ 66,789.45</td>
</tr>
<tr>
<td>Total</td>
<td>$ (141,148.00)</td>
<td>$ 80,676.00</td>
<td>$ 76,219.00</td>
<td>$ 9,763.14</td>
</tr>
</tbody>
</table>

**4.409%**

**Monthly rent required to get 4.41% IRR with LKE** $2,241

**Monthly rent required to get 4.41% IRR without LKE** $2,360

**Rental Rate reduction with LKE** 5.04%
**Depreciation Mechanics**

<table>
<thead>
<tr>
<th>LKE basis carryover of old asset</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Year 6</th>
<th>Tax Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>$50,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>11.52%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>11.52%</td>
<td></td>
<td></td>
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<td></td>
<td></td>
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</tr>
<tr>
<td>5.76%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation $ *</td>
<td>$11,520</td>
<td>$11,520</td>
<td>$5,760</td>
<td></td>
<td></td>
<td></td>
<td>$28,800</td>
</tr>
<tr>
<td>Tax basis of new asset component</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$25,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>20.00%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>32.00%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>19.20%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>11.52%</td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>11.52%</td>
<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>5.76%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation $</td>
<td>$5,000</td>
<td>$8,000</td>
<td>$4,800</td>
<td>$2,880</td>
<td>$2,880</td>
<td>$1,440</td>
<td>$25,000</td>
</tr>
<tr>
<td>$75,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$53,800</td>
</tr>
</tbody>
</table>

* $50,000 of the purchase price of the new asset is derived from the cash proceeds of the old asset, with the balance provided by ABC. The portion of the new asset funded by the LKE ($50,000) assumes the tax basis of the old asset and remaining MACRS life and schedule. The portion of the new asset funded with new funds from ABC commences depreciation using standard MACRS rates per year for the 5-year period, spread over 6-years.
Like Kind Exchange Example

Reduced Funding Cost - LKE Increase in Deferred Tax Liability

Portfolio Assumptions
- Depreciation Method: **MACRS, No Bonus**
- Tax Rate: **38%**
- Inflation Rate: **2%**
- Fleet Growth: **2%**
- Avg. lease Term @ Disp: **3.61 yrs**
- MACRS Life (3, 5 or 7): **Various**

<table>
<thead>
<tr>
<th>Portfolio Size In 000's</th>
<th>7 Year Total Tax Savings</th>
</tr>
</thead>
<tbody>
<tr>
<td>$100,000</td>
<td>$10,769</td>
</tr>
<tr>
<td>$500,000</td>
<td>$53,846</td>
</tr>
<tr>
<td>$1,000,000</td>
<td>$107,693</td>
</tr>
<tr>
<td>$1,500,000</td>
<td>$161,539</td>
</tr>
<tr>
<td>$2,000,000</td>
<td>$215,386</td>
</tr>
<tr>
<td>$3,000,000</td>
<td>$323,079</td>
</tr>
</tbody>
</table>
**General Tax Requirements**

- There must be an exchange (as distinguished from a sale and repurchase)
- Relinquished and Replacement Property must be held for trade or business (or investment) purposes
- Relinquished property must be exchanged solely for “Like Kind” replacement property
- Taxpayer must maintain value and equity between relinquished and replacement property
- The same taxpayer must accomplish the exchange
- Taxpayer must acquire or “identify” replacement property within 45 days of relinquished property transfer
- If timely “identification” then taxpayer may acquire replacement property up to 180 days after the transfer of relinquished property
Like Kind Definition

**Definition of “Like-Kind”**

- Like kind refers to nature and character of property, not grade or quality
- One kind of property may not be exchanged for property of different kind or class
- Real property
  - Generally a single class
  - For example - unimproved land is of like kind to an office building
- Personal property – Like Class Safe Harbor
  - General Asset Class – Rev. Proc. 87-56
    - Office furniture and fixtures
    - Automobiles
    - Over the road tractors
  - Product Class or NAIC Codes (Sections 31, 32, 33)
    - NAIC Code 333120; Construction machinery, surface mining, and logging
Like Kind Exchange Flow

**Exchange**

- Taxpayer
- Old Asset → New Asset
- Buyer & Seller

**Sale & Repurchase**

- Taxpayer
- Old Asset
- Sale:
- Buyer → $ → New Asset
- Repurchase:
- New Asset → Seller
Deferred Like Kind Exchange Rules

The Deferred Exchange Regulations

- A deferred exchange is an exchange in which:
  - The taxpayer’s receipt of replacement property does not coincide with the taxpayer’s disposition of relinquished property; and/or
  - The “buyer” of the taxpayer’s relinquished property and the seller of the taxpayer’s replacement property are not one and the same

- Taxpayer must avoid receipt or constructive receipt of exchange proceeds during the exchange period

- Actual or constructive receipt of sales proceeds can be avoided by using the Qualified Intermediary ("QI") safe harbor rules
  - QI enters into a written agreement with the taxpayer to acquire and transfer relinquished property and replacement property
  - Acquisition and transfer of property accomplished through assignment of rights and written notification of other parties to the transaction.
  - Agreement must provide that taxpayer has no rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property before the end of the identification period
Like Kind Exchange— QI Safe Harbor

The QI Safe Harbor and Deferred Exchanges

Equipment Lessor

Old Asset  Deemed Exchange  New Asset

Qualified Intermediary "QI"

$\$$ Sales Proceeds

Buyer

$\$$ Cost of Replacement Property

Seller

Transfer Title

Transfer Title
Like Kind Exchange Rev Proc

Revenue Procedure 2003-39

• Applicable only to “LKE Programs”

  • Multiple exchanges of 100 or more properties with all of the following characteristics
    • Regular and routine sales & acquisitions of tangible personal property
    • Single QI
    • “Master Exchange Agreement”
    • Process for receipt or “identification” of replacement property
    • Process for collecting, holding, & disbursing exchange funds ensuring QI control
    • Process for matching relinquished with replacement property

• Created 3 separate and distinct safe harbors
  • “Separate exchange”, identification and matching
  • Actual and constructive receipt of money or other property, and
  • Definition and activities of Qualified Intermediary
IRC Section 467 Level Rent Rules
IRC 467 Basics – Why?

• Tax lease pricing is most competitive when expenses can be accelerated and revenues can be deferred

• Largest expense of a lease is typically tax depreciation; assets must be depreciated according to applicable tax depreciation guidelines; little room for changes

• Prior to Section 467, “creative” lease structuring advisors sought to defer rents as much as possible, effectively “sheltering” rental income and thus enabling rents and underlying financing costs to be lowered; it’s all about the price competitiveness
  
  • Example – maximum deferral of all rents due on the last day of the lease

• Extreme deferral of rents were increasingly looked upon as an abusive tax shelter mechanism
IRC 467 Basics – Congressional and IRS Action

• In 1984 Congress was focused on the Deficit Reduction Tax Act of 1984, looking to, among other things, to remove ‘abusive’ tax strategies

• IRC Section 467 was passed as a means of removing this tax shelter structuring mechanism

• Final Treasury Regulations issued in 1999; revisions issued in 2001

• Implementation of Section 467 proved more challenging than expected as not every rent structuring mechanism was done for tax sheltering purposes;
  • Sale-leasebacks – normal business and administrative processes for leasing large groups of similar assets (e.g. trucks purchased in volume) often aggregated volume for purely administrative reasons
  • Rent structures were often tailored to meet seasonal cash flow requirements of lessees
  • Smaller rent agreements were often structured as accommodations to lessees
• Section 467 rules are only applicable for leases with total rents of $250,000 or more

• Rental agreements would allow for a 90-day rent holiday period at the beginning of a lease which would generally be respected by the IRS
  
  • A rent holiday is a period when the lessee has possession of the asset and is actively using it but no rents are due; often part of the ‘build out period’ for real estate assets being leased

• Rents shall not fluctuate during any year more than 10% above or below of the average annualized rents for non-real estate assets and 15% for real estate assets;

  • The 10% rule became known as the “90/110” rule; rents shall not fall below 90% or above 100% of the average annualized rents; if such rents fall outside of those parameters, for tax reporting purposes, rental adjustments may be required.

  • The 15% rule for real estate is similarly known as the 85%/115% rule.

• When rents fluctuate below the lower point or above the upper point, the difference is construed for tax purposes only, to be a loan as between the lessee and lessor as the case may be, with interest (if not started) imputed at a rate not less than 110% of the Federal Applicable Rate (AFR)
• Most lessors require that leases be structured to comply with the “level-rent” 90/110% rules
  • e.g. - rents start at $90,000 per month for 24-months then increase to $110,000 for another 24 months (total rents = $4.8 million)

• While non-compliance causes tax reporting issues, it does not necessarily change the characterization of the lease from qualifying as a tax lease

• Extreme non-compliance MAY affect the tax characterization of the lease
  • e.g. – lessee makes a 50% upfront rental payment; has the lessee “loaned” the lessor proceeds to invest in the asset?
  • Anecdotally, when providing tax opinions on structures intentionally structured with a Sec 467 loan, tax counsels prefer that lessee advance rent payments not exceed 20% of the assets’ FMV and such rents be made a reasonable time after the asset has been funded by the lessor, so that the lessor is at risk for a significant enough time
IRC 467 “Triggered”

- When rents fall outside the Sec 467 parameters, the IRS may reallocate the rents to reflect compliance with the Sec 467 rules
- Usually the calculation to report tax compliance is complicated because interest must be imputed
- Example:
  - Lease for 24-months at $60,000 ($720,000 per year) and then 24-months at $140,000 per ($1,680,000 per year) month; total rents = $4.8 million
  - Average annualized rent = $1,200,000
  - Basic Sec 467 loan activity; Note: Imputed interest expense not included in table

<table>
<thead>
<tr>
<th>Period</th>
<th>Average Annualized</th>
<th>Actual Rent</th>
<th>467 loan activity</th>
<th>Sec 467 loan balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>1,200,000</td>
<td>720,000</td>
<td>480,000</td>
<td>480,000</td>
</tr>
<tr>
<td>2</td>
<td>1,200,000</td>
<td>720,000</td>
<td>480,000</td>
<td>960,000</td>
</tr>
<tr>
<td>3</td>
<td>1,200,000</td>
<td>1,680,000</td>
<td>(480,000)</td>
<td>480,000</td>
</tr>
<tr>
<td>4</td>
<td>1,200,000</td>
<td>1,680,000</td>
<td>(480,000)</td>
<td>0</td>
</tr>
</tbody>
</table>
• Situation
  • Solar developer builds a solar array and sells it to a project company (SPE owned by the developer) so as to legally isolate it.
  • Developer seeks funding via a lease; lessor can use tax depreciation and tax credits while developer cannot; developer has few assets to provide a guarantee
  • Lessor is willing to buy the array and lease it back to the developer provided the lessee (the project company) makes a large upfront lease payment = 20% of the project cost
  • Lessor recovers their investment via (30% ITC); 20% 1st rent and then subsequent tax benefits and rent

• Execution
  • Tax treatment of upfront payment triggers Sec 467 tax-only loan
  • Document three separate schedules; cash rent, tax rent and Sec 467 loan payment with agreed upon or imputed interest

• Result
  • Sec 467 total taxable income is equal to taxable income before any 467 adjustment
  • Sec 467 merely reallocates the aggregate amount of taxable income to different periods
Questions
Understanding Tax Accounting
Tax Accounting Objectives

To provide an understanding and overview of ASC 740 “Income Taxes” (old FASB # 109) to enable the attendees to:

• Understand the basis for calculating the tax provisions and the current and deferred tax assets and liabilities for their own corporation

• Prepare tax financial statement footnotes tax

• Understand and interpret the tax footnotes of your clients and

• Provide value-added insight to your firm’s marketing staff to identify tax-driven leasing opportunities within clients
Accounting for Income Taxes

ASC 740/ FAS 109 defines the financial accounting and reporting for income taxes that are currently payable and for the tax consequences of the following:

- Revenues, expenses, gains, or losses that are included in taxable income of an earlier or later year than the year in which they are recognized in financial income
- Other events that create differences between the tax bases of assets and liabilities and their amounts for financial reporting
- Operating loss or tax credit carry-backs for refunds of taxes paid in prior years and carry-forwards to reduce taxes payable in future years. (ASC 740-10-05-05-1/ FAS 109 ¶ 3)

Included in the Scope

- Domestic federal (national) income taxes (U.S. federal income taxes for U.S. enterprises) and foreign, state, and local (including franchise) taxes based on income
- An enterprise's domestic and foreign operations that are consolidated, combined, or accounted for by the equity method
- Foreign enterprises in preparing financial statements in accordance with U.S. generally accepted accounting principles. (ASC 740-10-15-15-X / FAS 109 ¶ 4)

Excluded from the Scope

- The basic methods of accounting for the U.S. federal investment tax credit (ITC) and for foreign, state, and local investment tax credits or grants
- Discounting of future taxes payable or receivable [deferred taxes]
- Accounting for income taxes in interim periods (other than the criteria for recognition of tax benefits and the effect of enacted changes in tax laws or rates and changes in valuation allowances). (FAS 109 ¶ 5)
**Objectives**

The two major objectives of the Statement are to recognize the following items:
- the amount of income taxes payable or refundable in the current period (the current provision)
- deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an enterprise’s financial statements or tax returns (the deferred tax provisions) (ASC 740-10-10-X / FAS 109 ¶ 7)

**Principles**

Following are the basic principles applied at each financial statement date:
- A **current** tax liability or asset is recognized for the estimated taxes payable or refundable on tax returns for the current year.
- A **deferred** tax liability or asset is recognized for the estimated future tax effects attributable to temporary differences and carry-forwards.
- The measurement of current and deferred tax liabilities and assets is based on provisions of the enacted tax law; the effects of future changes in tax laws or rates are not anticipated.
- The measurement of deferred tax assets is reduced, if necessary, by the amount of any tax benefits that, based on available evidence, are not expected to be realized [valuation allowance] (ASC 740-10-25-2/ FAS 109 ¶ 8)
Terms and Definitions

**Temporary Differences**
A difference between the tax basis of an asset or liability and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount of the asset or liability is recovered or settled, respectively.
- Revenues or gains that are taxable after they are recognized in financial income
  - i.e. – tax gains deferred through like-kind exchange
- Expenses or losses that are deductible after they are recognized in financial income
  - i.e. – increases in the allowance for credit losses charged to the provision for credit losses
- Revenues or gains that are taxable before they are recognized in financial income
  - i.e. – advance rents
- Expenses or losses that are deductible before they are recognized in the financial statements
  - i.e. – accelerated tax depreciation

**Current Tax Expense or Benefit**
The amount of income taxes paid or payable (or refundable) for a year as determined by applying the provisions of the enacted tax law to the taxable income or excess of deductions over revenues for that year. (FAS 109 ¶ 289)

**Deferred Tax Asset**
A difference between the tax basis of an asset or liability and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount of the asset or liability is recovered or settled, respectively. (FAS 109 ¶ 289)
Deferred Tax Liability
The deferred tax consequences attributable to taxable temporary differences. A deferred tax liability is measured using the applicable enacted tax rate and provisions of the enacted tax law. (FAS 109 ¶ 289)

Carrybacks and Carryforwards
Deductions or credits that cannot be utilized on the tax return during a year that may be carried back to reduce taxable income or taxes payable in a prior year.
Deductions or credits that cannot be utilized on the tax return during a year that may be carried forward to reduce taxable income or taxes payable in a future year. (FAS109 ¶ 289)

Valuation Allowance
The portion of a deferred tax asset for which it is more likely than not that a tax benefit will not be realized.

Applicable Tax Rate
The enacted tax rate(s) expected to apply to taxable income in the periods in which the deferred tax liability or asset is expected to be settled or realized (ASC 740-10-30-X / FAS 109 ¶18)
In the U.S. federal tax jurisdiction, the applicable tax rate is the regular [statutory] tax rate, and a deferred tax asset is recognized for alternative minimum tax credit carry-forwards (ASC 740-10-30-X / FAS 109 ¶ 19)
A combined federal and state rate can be used if there is little variation between the tax laws. (Implementation Guide)
Scheduling

• Preparing a pro forma income tax return for future years to determine the reversal of temporary differences and the ability to utilize NOL carry-forwards and to determine if a valuation allowance is necessary.

Net Operating Loss

• A tax position where a company has negative taxable income. Under U.S. tax rules an NOL can be carried back to offset previous years’ taxable income to generate a refund. If an NOL still exists it is carried forward [up to 20 years] to offset future years’ taxable income
• Customers often lease when they have an NOL to lower their after-tax cost of financing equipment. If a customer has a large NOL carry forward it means it can’t take advantage of tax benefits such as the accelerated depreciation write offs (MACRS deductions) in the current year
• An NOL carry-forward is represented on the balance sheet as a deferred tax asset and on the income statement as a negative tax provision [benefit]
• NOLs are calculated using the statutory applicable [federal and states] tax rates [usually 35% for federal]
• Note - Financial statements prepared under IAS may NOT report an NOL on the balance sheet as a deferred tax asset. IAS rules stipulate disclosing the NOL ‘available but not recorded’ if realization is not ‘more likely than not’
Alternative Minimum Tax

- AMT is calculated by adding AMT preference items to regular taxable income and applying a 20% AMT rate.
- The excess of AMT over regular tax is an AMT credit [deferred tax asset] which can be carried forward to reduce regular tax in the future when it exceeds AMT. Accelerated depreciation is a preference item; rent is not.
- AMT ‘breakeven’ occurs when AMT preference items equal 75% of regular taxable income. Each dollar above that level will result in paying at the AMT rate and will create an AMT credit.

<table>
<thead>
<tr>
<th>Regular taxable income</th>
<th>$100</th>
<th>$100</th>
<th>$100</th>
</tr>
</thead>
<tbody>
<tr>
<td>AMT Preference</td>
<td>0</td>
<td>75</td>
<td>80</td>
</tr>
<tr>
<td>Taxable Income</td>
<td>$100</td>
<td>$175</td>
<td>$180</td>
</tr>
<tr>
<td>Rate</td>
<td>35%</td>
<td>20%</td>
<td>20%</td>
</tr>
<tr>
<td>Tax</td>
<td>$35</td>
<td>$35</td>
<td>$36</td>
</tr>
</tbody>
</table>

- The chart below illustrates how AMT should reverse itself for depreciable assets.

<table>
<thead>
<tr>
<th></th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>TOTALS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Income</td>
<td>500,000</td>
<td>500,000</td>
<td>500,000</td>
<td>500,000</td>
<td>2,000,000</td>
</tr>
<tr>
<td>3 YR MACRS</td>
<td>333,300</td>
<td>444,500</td>
<td>148,100</td>
<td>74,100</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Reg Taxable Income</td>
<td>166,700</td>
<td>55,500</td>
<td>351,900</td>
<td>425,900</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Reg Tax @ 35%</td>
<td>58,345</td>
<td>19,425</td>
<td>123,165</td>
<td>149,065</td>
<td>350,000</td>
</tr>
<tr>
<td>AMT Preference Calc</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3 YR MACRS</td>
<td>333,300</td>
<td>444,500</td>
<td>148,100</td>
<td>74,100</td>
<td>1,000,000</td>
</tr>
<tr>
<td>SL Depreciation</td>
<td>166,667</td>
<td>333,333</td>
<td>333,333</td>
<td>166,667</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Excess depreciation</td>
<td>166,633</td>
<td>111,167</td>
<td>185,233</td>
<td>92,567</td>
<td>0</td>
</tr>
<tr>
<td>AMT Income</td>
<td>333,333</td>
<td>166,667</td>
<td>166,667</td>
<td>333,333</td>
<td>1,000,000</td>
</tr>
<tr>
<td>AMT</td>
<td>66,667</td>
<td>33,333</td>
<td>33,333</td>
<td>66,667</td>
<td>200,000</td>
</tr>
<tr>
<td>AMT Credit</td>
<td>8,322</td>
<td>13,908</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cum AMT credit</td>
<td>8,322</td>
<td>22,230</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Utilization of AMT Credit</td>
<td>-22,230</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax payments due</td>
<td>66,667</td>
<td>33,333</td>
<td>100,935</td>
<td>149,065</td>
<td>350,000</td>
</tr>
<tr>
<td>Effective tax rate</td>
<td>40.0%</td>
<td>60.1%</td>
<td>28.7%</td>
<td>35.0%</td>
<td>35.0%</td>
</tr>
</tbody>
</table>
Tax Provision Calculation

Composition of Provision
Total income tax expense or benefit for the year is equal to the sum of deferred tax expense or benefit and income taxes currently payable or refundable. Income taxes currently payable or refundable is the amount of income taxes paid or payable (or refundable) for a year as determined by applying the provisions of the enacted tax law to the taxable income or excess of deductions over revenues for that year. Under the ‘matching principle’, the tax provision should be GAAP earnings net of permanent differences multiplied by the statutory tax rate.

Calculating the Deferred Tax Provision
Identify [i] the types and amounts of existing temporary differences and [ii] the nature and amount of each type of operating loss and tax credit carry-forward and the remaining length of the carry-forward period. Measure the total deferred tax liability for taxable temporary differences using the applicable tax rate. Measure the total deferred tax asset for deductible temporary differences and operating loss carry-forwards using the applicable tax rate. Measure deferred tax assets for each type of tax credit carry-forward. Reduce deferred tax assets by a valuation allowance if, based on the weight of available evidence, it is more likely than not (a likelihood of more than 50 percent) that some portion or all of the deferred tax assets will not be realized. The valuation allowance should be sufficient to reduce the deferred tax asset to the amount that is more likely than not to be realized. (ASC 740-10-30-5 / FAS 109 ¶17)

Summary observation
In the end, the taxes recognized for any given transaction must equal the income from that transaction multiplied by the statutory tax rate, unless a permanent difference exists [i.e. Section 199 Qualified Production deductions]. Timing differences should theoretically always reverse over the transaction term.
Assumptions
Operating lease for GAAP purposes and a true lease for income purposes.
Lessor enters into a 60-month FMV lease of material handling equipment, having a cost of $1 million, monthly rent of $18,500, a residual of $200,000, and an implicit interest rate of 10%.
The first basic rent date is April 1, 1996.
There is no automatic transfer of ownership.
There is no bargain purchase option.
The equipment has an economic life of 10 years, therefore the lease term of 5 years is less than 75% of the economic life.
The PV of the rents at the implicit rate of 10% is $878,000, which is less than 90% of the cost the equipment. Therefore, the lease is an operating lease for financial reporting purposes.

MACRS Depreciation
Material handling equipment (generally) is five-year class property. MACRS depreciation rates (from the IRS table) are (excludes bonus depreciation):

<table>
<thead>
<tr>
<th>Year</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1996</td>
<td>20.00</td>
</tr>
<tr>
<td>1997</td>
<td>32.00</td>
</tr>
<tr>
<td>1998</td>
<td>19.20</td>
</tr>
<tr>
<td>1999</td>
<td>11.52</td>
</tr>
<tr>
<td>2000</td>
<td>11.52</td>
</tr>
<tr>
<td>2001</td>
<td>5.76</td>
</tr>
</tbody>
</table>
# Operating Lease Example – GAAP I/S

<table>
<thead>
<tr>
<th>Tax Books</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rental Income</td>
<td>$166,500</td>
<td>$222,000</td>
<td>$222,000</td>
<td>$222,000</td>
<td>$222,000</td>
<td>$55,500</td>
<td>$1,110,000</td>
</tr>
<tr>
<td>Sale Proceeds</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>200,000</td>
</tr>
<tr>
<td>Depreciation Expense</td>
<td>200,000</td>
<td>320,000</td>
<td>192,000</td>
<td>115,200</td>
<td>115,200</td>
<td>57,600</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Tax Income (Loss)</td>
<td>(33,500)</td>
<td>(98,000)</td>
<td>30,000</td>
<td>106,800</td>
<td>106,800</td>
<td>197,900</td>
<td>310,000</td>
</tr>
<tr>
<td>Tax Rate 40% (Combined Federal &amp; State Rate)</td>
<td>40%</td>
<td>40%</td>
<td>40%</td>
<td>40%</td>
<td>40%</td>
<td>40%</td>
<td>40%</td>
</tr>
<tr>
<td>Tax Liability (Savings)</td>
<td>($13,400)</td>
<td>($39,200)</td>
<td>$12,000</td>
<td>$42,720</td>
<td>$42,720</td>
<td>$79,160</td>
<td>$124,000</td>
</tr>
</tbody>
</table>

## GAAP Books

<table>
<thead>
<tr>
<th></th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rental Income</td>
<td>$166,500</td>
<td>$222,000</td>
<td>$222,000</td>
<td>$222,000</td>
<td>$222,000</td>
<td>$55,500</td>
<td>$1,110,000</td>
</tr>
<tr>
<td>Sale Proceeds</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>200,000</td>
</tr>
<tr>
<td>Depreciation Expense</td>
<td>120,000</td>
<td>160,000</td>
<td>160,000</td>
<td>160,000</td>
<td>160,000</td>
<td>240,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Income before Tax</td>
<td>46,500</td>
<td>62,000</td>
<td>62,000</td>
<td>62,000</td>
<td>62,000</td>
<td>15,500</td>
<td>310,000</td>
</tr>
<tr>
<td>Tax Expense @ 40%</td>
<td>18,600</td>
<td>24,800</td>
<td>24,800</td>
<td>24,800</td>
<td>24,800</td>
<td>6,200</td>
<td>124,000</td>
</tr>
<tr>
<td>Net Income</td>
<td>$27,900</td>
<td>$37,200</td>
<td>$37,200</td>
<td>$37,200</td>
<td>$37,200</td>
<td>$9,300</td>
<td>$186,000</td>
</tr>
<tr>
<td>Current Tax Liability</td>
<td>13,400</td>
<td>39,200</td>
<td>(12,000)</td>
<td>(42,720)</td>
<td>(42,720)</td>
<td>(79,160)</td>
<td>(124,000)</td>
</tr>
<tr>
<td>Deferred Tax Balance</td>
<td>(32,000)</td>
<td>(96,000)</td>
<td>(108,000)</td>
<td>(90,880)</td>
<td>(72,960)</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>
## Operating Lease Tax Provision Calculation

<table>
<thead>
<tr>
<th></th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Equipment Tax Basis</strong></td>
<td>800,000</td>
<td>480,000</td>
<td>288,000</td>
<td>172,800</td>
<td>57,600</td>
<td>-</td>
</tr>
<tr>
<td><strong>Equipment Book Basis</strong></td>
<td>880,000</td>
<td>720,000</td>
<td>560,000</td>
<td>400,000</td>
<td>240,000</td>
<td>-</td>
</tr>
<tr>
<td><strong>Taxable Temporary Difference</strong></td>
<td>-(80,000)</td>
<td>-(240,000)</td>
<td>-(272,000)</td>
<td>-(227,200)</td>
<td>-(182,400)</td>
<td>-</td>
</tr>
<tr>
<td><strong>Applicable tax rate</strong></td>
<td>40%</td>
<td>40%</td>
<td>40%</td>
<td>40%</td>
<td>40%</td>
<td>40%</td>
</tr>
<tr>
<td><strong>Deferred tax liability</strong></td>
<td>-(32,000)</td>
<td>-(96,000)</td>
<td>-(108,800)</td>
<td>-(90,880)</td>
<td>-(72,960)</td>
<td>-</td>
</tr>
<tr>
<td><strong>Current tax receivable/(payable)</strong></td>
<td>13,400</td>
<td>39,200</td>
<td>-(12,000)</td>
<td>-(42,720)</td>
<td>-(42,720)</td>
<td>-(79,160)</td>
</tr>
<tr>
<td><strong>Change in the Deferred Tax Liability</strong> (Deferred Tax Expense)</td>
<td>-(32,000)</td>
<td>-(64,000)</td>
<td>-(12,800)</td>
<td>17,921</td>
<td>17,920</td>
<td>72,960</td>
</tr>
<tr>
<td><strong>Total Income Tax Provision</strong></td>
<td>-(18,600)</td>
<td>-(24,800)</td>
<td>-(24,800)</td>
<td>-(24,800)</td>
<td>-(24,800)</td>
<td>-(6,200)</td>
</tr>
<tr>
<td>GAAP Books</td>
<td>Year ended December 31</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>--------------------------------</td>
<td>------------------------</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>1999</td>
<td>2000</td>
<td>2001</td>
<td>2002</td>
<td>2003</td>
<td>2004</td>
</tr>
<tr>
<td>Cash</td>
<td>$179,900</td>
<td>$441,100</td>
<td>$651,100</td>
<td>$830,380</td>
<td>$1,009,660</td>
<td>$1,186,000</td>
</tr>
<tr>
<td>Equipment under lease</td>
<td>1,000,000</td>
<td>1,000,000</td>
<td>1,000,000</td>
<td>1,000,000</td>
<td>1,000,000</td>
<td>0</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>(120,000)</td>
<td>(280,000)</td>
<td>(440,000)</td>
<td>(600,000)</td>
<td>(760,000)</td>
<td>0</td>
</tr>
<tr>
<td>Equipment under lease, net</td>
<td>880,000</td>
<td>720,000</td>
<td>560,000</td>
<td>400,000</td>
<td>240,000</td>
<td>0</td>
</tr>
<tr>
<td>Total Assets</td>
<td>$1,059,900</td>
<td>$1,161,100</td>
<td>$1,211,100</td>
<td>$1,230,380</td>
<td>$1,249,660</td>
<td>$1,186,000</td>
</tr>
<tr>
<td>Deferred Taxes</td>
<td>32,000</td>
<td>96,000</td>
<td>108,800</td>
<td>90,880</td>
<td>72,960</td>
<td>0</td>
</tr>
<tr>
<td>Stockholder's Equity</td>
<td>1,027,900</td>
<td>1,065,100</td>
<td>1,102,300</td>
<td>1,139,500</td>
<td>1,176,700</td>
<td>1,186,000</td>
</tr>
<tr>
<td>Total Liabilities &amp; Equity</td>
<td>$1,059,900</td>
<td>$1,161,100</td>
<td>$1,211,100</td>
<td>$1,230,380</td>
<td>$1,249,660</td>
<td>$1,186,000</td>
</tr>
</tbody>
</table>
Balance Sheet Presentation

In a classified balance sheet, the deferred tax liabilities and assets are separated into a current amount and a noncurrent amount. Deferred tax liabilities and assets will be classified as current or noncurrent based on the classification of the related asset or liability for financial reporting. (ASC 740-10-45-X / FAS 109 ¶ 41)

For a particular tax-paying component of an enterprise and within a particular tax jurisdiction, (a) all current deferred tax liabilities and assets shall be offset and presented as a single amount and (b) all noncurrent deferred tax liabilities and assets shall be offset and presented as a single amount. However, an enterprise shall not offset deferred tax liabilities and assets attributable to different tax-paying components of the enterprise or to different tax jurisdictions. (ASC 740-10-45-6 / FAS 109 ¶ 42)

Disclosures

The components of the net deferred tax liability or asset recognized is disclosed as follows:
- The total of all deferred tax liabilities
- The total of all deferred tax assets
- The total valuation allowance recognized for deferred tax assets

The net change during the year in the total valuation allowance also shall be disclosed.

The approximate tax effect of each type of temporary difference and carry-forward that gives rise to a significant portion of deferred tax liabilities and deferred tax assets. (FAS 109 ¶43)
Disclosures [cont’d]

The significant components of income tax expense from continuing operations, such as:

- Current tax expense or benefit
- Deferred tax expense or benefit (exclusive of the effects of other components listed below)
- Investment tax credits
- The benefits of operating loss carry-forwards
- Tax expense that results from allocating certain tax benefits either directly to contributed capital or to reduce goodwill or other noncurrent intangible assets of an acquired entity
- Adjustments of a deferred tax liability or asset for enacted changes in tax laws or rates or a change in the tax status of the enterprise
- Adjustments of the beginning-of-the-year balance of a valuation allowance because of a change in circumstances that causes a change in judgment about the ability to realize the related deferred tax asset in future years.
- A reconciliation using percentages or dollar amounts (a) the reported amount of income tax expense attributable to continuing operations for the year to (b) the amount of income tax expense that would result from applying domestic federal statutory tax rates to pretax income from continuing operations. (ASC -740-10-50-1X / FASB 109 ¶47)
- The amounts and expiration dates of operating loss and tax credit carry-forwards.
- The portion of the valuation allowance allocated to goodwill or intangible assets. (ASC 740-10-50-3 / FASB 109 ¶ 48)
Restructuring and Terminating Leases and Loans
Restructuring and Terminating Leases and Loans

**Issues for Lenders in Foreclosures**

- A lender acquiring title to collateral through foreclosure or deed in lieu of foreclosure is treated as purchasing assets at fair market value if the debt forgiven exceeds asset value.

- A foreclosure sale to third parties results in a bad debt deduction or worthless securities write-off.

- COD income requires lender to provide to the debtor and file with the IRS an IRS Form 1099-C. Such income is generally taxable to debtor. Subject to insolvency exception or if in a Chapter 11 proceeding but tax attribute reduction is required.

**Issues for Lessors**

- Defaulting lessors financing collateral with non-recourse debt would have taxable gain or loss upon foreclosure equal to the debt minus the basis of property – sale or exchange treatment.

- If the debt is recourse, the lessor would have taxable gain or loss equal to the debt minus adjusted basis. Any excess of the debt over fmv of the collateral would be COD income (if debt unpaid).

- Workouts – lessor/borrower may have COD income from any reduction of debt.
Restructuring and Terminating Leases and Loans

Debt Reissuance

- Any “significant modification” of a debt causes a sale or exchange of the original and modified debt instrument; termed a reissuance

- If the issue price of the new debt is less than that of the original debt, the borrower would have COD income and the lender would have a bad debt or worthless security loss – generally only an issue for publicly traded debt

- Significant modification includes any material alteration, deletion or addition of a legal right or obligation of an issuer

- There are several safe harbors.
  - A deferral of payments for the lessor of 5 years or 50% of the original term is not a reissuance
  - Forbearance for two years by a lender is not a modification
  - Changes in interest rate of the greater of 25 basis points or 5% treated as a reissuance
Restructuring and Terminating Leases and Loans

**Lease Modifications**

- No sale or exchange on a substantial modification
- Section 467 analysis reapplied with a substantial modification of a lease
- If rent leveling applied or 467 loan existed, modified lease must account for such 467 loan balances
- Otherwise, old and modified leases tested separately
Anyone want to work in taxes?

So that sums it up; an easy topic
Any questions?