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SALE-LEASEBACK TRANSACTIONS BY TAX-EXEMPT ENTITIES AND THE NEED FOR CONGRESSIONAL GUIDELINES

I. Introduction

Legislation is pending in Congress to restrict transactions in which tax-exempt entities sell properties to private investors who in turn lease them back.\(^1\) The primary issue presented by the proposed legislation is whether tax benefits associated with leasing should indirectly be allowed to tax-exempt entities.\(^2\) The proposed legislation decreases depreciation allowances for property leased to tax-exempt institutions (tax-exempt use property) from the current, accelerated system\(^4\) to the

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3. Description of H.R. 4170, supra note 1, at 62. Secondary issues include the efficiency of sale-leasebacks as a financial device, the lack of neutrality in the tax system in the decision whether to own or lease by tax-exempt entities, the privatization of public services, a distortion of the appropriation process, a lack of accountability in the budgets of federal agencies, and negative public perceptions. See Description of S. 1564, supra note 1, at 12-14; discussion infra in notes 102-04 and accompanying text.

4. See I.R.C. § 168(a) (1976). See also, Depreciation Guide (CCH) ¶ 100-04 (Tax Analysis Series 1983) [hereinafter cited as Depreciation Guide] (ACRS was created to provide further incentives to stimulate capital investment since "inflation had diminished the value of previous depreciation allowances, and the need to upgrade technology had further increased the cost of replacing older equipment") Id. at ¶ 100. Federal Tax Handbook ¶ 2004 (Prentice-Hall 1983) [hereinafter cited as Tax Handbook] (cost of "recovery property", depreciable property placed in service after 1980, will generally be recovered under accelerated cost recovery system, over prescribed period by using statutory accelerated methods); SyCip and Alindada,
straight-line method\(^5\) in an attempt to reduce what are in effect federal subsidies flowing to tax-exempt entities through the use of sale-leasebacks.\(^6\) The bills also include criteria for determining whether to allow investment tax credits (ITCs)\(^7\) in property transactions involving tax-exempt entities.\(^8\)

Depreciation, in, Accountants’ Handbook 22-14 (L.J. Seidler & D.R. Carmichael eds. 1981) (decreasing charge method used to allocate a greater value to asset initially with this value diminishing proportionately over time).

5. See Seidler & Carmichael, supra note 4, at 22-11 (straight-line method of allocating depreciation “is a function of the passage of time and recognizes equal periodic charges over the service life of the asset” and thus “is not affected by asset productivity, efficiency, or degree of use”).

6. See Description of S. 1564, supra note 1, at 17-18; Description of H.R. 3110, supra note 1, at 16-17; Description of H.R. 4170, supra note 1, at 72-74. Under the Senate version, the recovery period is lengthened, for example, from the current 15-year real property ACRS class to 40 years or 125 percent of the lease term, whichever is greater. Under the House version, a set of extended recovery periods is set out in an attempt to give the tax-exempt entity leasing an asset from a taxable entity the same tax treatment accorded property owners. This result is clearly designed to conform with the Committees’ idea of the principle of neutrality, detailed infra in note 111 and the accompanying text. The primary factor motivating this legislation is revenue loss to the Treasury at a time of federal deficits through what is termed by the congressional committees an indirect federal subsidy to tax-exempt entities and their taxpaying partners in sale-leasebacks. Description of H.R. 4170, supra note 1, at 64.

7. See I.R.C. §§ 38, 46-48 (1976). See, e.g., S. Rep. No. 1881, 87th Cong., 2d Sess. 10 (1962), reprinted in 1962 U.S. Code Cong. & Ad. News 3304, 3304. This Senate Finance Committee report concerning the introduction of the investment tax credit in 1962 states that the ITC was designed to encourage modernization and expansion of the nation’s productive facilities, improve the economic potential of the country, and increase job opportunities by stimulating investment. This was to be accomplished by (1) reducing the net cost of acquiring depreciable assets, which in turn would increase the rate of return after taxes arising from their acquisition; and (2) increasing the flow of cash, thereby making investment decisions easier since they are in large part influenced by the availability of funds. Policy Readings in Individual Taxation 311, 313 (Philip F. Postlewaite ed. 1980).


The congressional policy originally reflected in extension of the nontaxable use restriction to cover non-governmental tax-exempt entities was to prevent the flow through to a taxpayer of this benefit based on a tax-exempt’s use of the property. S. Rep. No. 1881, 87th Cong., 2d Sess. 10 (1962), reprinted in 1962 U.S. Code Cong. & Ad. News 3304, 3304-05. Purported service contracts under the nontaxable use restrictions on the ITC remain largely undisturbed. Description of H.R. 4170, supra note 1, at 75. The legislation will require a particularized factual inquiry into matters such as the degree of control exerted by the tax-exempt entity and the extent
This Note explores the use, mechanics, and financial and tax ramifications of sale-leaseback transactions, focusing on their growing use by tax-exempt entities and the concerns this use has created in Congress. This analysis demonstrates that these transactions do not pose the problems feared by Congress, the Treasury Department (IRS), and the current Administration. Furthermore, it will be shown that under most circumstances sale-leaseback transactions by tax-exempt entities, although causing a revenue loss, are a useful device for providing certain tax-exempt entities with the financial means to maintain services in the face of rising costs and the withdrawal of federal funding. Finally, this Note proposes the legitimization of the use of sale-leasebacks by tax-exempt entities and adoption of guidelines of its possessory or economic interest. Id. at 74-75. A three-part test is given in which ITC will be denied if all of the following factors are present in a transaction: (1) property is used primarily to provide services for a tax-exempt entity for a large portion of the useful life (or value) of the property; (2) the tax-exempt entity bears the risk of loss of the property's residual value; and (3) the tax-exempt entity bears the risk of damage to or loss of the property during the term of the lease. Id. at 75-76. It should be noted that under the present law this situation would possibly also cause denial of the ITC. Id. at 74. This test could also cause the tax-exempt entity to be declared the owner for federal income tax purposes, eliminating depreciation deductions. Id. at 75. The ITC may be allowed where property is used in such a way that the economic benefits and burdens of ownership are split between the tax-exempt and a taxable entity. Id. at 76-77.

9. See infra notes 97-101 and accompanying text. For example, the House Ways and Means Committee noted its concern that: investment incentives that were intended to reduce the tax on taxable entities have been turned into unintended benefits for tax-exempt entities, including foreign entities. The benefits are equivalent to an open-ended spending program, operated within the tax system, that increases the Federal deficit, encourages tax-exempt entities to dispose of the assets they own and forego control over the assets they use, disorders public budgeting processes, and feeds a popular perception that the tax system is open to manipulation.

DESCRIPTION OF H.R. 4170, supra note 1, at 62. See also A Tax-Leasing Twist That Is In Trouble, BUS. Wk. 57 (July 18, 1983) [hereinafter cited as Tax-Leasing Twist] (“Leasing by nonprofit organizations has boomed to the point where the Treasury argues that it will lose $14 billion in tax receipts over the next five years unless something is done”); College Leasing Deals Are Target of Proposal to Clamp Down on “Costly Tax Shelters,” 26 CHRON. OF HIGHER EDUC. 13 (June 29, 1983) (Rep. J.J. Pickle (D. Tex.), in introducing bill to House Ways and Means Committee, called the leasing arrangements “one of the most unusual, ingenious, and costly tax shelters that we’ve seen in years”); Growth of Tax-Exempt Financing Stirs Battle on Revenues and Rights, WALL ST. J., Nov. 7, 1983, at § 2, at 37, col. 4 (“tax-exempt financing has spread into areas where it doesn’t belong...”).

10. See infra notes 103-104 and accompanying text for discussion of relevant issues perceived by the Joint Committee on Taxation and the House Ways and Means Committee addressed by the proposed legislation.

11. See infra notes 127-35 and accompanying text for discussion of proposed guidelines for use in formation of sale-leaseback transactions.
through which the expanding use of this financial device could be controlled. The fundamental issues of ownership, control, and accountability will become manageable and straightforward through the certainty of financial and tax consequences resulting from the use of official guidelines.

II. Sale-Leasebacks Generally

A. Structure

The unification of such diverse elements of property transactions as the sale, lease and option in the sale-leaseback transaction creates an efficient vehicle for accomplishing various economic and business objectives. Frequently an owner of property is able to dispense with ownership of the asset but is unwilling or unable to give up the use of the property in its business. The term "sale-leaseback" is a loosely-defined term of art used to describe various transactions involving the transfer of property followed by its subsequent lease back to the seller. Typically, sale-leaseback transactions of real property consist

12. See, e.g., Note, Sale-Leaseback v. Mere Financing: Lyon's Roar and the Aftermath, 1982 U. Ill. L. Rev. 1075 (to raise capital or relieve itself of debt, entity may desire method by which to sell yet retain use of its property). But see Description of S. 1564, supra note 1, at 12-13 (since tax deductions can convert positive tax on equity-financed structures into negative tax, they create "tax incentive for tax-exempt entities to lease, rather than own, the buildings they use").

13. See, e.g., Cary, Corporate Financing Through the Sale and Lease-Back of Property: Business, Tax, and Policy Considerations, 62 Harv. L. Rev. 1, 2 (1948) ("sale and lease-back is being hawked and brokered as a panacea for corporate ills"); Morris, Sale-Leaseback Transactions of Real Property—A Proposal, 30 Tax Law. (A.B.A. Sec. of Tax'n) 701 (1977) (sale-leaseback is "a catch-all phrase which describes many kinds of transactions carried out for various motives"); Note, Sale and Leaseback Transactions—A General Review, 32 Vand. L. Rev. 945, 947 (1979) (sale-leasebacks "take a myriad of forms and transfer diverse types of property, such as equipment, improved or unimproved real estate, and intangible property").

14. Note, supra note 13, at 945 n.10-13 (description of various leaseback vehicles, including gift and leaseback, trust and leaseback, lease-leaseback, and particularly the bootstrap sale and leaseback, which presents sale of property to tax-exempt entity, thus allowing for "bailing out" of ordinary income from the property at capital gains rates which has, however, been largely curtailed by I.R.C. § 512). See also Vogt & Cole, Introduction and Types of Leases and Identifying Characteristics of Tax-Exempt Leases, in A Guide to Municipal Leasing 1-32 (A.J. Vogt & L. Cole eds. 1983) (Municipal Finance Officers Association, Government Finance Research Center) (municipalities may sign service agreements with investors or equipment manufacturers to build such projects as waste-water treatment plants; investors might qualify in these transactions for the investment tax credit (ITC)); New Design at GM, Forbes, Feb. 1, 1982, at 38, col. 1 [hereinafter cited as New Design at GM] (unusual loan transaction resembling sale-leaseback with option to purchase in creditor). See infra notes 88-89 and accompanying text for mortgage discussion.
of a sale of land, land and improvements, or improvements alone to an unrelated investor, and the simultaneous lease of the property back to the seller. The purchaser takes title by purchasing the property at its full value, often financing its acquisition by borrowing funds from an institutional lender or other investors secured by a mortgage on the property and a conditional assignment of the lease. The seller-lessee commits itself to a long term lease of the property. Thus, the basic documents involved in a sale-leaseback transaction are a sales contract and a lease.

The purchaser will often seek to limit his financial obligation toward the newly-acquired property to his initial contribution of capital through the use of some form of net lease. In the typical net lease, the lessee (seller) pays a rental fee to the lessor (purchaser) while also remaining responsible for paying operating expenses such as utilities, maintaining the premises in good repair, paying real estate taxes, and carrying adequate insurance coverage. Under this arrangement, therefore, the lessor receives rent payments as income while avoiding all expenses related to the management of the property. This arrangement conveniently provides benefits to both parties, but can

16. To avoid any potential confusion posed by the unusual relationships of the sale-leaseback transaction, this Note will use only the terms “purchaser” and “seller” to describe the basic trading partners. Thus, “purchaser” will stand for “lessor” and, in the transactions central to this article, for “taxpayer”; “seller” will stand for “lessee” and “tax-exempt entity.” Where necessary, full explanation of relationships and additional or different terms will be provided.
17. See Vogt and Cole, Introduction, in A Guide to Municipal Leasing 1, 2-5 (A.J. Vogt and L. Cole eds. 1983) (Municipal Finance Officers Association, Government Finance Research Center). These categories of transactions include “tax-exempt or municipal leases,” which are essentially conditional-sale leases or lease-purchase agreements; “certificate of participation (COP) leases,” a type of tax-exempt lease which provides investors with fractional interests or shares, often represented by small denomination certificates and marketed to the public; “finance leases,” which recoup the initial investment for the lessor bank or investor group plus provide a satisfactory return on investment; and “leveraged leases,” true leases with third-party lenders or investors which yield the depreciation write-offs to the lessor and a return to the investors. Id.
18. See infra notes 23-26 and accompanying text for discussion of renewal or repurchase options.
20. See, e.g., Vogt & Cole, supra note 17, at 4 (lessee is responsible for “executory” costs on leased property); Note, supra note 12, at 1077 n.7 (also called “net lease” or “net net lease”); Weinstein & Silvers, The Sale and Leaseback Transaction After Frank Lyon Company, 24 N.Y.L. Sch. L. Rev. 337, 339 (1978) (typical term used to describe this type of lease is “triple net lease”).
21. Id.
prompt an investigation by the Internal Revenue Service as to true ownership.\(^2\)

Options in the lease are often critical aspects of these transactions since they serve to place the lessee in essentially the same position he enjoyed as owner of the property.\(^3\) They may include options to renew the leasehold for an extended term or to purchase the property back from the investor at any time during the lease, at specified times, or at the expiration of the lease term. These options also assure the seller of continued use of property needed in his trade or business even though he has relinquished title, and provide him a right to reacquire the property should future business developments make this necessary or desirable.\(^4\) The lease frequently allows the lessee to repurchase the property at a price which declines over the property's expected useful life; alternatively, the price may be left to determination by a future appraisal.\(^5\) The lessee is sometimes given the right to terminate the lease under specified conditions.\(^6\)

**B. Financial Incentives**

The general reduction in federal funding to states and localities and the continuing need to renovate and maintain existing facilities have

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\(^2\) See *infra* notes 78-91 and accompanying text for discussion of larger question of "ownership" for tax purposes.

\(^3\) See *infra* note 82 and accompanying text for discussion of tax ramifications where purchaser only retains a nominal residual value in the property through granting of option.

\(^4\) Note, *supra* note 13, at 949. In the case of a tax-exempt entity, for example, use of a sale-leaseback could provide a period in which to reorganize and generate new sources of income, such as development of a new curriculum at a university having sold its campus, or annexation of new property in the case of a municipality.

\(^5\) See *infra* note 82 and accompanying text for discussion of tax ramifications where purchaser only retains a nominal residual interest in the property through granting option. The test developed in case law is "compulsion to exercise" option: if the seller is "compelled" to exercise the option (a "put"), then the lease transaction will be labeled a financing arrangement and tax benefits will shift dramatically. Frank Lyon v. United States, 435 U.S. 561, 583-84 (1978); Sun Oil Co. v. Comm'r, 562 F.2d 258, 269 (3d Cir. 1977), *cert. denied*, 436 U.S. 944 (1978); Frito-Lay, Inc. v. United States, 209 F. Supp. 886, 891-92 (N.D. Ga. 1962). See also Harmelink and Schurtz, *Sale-Leaseback Transactions Involving Real Estate: A Proposal for Defined Tax Rules*, 55 S. Calif. L. Rev. 833, 840-41 (1982) (option price is important factor in determining whether purchaser has taken an equity interest).

\(^6\) See Weinstein & Silver, *supra* note 20, at 339 (seller may have options to renew lease for extended periods, including terms beyond useful life of property of transaction or options to repurchase property at specified times; purchaser may have termination rights under certain conditions, usually after substantial condemnation or casualty).
prompted tax-exempt entities such as municipalities to search for new sources of funds. The tax-exempt seller may be unable to raise funds in traditional ways due to an unfavorable money market environment, an excess of debt or restrictions in corporate or municipal charters. Present economic conditions combined with the en-

27. See, e.g., Coughlan, Financing Alternatives Available to Local Governments, in Urban Land Policy for the 1980s 147 (G. Lefcoe ed. 1983) (in face of "severe cutbacks in federal funds," it has become "patently obvious" that state governments are no longer financially able to extend substantial aid to local governments, thus forcing them into utilizing "creative financing alternatives"); Vogt, Why Lease? in A Guide to Municipal Leasing 33 (A.J. Vogt and L. Cole eds. 1983) (Municipal Finance Officers Association, Government Finance Research Center). The author states that the overriding reason to lease is a desire to spread the costs of capital acquisitions over several fiscal periods or years, caused by (1) lack of revenue for recurring capital replacements resulting from declining tax bases, taxpayer revolts, and inflation; (2) backlog of capital replacement needs due to political pressure to maintain services in the face of slow-growing or declining revenues; (3) impracticality of bond financing for purchases of short-lived but expensive equipment which should be spread across several years; (4) major capital expenditures necessitated by a one-time or non-recurring event such as municipal annexation; (5) need to conserve operating reserves; (6) financial policy considerations such as limiting capital reserves to major improvement projects or for investment purposes; or (7) seller insistence on installment payments for income tax and cash flow purposes. Id. at 33-41.


Long-term sale-leaseback transactions are substituted for revenue bond issues to provide local governments with a means to avoid statutory limits on the interest rates that may be charged for debt. Id. Voter approval is also thus avoided, which may prove more efficient in terms of quickly obtaining cash or the use of the property. Where voter antagonism to bond issues or poor credit ratings exists for a particular local government, such transactions may be the only available means of generating needed capital. Growth of Tax-Exempt Financing Stirs Battle on Revenues and Rights, Wall St. J., Nov. 7, 1983, § 2, at 37, col. 4

[T]raditionally lower rates on municipal bonds are being washed away in the flood of new bond issues. The huge supply of these bonds forces issuers to entice investors with higher yields, thus increasing the cost of borrowing for states and cities across the country—a cost ultimately borne by the taxpayer. For example, for last year's record $78 billion of new long-term municipal debt, rates offered by local and state governments were so high that in some cases the difference between interest rates on taxable government and tax-exempt securities virtually disappeared.
hanced tax benefits available to property-owning taxpayers since 1981, have generated greater use of the sale-leaseback transaction as an important source of funds.  

A wide variety of business, accounting and tax considerations provide incentives for using the sale-leaseback vehicle. The tax-exempt seller of property utilizes the sale-leaseback transaction to generate working capital or for investment funds. While the seller has trans-

Id. See also Ways and Means Committee Plans Combination of Tax Bills Designed to Close Loopholes, 233 WEEKLY BOND BUYER, Sept. 6, 1983, at 1, col. 1 (reporting on proposed H.R. 4170, “a single ‘loophole closing’ tax bill,” stating that combination of bond restrictions, increased taxes on life insurance companies, and sharp limits on sale-leasebacks by tax-exempt entities will “generate some of the $73 billion in additional revenues the latest congressional budget plan calls for over the next three years”).  

30. See infra notes 63-64 and accompanying text. See also DESCRIPTION OF S. 1564, supra note 1, at 2; DESCRIPTION OF H.R. 3110, supra note 1, at 2; DESCRIPTION of H.R. 4170, supra note 1, at 62. The major attraction of sale-leaseback transactions involving tax-exempt entities is that depreciation deductions may flow through in a sale-leaseback in the form of reduced rents to tax-exempt entities otherwise ineligible for these benefits. DESCRIPTION of H.R. 4170, supra note 1, at 62. If arranged as a service contract with a tax-exempt entity, the transaction may allow the parties to avoid the nontaxable use restriction on the investment credit. Id. at 75-84; See Vogt & Cole, supra note 17, at 1 (listing economic and legal factors leading to “the growth and interest in leasing at the state and local government levels . . . .,” including spreading of cost of equipment and capital assets over multi-year periods, expensive capital asset purchases with short useful lives, and federal tax laws and regulations making leasing preferable to ownership); Pickle Introduces Bill to Restrict Sale-Leasebacks By Tax-Exempt Entities, 11 Hous. & Dev. Rep. (BNA) 11, 12 (June 6, 1983) (sale-leaseback transaction creates opportunity for cities, counties, states, and federal agencies to sell tax writeoffs in the forms of accelerated depreciation, investment tax credits and interest deductions that they would never qualify for on their own account; this will cause staggering revenue losses and add to federal deficit) (citing Rep. Pickle (D. Tex.), sponsor of H.R. 3110).  

31. Vogt & Cole, supra note 17, at 1 (“state and local governments have greatly increased their reliance on leasing as a means to acquire the assets necessary to provide public services”; “leasing has become a viable financing option for capital assets as governments seek to continue to provide services and facilities while their costs for doing so increase at a faster pace than revenues”); Tax-Leasing Twist, supra note 9, at 57 (July 18, 1983) (Bennington College to generate $8.5 million in cash while retaining use of its campus after lease-leaseback transaction to limited partnership of alumni); Coughlan, Financing Alternatives Available to Local Governments, in URBAN LAND POLICY FOR THE 1980s, THE MESSAGE FOR STATE AND LOCAL GOVERNMENTS 147 (G. Lefcoe ed. 1983) (explores the creative financing alternatives local governments are using in order to generate working capital since withdrawal of federal and state aid); College Leasing Deals Are Target of Proposal to Clamp Down on “Costly Tax Shelters,” 26 CHRON. OF HIGHER EDUC. 13 (June 29, 1983) (art school significantly cut operating losses by use of sale-leaseback).  

formed his fixed asset into working capital, he has retained both possession and use of the property. Additionally, the sale of the property for its full value in a sale-leaseback transaction can yield more cash than could be raised through borrowing against the property.\textsuperscript{33}

Perhaps the most important incentives behind sale-leaseback transactions are the tax benefits associated with ownership of the property.\textsuperscript{34} These include depreciation or accelerated cost recovery (ACRS) deductions\textsuperscript{35} and investment tax credits (ITCs).\textsuperscript{36} ITCs may not be claimed for property leased to and used by a governmental unit or by a tax-exempt organization in its exempt function.\textsuperscript{37} This “nontaxable

markets to capitalize on price differences. \textit{Id}. For instance, the issuing of tax-exempt bonds, such as industrial development bonds (IDBs) or other obligations, is prohibited for the purpose of investment of the proceeds in higher yielding taxable securities, the interest on which is used to cover rental payments. \textit{Id}.


34. See \textit{infra} notes 105-07 and accompanying text for discussion of eligibility of tax-exempt entities for use of tax benefits in the form of lowered rent payments passed through by taxpaying entities claiming tax deductions and credits.

35. I.R.C. § 168 (1976). For convenience of terms in this Note, “depreciation” will stand for both depreciation deductions and for the accelerated cost recovery system (ACRS). ACRS applies to recovery property which is tangible property (1) of a depreciable character, (2) placed in service after 1980, and (3) used in a trade or business or held for the production of income. See \textit{Depreciation Guide, supra} note 4, at ¶¶ 100-170 (ACRS was made mandatory for most depreciable-type tangible property placed in service after 1980 due to intent to create new incentives to stimulate capital investment in face of diminished value of previous depreciation allowances due to inflation and urgent need to upgrade technology); \textit{Tax Handbook, supra} note 4, at ¶ 2004 (“recovery of cost of depreciable property placed in service after 1980 will generally be determined under the ACRS by using statutory accelerated methods, applied over a prescribed statutory period”).

36. See \textit{infra} notes 51-55 and accompanying text for discussion of governmental use property and eligibility for a claim of ITC.

37. I.R.C. § 48(a)(4)-(5) (1976). The 10% investment credit regularly claimed applies to depreciable tangible personal property which is either ACRS recovery property (I.R.C. § 168) or other depreciable property with a useful life of at least 3 years (I.R.C. § 48(a)(1)). See \textit{Description of H.R. 4170, supra} note 1, at 67-72 (definitions and explanation of provisions affecting tax-exempt use property).
use restriction” does not, however, otherwise restrict an eligible purchaser from claiming depreciation deductions or other tax benefits.\(^3\)

Rent payments constitute ordinary income to the purchaser.\(^3\) As owner of the property, the purchaser may depreciate the real property improvements over their useful lives in order to offset this income.\(^4\) Since depreciation is not a current out-of-pocket expense to the purchaser,\(^4\) he may have cash in hand in spite of aggregate deductions exceeding the amount of the rental income, especially during the early years of the lease when the depreciation deductions are greatest.\(^4\) In this way “tax-sheltered cash flow” is generated.\(^4\)

This net cash flow to the investors in the property during the initial lease term and any renewals, as well as any sale or financing proceeds,

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38. Description of H.R. 4170, supra note 1, at 67-72. For purposes of eligibility for claiming these deductions, present rules used for determination of whether personal property is tax-exempt use property apply except to the extent modified by the provisions of H.R. 4170 dealing with service contracts or similar arrangements. If owned by, leased to, or otherwise used by a tax-exempt entity, property other than 15-year real property will be tax-exempt use property. Therefore, it remains possible that a tax-exempt entity could be treated as the property owner under a purported lease, service contract, or other arrangement. Id.


40. I.R.C. § 62(5) (1976). See Burke, Why Some Sale and Leaseback Arrangements Succeed While Others Fail, 26 J. Tax’n 130 (March 1967) (when used together with analysis of option price, as where seller’s rental payments are applied toward option price as part of deal, rate of rental payments may trigger recharacterization by IRS as a financial device and eliminate tax aspects of transaction); Tax Handbook, supra note 4, at ¶ 2410 (these are deductions from adjusted gross income, including, from accounting point of view, only such deductions regarded as being directly incurred from rental of property); Harmelink & Schurtz, supra note 25, at 838-39 (unreasonably high or low rental payments may serve as gauge for use by IRS and courts in determining whether equity interest has in fact passed and valid lease arrangement has been made).

41. See Seidler & Carmichael, supra note 4, at 22-23 (depreciation is “a process of allocation, not of valuation,” aiming to apportion cost or other fundamental value of tangible capital assets, less any salvage value, “over the estimated useful life of the unit . . . in a systematic and rational manner,” thus reflecting its assigned value in operating statement).

42. 1983 Stand. Fed. Tax Rep. (CCH) ¶ 300 (“noncash charges added to other deductions exceed gross income . . . resulting in cash available for distribution to investors that may not be currently taxed or is taxed at a lower rate”; in the case of tax-exempts, of course, this cash is not taxed at all). See supra notes 30-31 and accompanying text for discussion of cash flow and tax-exempt entities.

43. See How Leasebacks Beat the High Cost of Money, Bus. Wk., Jan. 12, 1981, at 26, col. 2 (investors near federal tax ceiling are better able to take advantage of property depreciation than corporations at maximum federal tax rate of 46%); New Design at GM, supra note 14 (GM put premium on cash flow in five year, $40 billion modernization, thus necessitating unusual $500 million lease transaction of its Manhattan office tower).
usually provides a higher rate of return than a loan secured by the property.\footnote{44} Rental payments are usually set at the fair rental value of the property, but they may be set at a rate designed to amortize the purchaser's investment over the primary term of the lease at a specified rate of return.\footnote{45}

The purchaser's deductions for depreciation are based on the property's cost to him, rather than its current market value\footnote{46} which may have increased or decreased during the seller's years of ownership. The purchaser must have made an actual capital investment\footnote{47} in the property for the investment to be included in the property's basis when computing depreciation.\footnote{48} No amount of basis attributable to land is depreciable.\footnote{49}

\footnote{44} Cary, supra note 13, at 9-11. This higher rate of return to purchaser results from the fact that risk is higher since purchaser investing 100% of property's fair market value rather than lower percentage generally risked on a loan. Purchaser's margin will of course reflect market price fluctuations caused by economic conditions such as inflation versus a stable economy. \textit{Id.}

\footnote{45} See infra notes 88-90 and accompanying text. Rent payments unrealistically below fair rental value may be a crucial factor in recharacterization by IRS of a sale-leaseback transaction as a mortgage. Harmelink & Schurtz, \textit{supra} note 25, at 838-39.

\footnote{46} I.R.C. § 167(g) (Basis for Depreciation); \textit{id.} § 1011 (Adjusted Basis for Determining Gain or Loss); \textit{id.} § 1012 (Basis of Property—Cost) (1976); see also \textit{Depreciation Guide, supra} note 4, at ¶ 201-206 (three items essential for computing depreciation are (1) basis of asset for depreciation purposes, (2) estimated salvage value at end of useful life of asset, and (3) estimated useful life of asset); Fuller, Sales and Leasebacks and the Frank Lyon Case, 48 Geo. Wash. L. Rev. 60, 62 (1979) (depreciation deductions are limited by three factors: (1) historical basis used for its calculation is generally less than market value, (2) original basis is reduced over the years lowering the value of deductions, and (3) no amount of basis allocable to land is subject to depreciation); Schurtz, \textit{supra} note 33, at 391-92 (rental income is only taxable if it is “related” business income to a purchasing tax-exempt entity). Depreciation amount is found by subtracting salvage value from basis; period over which asset is depreciated is useful life. \textit{Depreciation Guide, supra} note 4, at ¶ 201-206.

\footnote{47} Cf. Vogt & Cole, \textit{supra} note 17, at 4 (leveraged leases involve lenders as third parties with actual substantial financial stake, often as much as 50-80% of capital needed to buy leased property).

\footnote{48} Helvering v. Lazarus & Co., 308 U.S. 252 (1939), \textit{aff'd}, 101 F.2d 728 (6th Cir.), \textit{aff'd}, 32 B.T.A. 633 (1935) (test of who bears burden of exhaustion of capital investment is based on whether legal title passes, how parties treat transaction, whether equity was acquired in the property, whether parties are in fact obligated to each other as seller and buyer, who pays taxes on property, and who bears risk of loss or damage); Frank Lyon v. United States, 435 U.S. 561 (1977), \textit{rev'd}, 536 F.2d 746 (8th Cir. 1976) (four elements in test to determine economic reality to transaction: (1) whether transaction is genuinely multiple party, (2) with economic substance, (3) compelled by business realities, and (4) imbued with tax-independent considerations not shaped solely by tax avoidance); Hilton v. Comm'r, 74 T.C. 305, 360-61 (1980), \textit{aff'd per curiam}, 671 F.2d 316 (9th Cir.), \textit{cert. denied}, 103 S.Ct. 211 (1983) (distinguished Lyon and adopted an “imprudent abandonment” test focusing on value of
The evaluation of the economic substance of the transaction is necessary to determine whether property is “used by” a tax-exempt entity and thus ineligible for the ITC. Subject to several exceptions, a nontaxable use restriction will exist on property leased to any tax-exempt entity, in which case the ITC may not be claimed by the purchaser. The ITC was created in 1962 to stimulate expansion of productive facilities by reducing the net costs of acquiring new equipment. Since governmental demand for property was viewed as being independent of its price, no corresponding increase in production was believed to have been derived from extending the ITC to government-cash flow derived from rental payments and giving little weight to speculative possibility that the property would have a substantial residual value at end of lease term; court concluded that purchaser would not “at any time find it imprudent from an economic point of view to abandon the property,” and thus there was no justification for transaction apart from its tax consequences. See 1983 STAND. FED. TAX REP. (CCH) ¶ 1715.23 (IRS uses “economic reality test” based on capital investment requirement for claiming depreciation deductions in determining whether tax shelter activities are formed merely for tax avoidance purposes; a true obligation must be represented by nonrecourse indebtedness in property for it to be included in basis of such property for determining amount of depreciation).

49. Treas. Reg. § 1.167(a)-2 (1960) (“depreciation allowance for tangible property applies only to that part of property subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence”; “allowance does not apply to inventories or stock in trade, or to land apart from improvements or physical development added to it”). See DEPRECIATION GUIDE, supra note 4, ¶ 329 (“the excess of expenditures for repair, maintenance, rehabilitation and improvement of repair allowance property . . . over the repair allowance is called a ‘property improvement’ ”); Comment, Loss Recognition Upon Sale and Leaseback: the Like Kind Exchange Controversy, 28 Loy. L. Rev. 1146, 1148 n.14 (1982) (“to be depreciated . . . improvements must either be used in the taxpayer’s trade or business or held for the production of income”).

50. See supra notes 37-38 and accompanying text for discussion of requirements for eligibility for ITC claim.

51. See DESCRIPTION OF S. 1564, supra note 1, at 7-10; DESCRIPTION OF H.R. 3110, supra note 1, at 7-10; TAX ASPECTS, supra note 1, at 13-15; DESCRIPTION OF H.R. 4170, supra note 1, at 58-61 (statutory exceptions to nontaxable use restriction include property used by tax-exempt organization in taxable unrelated trade or business; certain international organizations; foreign governments and possessions of U.S.; foreign persons, unless property used predominantly outside U.S.; and rehabilitation tax credits for qualified rehabilitation expenditures); DESCRIPTION of H.R. 4170, supra note 1, at 58-61. See also Treas. Reg. §§ 1.48-1(j) and (k) (1972) (“casual or short-term lease” exception); Rev. Rul. 68-109, 1968-1 C.B. 10 (“service contract” exception).

52. See DESCRIPTION OF S. 1564, supra note 1, at 6-10; DESCRIPTION OF H.R. 3110, supra note 1, at 6-10; TAX ASPECTS, supra note 1, at 13-15; DESCRIPTION of H.R. 4170, supra note 1, at 57-61.

53. See DESCRIPTION OF S. 1564, supra note 1, at 7; DESCRIPTION of H.R. 3110, supra note 1, at 7; TAX ASPECTS, supra note 1, at 13; DESCRIPTION of H.R. 4170, supra note 1, at 62-63.
tual units. Under the legislation pending in 1984, availability of the ITC to tax-exempt entities would be further eliminated.

C. Advantages v. Disadvantages

While the seller may obtain more cash through a sale-leaseback transaction than through a mortgage or bond issuance, this advantage must be weighed against a generally higher rate of interest implied in the rental payments, and the greater costs and complexities involved in structuring these transactions. The higher costs of this method of financing are less significant where ordinary debt or debt secured by an encumbrance against the property is unavailable or available only on unattractive terms.

A sale-leaseback transaction provides superior security to the purchaser in the form of simple default remedies. Since the purchaserlessor has title to the property and a valid lease exists, landlord and tenant law applies to the leasehold relationship. If the seller defaults by failing to make rental payments, the purchaser can usually evict

54. Tax Aspects, supra note 1, at 13. For discussion of the policy related to economic issue of neutrality addressed by Joint Committee, see infra at note 99 and accompanying text.

55. Description of S. 1564, supra note 1, at 18; Description of H.R. 3110, supra note 1, at 17-18; Description of H.R. 4170, supra note 1, at 74-75.

56. Cary, supra note 13, at 6-8.

57. See Tax Aspects, supra note 1, at 22. The Joint Committee questions whether the amount of the benefits given tax-exempt entities at the cost of loss of revenue to the U.S. Treasury is not "dissipated in the form of private profits and legal and administrative expenses?" Id. The Committee believes that these benefits pass to the attorneys, bankers, leasing companies, and other investors or agents involved in these transactions. Id. at 22-23. See also Cary, supra note 13, at 9-11 (higher charges of sale-leaseback transactions due largely to (1) greater risk to investor since, in spite of having simple default remedies, there is no general obligation from seller, (2) lower liquidity and marketability of investment, and (3) transaction costs greater than with other investments).

58. See supra notes 28-30 and accompanying text for discussion of general economic climate and particular restrictions on borrowing.

through a summary process. After a simple eviction process, purchaser-lessee has the right to immediately lease the property to a new lessee.60 In contrast, a mortgagee must use the lengthy and expensive foreclosure process to take possession where a mortgageor defaults on payments of principal or interest.61

The purchaser’s risk is higher than that of the mortgagee because the purchaser is investing the entire fair market value of the property rather than the lower percentage usually securing a loan.62 This risk is partially offset by the more advantageous default remedies available to a purchaser,63 although the problem of re-renting or selling the property should the seller default remains.64

Any rise in the value of the property is an advantage to the purchaser who retains a reversionary interest in the leased property and any of the lessee’s remaining improvements upon expiration of the lease.65 The purchaser may realize the property’s appreciated value by selling or renting at a higher rate upon termination of the original

60. Rosenberg & Cohn, Sale-Leaseback Transactions, in Evaluating Tax Shelter Offerings 831, 835 (P.L.I. 1981). But see Tax Aspects, supra note 1, at 24. If the property is unique and useable only by the current lessee, purchaser could not easily re-rent (e.g., a college campus or a municipality’s city hall). Id. This factor will naturally decrease the attractiveness of the transaction and therefore will directly influence its financial usefulness. Id.


62. See, e.g., Description of S. 1564, supra note 1, at 13; Description of H.R. 3110, supra note 1, at 12-13; Tax Aspects, supra note 1, at 22-23 (this risk may be outweighed by tax benefits gained by these investors; some benefits to tax-exempt entities may be siphoned off by transaction costs); Sale-Leasebacks Intrigue the Nation’s Municipalities, But Complex Tax Consequences Are Leading to A Cautious Approach, N.Y. Times, July 31, 1983, § 8 (Real Est.), at 7, col. 1 [hereinafter cited as Nation’s Municipalities] (“[m]ost deals offer more tax shelter than cash flow benefits to private investors,” indicating the limited appeal of these transactions; “[t]here are investments out there of greater quality and security”) (quoting Jack Freeman, consultant to New York City on sale-leaseback transactions). See supra note 30 and accompanying text for discussion of limitations on mortgage borrowing.

63. See supra notes 59-60 and accompanying text for discussion of default remedies available to lessor.

64. See infra notes 65-69 and accompanying text for discussion of value of reversionary interests in leased property and improvements.

65. See, e.g., Fuller, supra note 46, at 48 (trend in United States has been for fair market value of real estate to rise); Tax Aspects, supra note 1, at 7 (U.S. Navy required to pay termination value to contractor if specially designed naval vessels prove unsaleable at end of lease term; shipowner, a third party to transaction, retains any excess of proceeds over termination value); Weinstein & Silver, supra note 20, at 337 n.1 (equipment more likely to incur actual decline in value from wear-and-tear or economic obsolescence, thus necessitating shorter-term leases than those of real estate).
lease. If the seller has obtained a repurchase option exercisable at termination of the leasehold, the purchaser may still realize the property's increased value if the purchase price of the option is determined as a function of the market value at the expiration of the lease term. The purchaser, however, assumes the risk of the property depreciating over time due to changes in market conditions or the neighborhood, or from the bankruptcy of a tenant of an unusual property. These conditions could make finding a new tenant or selling the property difficult or uneconomical.

D. Accounting Issues

For many years, sale-leaseback transactions were regarded for accounting purposes as operating leases, rather than capital leases. Consequently, they did not appear on the sellers' balance sheets as liabilities. The transformation of the fixed property asset into the current cash asset was coupled with the simultaneous elimination of any liability that had been attached to the property. The seller thus enhanced his credit standing by increasing his current ratio of assets to liabilities.

66. See infra note 82 and accompanying text for discussion of critical tax ramifications of residual value. See also Note, supra note 12, at 1096-98 (renewal and repurchase options can extend probable date of purchaser realizing residual value so far into future as to make any computation of amount impossible).

67. See infra notes 82-88 and accompanying text for tax ramifications of options. In general, the fixed price purchase option is precluded in sale-leaseback transactions since the IRS requires the option to be exercised at fair market value as determined at time of exercise. Description of H.R. 3110, supra note 1, at 17; Description of S. 1564, supra note 1, at 19; Description of H.R. 4170, supra note 1, at 69. Further, a purchaser may not retain a contractual right to require a seller to purchase property (a put). Id.

68. See New Design at GM, supra note 14 ($500 million financing transaction with creditor essentially paying for option to purchase at end of 5-year lease term; risk in this unusual transaction is shared by debtor, GM, in its spread between present value received, approximately $385 million, and apparent value given of $500 million).

69. See supra notes 59-64 and accompanying text for discussion of ability to rent property.

70. Cary, supra note 13, at 11-12.

71. Schurtz, supra note 33, at 389. From a business perspective, this gauge of an entity's liquidity (i.e., capacity to generate immediate cash) displays to the financial community the entity's general solvency, a basic indicator of credit-worthiness. By eliminating balance sheet reporting, the operating lease status replaces fixed assets with current assets and may remove a liability the seller carried prior to sale, thus increasing current ratio which may in turn increase the seller's credit standing and borrowing capacity. See infra note 72 and accompanying text for discussion of operating lease versus capital lease.
Since November 1976 a lease has had to meet the strict standards of the complex Statement of Financial Accounting Standard No. 13 (FASB 13) to qualify for treatment as an operating lease.\footnote{72} If the lease falls within the criteria of FASB 13, it is viewed as having essentially transferred certain attributes of ownership to the purchaser, who carries it on his books as a capital lease.\footnote{73} The seller, on the other hand, has transferred the asset as a financing device under the accounting standard and thus carries the lease as a “direct financing” or “sales-type” lease, which essentially means he is not treated as an owner.\footnote{74}

The use of a leasing device, as opposed to a purchase of property, may shift the disbursement of funds from a Federal agency’s procurement account to a less closely observed part of the budget such as an operations and maintenance account.\footnote{75} Where a Federal agency might otherwise show an authorization or annual outlay as a single entry in the procurement section of its budget, in a leasing transaction the cost of the property will appear only in the form of annual rental payments.\footnote{72}


\footnote{73} FASB 13, \textit{supra} note 72.

\footnote{74} See Harmelink & Schurtz, \textit{supra} note 25, at 870-78 (discussion of accounting treatment for sale-leaseback transactions under FASB 13, including “direct financing leases”—those other than leveraged leases, which do not give rise to manufacturer’s or dealer’s profit—and “sales-type leases,” which do give rise to manufacturer’s or dealer’s profit).

\footnote{75} See \textit{Description of H.R. 3110, supra} note 1, at 13.
This perceived distortion of outlays, which may in fact reflect more accurately the annual expenses of the tax-exempt entity, is believed by the Joint Committee on Taxation and House Ways and Means Committee (“Committees”) to obscure “the multi-year financial commitment of the lessee [seller].”

E. IRS Recharacterization Powers

The form that the parties to a sale-leaseback transaction use to characterize the transaction for federal income tax purposes will not always withstand analysis of its substance. The primary aspect of a designated “sale” that must withstand analysis is whether the purchaser, who desires to claim deductions as the owner of the property, has accumulated a satisfactory number of the economic incidents of ownership possessed by an ordinary purchaser in a bona fide sale. The Internal Revenue Service (IRS) challenges transactions which it believes consist of mere schemes for the purchase of tax benefits, a situation perceived by the IRS as more likely where one party is a tax-exempt entity. A tax audit leading the IRS to recharacterize the sale

76. Description of H.R. 4170, supra note 1, at 65. Leasing’s tax benefits are open-ended and therefore unmanageable as to composition and amount; appropriations are contained in size and can be linked to current yearly priorities. Id. Tax benefits also appear as reduced tax collections in the federal budget, unrelated to any distinct public purpose. Therefore, where tax benefits serve to convey federal aid, discovery is complicated as to what tax-exempt purposes have been federally assisted, the amount of assistance, and whether this assistance has been rendered consistently with other public policy objectives. Id. Such issues are generally observed, argued, and resolved in the appropriations process. Id.

77. See Tax Aspects, supra note 1, at 22. Accounting techniques used for leasing by many nonprofit entities are different than those used for ordinary purchases, resulting in the concealment of the character of outlays and a reduction in accountability. Id. The Joint Committee notes that this problem is not limited to nonprofit entities. Id. (leasing “constitutes a significant source of off-balance sheet financing in the corporate sector”). Cf. infra note 114 and accompanying text.

78. Frank Lyon v. United States, 435 U.S. 561, 581-84 (1977), rev’d, 536 F.2d 746 (8th Cir. 1976) (“so long as the lessor [purchaser] retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes”). See Description of H.R. 4170, supra note 1, at 56 (inherently factual determination of federal income tax ownership of property requires particularized factual inquiry, based on standards which have evolved in court cases, revenue rulings and revenue procedures); Weinstein & Silver, supra note 20, at 353 (“Court merely listed a torrent of factors instead of establishing a set of guidelines to be used by the Internal Revenue Service and the courts in future cases”); see supra note 48 and accompanying text for discussion of ownership tests.

79. Bond, Tax Benefit Transactions and the Public Sector, 15 Urban Law. 401, 423 (1983) (this likelihood may cause purchaser of property to insist on an indemnification from governmental unit for loss of tax benefits should transaction be recharacterized by IRS).
can cause the purchaser to forfeit his depreciation, interest, and “necessary and ordinary business expense” deductions.\(^8\)

The determination of whether a designated “lease” is truly a lease under present law requires a factual analysis of the transaction in light of principles enunciated in court cases, revenue rulings, and revenue procedures issued by the IRS. The courts and the IRS first look for economic indicia of ownership, such as whether the lessee holds title to or has an equity interest in the property.\(^8\) The seller (user) of the property may also jeopardize lease treatment by retaining an option to regain title at the end of the lease term for a nominal price, or for a price which is relatively small when compared with the total payment stream.\(^8\)

Absent sufficient indicia, further criteria focusing on the economic substance of the transaction rather than its form are applied.\(^8\) If tax considerations are determined to be a significant motive for the transaction, a court may disregard the form of the transaction and treat it as a secured financing device such as a mortgage.\(^8\) If, however, there

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80. Note, \textit{supra} note 12, at 1083. The purchaser’s loss of these deductions is cushioned by a decrease in income resulting from rental income being recharacterized as debt payments. \textit{Id.} Were seller a taxpayer, a major repercussion would be a 100\% loss of rent payment deductions as a business expense since payments would then be regarded as loan payments, restricting deductions to interest portion only. \textit{Id.}

81. \textit{See Description of H.R. 3110, supra} note 1, at 5-6; \textit{Description of S. 1564, supra} note 1, at 5-6; \textit{Tax Aspects, supra} note 1, at 9-13; \textit{Description of H.R. 4170, supra} note 1, at 56-57.


The purchaser will be regarded as having transferred total ownership in the property for the stream of rental payments where the property’s residual value is nominal. \textit{Description of S. 1564, supra} note 1, at 5. If the purchase option remains small compared with fair market value, full ownership will be seen as transferred due to the probability of repurchase at the end of the lease term. \textit{Id.} If a “put” exists in the lease (if the purchaser can force the original seller to repurchase the property), then the transaction might not qualify as a lease since there would be no risk to the purchaser at the end of the lease term. \textit{Description of H.R.3110, supra} note 1, at 5 See also Fuller, \textit{supra} note 46, at 66-67 (seller may be regarded by IRS as holding equity in property with result of loss of rent deduction if attractive option to repurchase exists which will likely compel repurchase); \textit{Nation’s Municipalities, supra} note 62 (since “most” sale-leaseback transactions to municipalities carry option provisions, there is danger of future financial difficulties in the period when they must reacquire the property for an unpredictable amount).


84. \textit{See infra} notes 87-88 and accompanying text for discussion of similarities of sale-leasebacks to mortgages; see also \textit{supra} note 81 and accompanying text for discussion of rules formulated by courts for determining ownership.
is also a bona fide business purpose and the purchaser retains sufficient burdens and benefits of ownership, the form of the transaction will control. This requires a showing of reasonable expectation of profit from the transaction independent of the anticipated tax benefits.

A sale-leaseback transaction may be substantively, although not formally identical to a long-term mortgage on the owner's property where title is transferred to the lender to secure the obligation. This type of transaction has been the subject of a series of major IRS challenges of sale-leasebacks for forty years. Similarly, the sale-

85. See Description of S. 1564, supra note 1, at 5-6; Description of H.R. 3110, supra note 1, at 5-6; Tax Aspects, supra note 1, at 9-12; (purchaser-lessee must be party suffering or gaining from value fluctuations); Tax Handbook supra note 4, at § 2005 (tax owner is entity sustaining financial disadvantage from property value decrease resulting from depreciation, usually being entity with capital invested in property).

86. See supra notes 46-48 and accompanying text. This element of test is clearly not determinative since mortgagee would also make a profit from a mere financing arrangement, as well as from a bona fide sale-leaseback.

87. Frank Lyon Co. v. United States, 435 U.S. 561, 583-84 (1978), rev'd, 536 F.2d 746 (8th Cir. 1976) (Court established general test of economic substance to avoid characterization as mortgage); Hilton v. Comm'r, 74 T.C. 305 (1980), aff'd per curiam, 671 F.2d 316 (9th Cir.), cert. denied, 103 S.Ct. 211 (1982) (first detailed examination of the purchaser's interest after Lyon). See Bond, supra note 79, at 423-26 (noting that Tax Court, since the Supreme Court's decision in Lyon, seems to have recognized financing requirements as valid business purpose for transactions, substantiating any tax motivations); Note, supra note 13, at 968-79 (1979) (analysis of American Realty, Sun Oil, and Lyon); Fuller, supra note 46, at 63-64 (IRS bases its attack on substance rather than form for determining tax consequences). See also Rev. Rul. 68-590, 1968-2 C.B. 66; Comment, Hilton v. Commissioner: Sale-Leaseback Analysis Sharpened, 1 Va. Tax Rev. 375, 376 (1982), reprinted in, Digest of Tax Articles 52, 52-53 (1983) (no matter how much agreement in mortgage form resembles an actual sale, owner-mortgagor may only deduct interest portion of loan payments (I.R.C. § 163), while creditor-lender recognizes equivalent sum of interest income (I.R.C. § 61(a)(4) (1976); in contrast, seller in sale-leaseback transaction may deduct 100% of rental payments for a business, while purchaser, taking cost basis of property, entitled to depreciation deductions).

88. See Helvering v. Lazarus & Co., 308 U.S. 252 (1939) (early, landmark Supreme Court decision regarding tax consequences of sale-leaseback transaction which IRS attempted to recharacterize as a mortgage); Hilton v. Comm'r, 74 T.C. 305 (1980), aff'd per curiam, 671 F.2d 316 (9th Cir.), cert. denied, 476 U.S. 1131 (1986).
leaseback also closely resembles the conditional-sale lease, in which the lessee, for federal income tax purposes, remains the owner of the property throughout the lease term.\textsuperscript{89}

Sale-leaseback transactions have remained difficult and expensive due largely to the lack of substantive guidance from the IRS and the courts regarding the proper structure to be utilized in their formation.\textsuperscript{90} As a result of litigation brought under the Freedom of Information Act, IRS Audit Guidelines became available to the public in 1975.\textsuperscript{91} Although the Guidelines provide criteria for determining

305 (1980), \textit{aff'd per curiam}, 671 F.2d 316 (9th Cir.), \textit{cert. denied}, 103 S.Ct. 211 (1982) (recent decision stating factors for determining ownership for tax purposes). See \textit{supra} note 81 and accompanying text for discussion of series of cases and rules formulated for determining ownership for tax purposes. For examples of approaches to the mortgage characterization problem see, e.g., 1 B. \textit{BITTKER}, \textit{FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS}, \textsection{} 4.4.6, 4-75 (1981) ("courts have vacillated between allowing taxpayers to invoke substance-over-form, business purpose, and step transaction doctrines" on equal basis with IRS and "letting them stew in their own juice if that appeals to the government's appetite," when taxpayers attempt to restructure a transaction); Bond, \textit{supra} note 79, at 419-26 (where no partnership agreement is determined by a court to have been intended, all facts and circumstances relating to beneficial ownership of property must be analyzed, including all contractual relationships between the entities); Rosenberg, Weinstein, \textit{Sale-Leaseback Transactions After Frank Lyon Company}, in \textit{EVALUATING TAX SHELTER OFFERINGS} 843 (Rosenberg & Cohn eds. P.L.I. 1981) (discussion of economic substance test which emerged after \textit{Lyon}); Schurtz, \textit{supra} note 33 (article presents decision model to assist tax planners in determining structure of valid sale-leaseback of real estate); Note, \textit{supra} note 13, at 968-81 (\textit{Lazarus} Court cited intentions of parties as important factor in determining ownership, and held that while transaction was structured as transfer and leaseback, IRS should respect parties' intentions to create mortgage).

89. Vogt & Cole, \textit{supra} note 72, at 11-32 (full survey of various types of leasing arrangements affecting tax-exempts, including conditional-sales leases in which lessee pays for asset in installments over time with payments which include both principal portion and interest or financing portion).

90. Harmelink & Schurtz, \textit{supra} note 25, at 835-36 (discusses various methods for determining usefulness of sale-leaseback of real estate as tax device, criticizing existing congressional, accounting, IRS, and judicial approaches for failure to comport with the four essential issues for achieving sensible tax treatment: specificity, feasibility, equity, and economic reality); Note, \textit{supra} note 12, at 1103 (\textit{Lyon}, subsequent case law, and IRS remain unclear as to necessary qualities of economic substance demanded of sale-leaseback transactions, causing uncertainty as to whether a court will recharacterize sale-leaseback as financing arrangement); Schurtz, \textit{supra} note 33, at 386 ("no single test or combination of tests seems to be absolutely determinative").

91. 5 U.S.C. \textsection{} 552 (1978 & Supp. IV 1980); Rev. Proc. 75-21, 1975-1 C.B. 715 and a companion document Rev. Proc. 75-28, 1975-1 C.B. 752 (if guideline requirements are fulfilled and circumstances direct, IRS will issue advance letter characterizing deal as lease and that lessor is owner for federal income tax purposes); \textit{see DESCRIPTION} of S. 1564, \textit{supra} note 1, at 6; DESCRIPTION of H.R. 3110, \textit{supra} note 1, at 6. Specific requirements to be met to receive advance letter indicating lease status
whether a given transaction is a valid leasing structure or merely a financing arrangement, they do not specify the number of criteria that must apply before a lease will be recognized as valid for tax purposes. 92 These criteria are still applied by the IRS and the courts in cases involving sale-leaseback transactions of both equipment and real estate. 93 Nevertheless, sale-leaseback transactions are used by tax-exempt entities because of the attractive depreciation allowances available to private investors under current tax law. 94 Congress perceives these allowances as an indirect, and therefore uncontrollable federal subsidy. 95

include (1) minimum 20% unconditional investment by purchaser at-risk in property; (2) purchase options exercisable only at fair market value at time of exercise; (3) neither lessee nor a related party may (a) furnish any of the investment cost nor (b) loan the investment funds to the lessor; (4) lessor must expect to receive a profit from the transaction, with a positive cash flow independent of tax benefits; and (5) property unique in use to lessee is ineligible for lease treatment. Id.

See also Vogt & Cole, supra, note 72, at 11-16 (IRS criteria for distinguishing between true and conditional sales leases); Harmelink & Schurtz, supra note 25, at 865-70 (test designed for use with IRS audit guidelines).

92. Harmelink & Schurtz, supra note 25, at 865-70.

93. See, e.g., Sun Oil v. Comm’r, 562 F.2d 258 (3d Cir. 1977), cert. denied, 436 U.S. 944 (1978) (listed series of factors without ascribing particular weight to any in finding a valid sale-leaseback); Estate of Franklin v. Comm’r, 544 F.2d 1045 (9th Cir. 1976), aff’g, 64 T.C. 752 (1975) (where seller continued to be responsible for first and second mortgages, with right to place additional mortgages, sale-leaseback held invalid); American Realty Trust v. United States, 498 F.2d 1194 (4th Cir. 1974) (adapted traditional intent test to multiple factor analysis, such as a repurchase option and fairness of purchase price); Miller v. Comm’r, 68 T.C. 767 (1977) (grossly undercapitalized purchaser constructed a building with mortgage financing and leased it to college which was to repay mortgage; college held to be owner); Frito-Lay, Inc. v. United States, 209 F. Supp. 886 (N.D. Ga. 1962) (seller entitled to repurchase for original price of the land, but would forfeit new buildings if option not exercised within twenty years). See also Description of S. 1564, supra note 1, at 6; Description of H.R. 3110, supra note 1, at 6 (“guidelines are not by their terms a definitive statement of legal principles and are not intended for audit purposes”); Harmelink & Schurtz, supra note 25, at 866 (IRS audit guidelines seem to refer basically to equipment leases, but they also cite several real estate sale-leaseback cases, including Frank Lyon Co. v. United States, 435 U.S. 561 (1978)).

94. See supra notes 35-55 and accompanying text for discussion of tax benefits associated with sale-leasebacks under current law.

95. Description of H.R. 4170, supra note 1, at 65. [T]he Committee believes that Federal aid to tax-exempt entities (above and beyond their tax exemption) should be made by appropriations rather than by tax benefits transferred through tax system. The tax benefits in leasing are open-ended and hence uncontrollable in amount and composition, whereas appropriations are limited and adjustable to current priorities from year to year.

Id. at 65. Accord Description of S. 1564, supra note 1, at 12; Description of H.R. 3110, supra note 1, at 12; Tax Aspects, supra note 1, at 23.
In response to a perceived flood of non-traditional leasing arrangements involving new types of properties and different partners, bills designed to curtail perceived abuses of tax-exempt status and certain provisions of the tax code were introduced in the House Ways and

96. See, e.g., Leasing City Hall: That’s the Latest Twist in Municipal Financing, 63 Barron’s, May 16, 1983, at 39, col. 1 (“city managers would almost be guilty of malfeasance” if they failed to utilize leasing since they can shift 30% of lease cost to federal government; “Why the hell not? It’s perfectly legal”) (quoting Reginald Todd, Rep. Pickle’s [bill’s sponsor] chief aide); How Cities Are Selling Tax Write-Offs, Bus. Wk., April 5, 1982, at 95, col. 1 (“under severe budget pressures, many municipalities are exploring ways to cut costs or raise cash by selling the long-neglected tax benefits inherent in their construction projects”); Harris, Wanna Buy the Brooklyn Bridge? 129 Forbes, March 15, 1982, at 59, col. 1 (impoveryished American cities seeking new sources of revenue to provide basic services expect more financial problems caused by federal withdrawal of funding, affecting such infrastructure operations as road repair and building maintenance; President Reagan’s “new federalism” proposals cited as further cause of stress on municipal budgets); Focus on Leasing, N.Y. Times, March 7, 1983, at D2, col. 3 (Rep. Pickle gathered evidence that “there may be a trend” toward leasing by tax-exempts); Bannon, Selling City Hall, 266 HARPER’S, June 1983, at 18, col. 2 (historic preservation tax incentives estimated to result in revenue loss to government of $40 million between 1976-1981); Many Universities Moving Into Real Estate Business As Need for Campus Expansion Eases, 26 CHRON. OF HIGHER EDUC., at 8, col. 1 (reduced enrollment has heightened income requirements to maintain instruction and research quality; fiscal support not only benefit since such partnerships close “the gap between intellectual and economic enterprise”); Moore, Lease-Purchase Financing for Community Development, 12 ECON. DEV. & L. CENTER REP. 28 (Fall 1982) (examples of and models for community economic development efforts paid for through lease-purchase financing agreements); Nation’s Municipalities, supra note 62, at 7 (sale-leaseback transactions perceived by municipalities as income generators “for capital construction or improving existing facilities”).

97. See also Rev. Rul. 83-46, 1983-1 C.B. 16 (disallowance of deductions under ACRS for townhouses sold and leased with term of resale after one year and a day following original sale at predetermined price); Martin, TAX SHELTER INSIDER 8 (May 1983) (leasing a brood mare already in foal, thus providing risk to investor since no guarantee of successful birth); Nicholson, CBOs and the New Tax Credits for Equipment Leasing, 12 ECON. DEV. & L. CENTER REP. 33 (Spring 1982) (community based organizations urged to take advantage of ACRS); Stewart, New Tax Incentives for the Rehabilitation of Older and Historic Structures, 12 ECON. DEV. & L. CENTER REP. 21 (Winter 1982); Stewart, Tax-Exempt Organizations and Equipment Leasing under the Tax Act of 1981, 12 ECON. DEV. & L. CENTER REP. 21 (Winter 1982); Tax Breaks: Try Rent-a-Kid, N.Y. Times, Jan. 10, 1982, § 3 (Bus.), at 2, col. 5 (scheme for rich families to “sell” their children to poor families and lease them back); New Design at GM, supra note 14 (unique arrangement of sale of option to buy with lease for use to seller).
Means Committee and in the Senate Finance Committee during the 1st session of the 98th Congress. Action prior to the 1984 elections is not expected, but it is unlikely that this financial and social issue will disappear. The questions presented by these transactions and addressed by the Congressional committees will now be discussed in detail.

something that does not actually exist”); *Leasing Tax Breaks Curbed*, Cong. Index (CCH) (July 29, 1983) (“bill to substantially curtail the tax advantages to private investors of leasing property and equipment to tax-exempt entities”); *Ways and Means Votes Curbs on Use of Leasing Tax Breaks*, Cong. Quart., July 30, 1983, at 1539, 1540, col. 1 (rehabilitation tax credits disallowed if leasing arrangement is with a tax-exempt entity using tax-exempt industrial development bonds to finance deal, to prevent “‘double-dipping’ or even ‘triple-dipping’ at the tax-payer’s expense”); *Pickle Introduces Bill to Restrict Sale-Leasebacks by Tax-Exempt Entities*, 11 Hous. & Dev. Rep. (BNA) 11, 11-12 (July 6, 1983) (the legislation is intended “to stop one of the most unusual, ingenious, and costly tax shelters that we’ve seen in years”) (quoting Rep. Pickle); *Ferris, Ways and Means Committee Plans Combination of Tax Bills Designed to Close Loopholes*, 223 Weekly Bond Buyer, Sept. 6, 1983, at 1, col. 1 (H.R. 4170 characterized as “combination loophole closing bill” incorporating measures to restrict use of private-purpose industrial development bonds and single-family mortgage revenue bonds, as well as increases in taxes on life insurance companies and sharp curtailment of sale-leaseback transactions by tax-exempt entities).


100. DESCRIPTION OF H.R. 4170, supra note 1, at 11. The House bill has been merged into a comprehensive revenue package for the second session of the 98th Congress. While the House Ways and Means Committee states that this bill is primarily intended to reform and simplify the present tax system, it further notes that “the overall revenue effect of the bill is to increase revenues by $2.31 billion in fiscal year 1984, $2.33 billion in fiscal year 1985, and $3.43 billion in fiscal year 1986.” Id. at 8. See 21 Tax Notes 528 (Nov. 7, 1983) (four panelists, including an assistant U.S. Treasury Secretary for Tax Policy, three representatives to Congress, and a tax counsel to Senate Finance Committee, agreed there would be no passage of tax legislation in 1984 due to lack of bipartisan action in election year, and that 1985 would be too late for any such legislation to help federal deficit).

101. See, e.g., *Amendment to Sale-Leaseback Bill Will Allow Continued Use of Rehab Tax Credit With IDBs*, 11 Hous. & Dev. Rep. (BNA) 48-49 (June 20, 1983) (Administration concerned by mounting evidence of leasing activity which it believes has tremendous potential for causing unanticipated federal revenue losses and believes corrective measures should be enacted along the lines suggested by the bill) (citing Assistant Treasury Secretary for Tax Policy John E. Chapoton); *Dole Introduces Bill to Restrict Sale-Leaseback Transactions*, 11 Hous. & Dev. Rep. (BNA) 89 (July 4, 1983) (Senate bill needed to “prevent the enormous end run on the federal Treasury that has been attempted through the use of long-term tax-exempt lease financing”) (quoting Sen. Dole, chairman of Senate Finance Committee); *Focus on Leasing*, N.Y. Times, March 7, 1983, at D2, col. 3 (‘’[j’]ust as the Navy is doing with leased ships, Mr. Pickle contends, local governments also can shift up to 30 percent of
III. Policy Considerations

The principal motivation for legislation limiting the use of sale-leaseback transactions by tax-exempt entities is curbing revenue losses to the United States Treasury.102 The Congressional committees, however, have focused on several tax policy issues.103 These include: (1) economic issues affecting all tax-exempt entities participating in sale-

acquisition costs to the Federal Treasury in the form of lost tax revenues”); Note, Municipal Sale-leasebacks Face Restrictions, TAX SHELTER INSIDER 8 (Aug. 1983) (Pickle claims sale-leaseback transactions by local governments and tax-exempt entities which own $2 trillion worth of property are a “perfectly legal tax shelter that could double the federal deficit within a few years”).

102. DESCRIPTION OF H.R. 4170, supra note 1, at 49

[T]he federal budget is in no condition to sustain the substantial revenue loss resulting from leasing [sic] to tax-exempt entities, which will certainly increase as more tax-exempt entities, financial entities, and tax-oriented investors learn how to take advantage of the tax system in that way. Nothing is accomplished to reduce budget deficits when spending cuts are matched or exceeded by revenue losses.

Id. The bill provides a chart indicating that Title I Tax-Exempt Entity Leasing Provisions will generate $683 million in revenue in 1984, escalating each year until nearly $5 billion is generated in 1988. Id. at 49-50.

See How Cities Are Selling Tax Write-Offs, Bus. Wk., April 5, 1982, at 95, col. 1 (“in light of dire federal budget troubles, it remains to be seen whether Washington will smile on the innovations [of tax-exempt entity use of sale-leasebacks] if they bring large tax losses to the Treasury”); Ways and Means Votes Curbs On Use of Leasing Tax Breaks, CONG. QUART., July 30, 1983, at 1539, col. 1 (“[c]onservative estimates show that the federal government could lose $15 billion in revenues over the next five years from use of the device”); Amendment to Sale-Leaseback Bill Will Allow Continued Use of Rehab Tax Credit With IDBs, 11 Hous. & Dev. Rep. (BNA) 48-49 (June 20, 1983) (Congressional Budget Office estimate of $2 trillion worth of property owned by governments and tax-exempt organizations, led bill’s sponsor, Rep. Pickle, to state: “it is conceivable sale-leaseback arrangements could double the federal deficit within a few years”); Dole Introduces Bill to Restrict Sale-Leaseback Transactions, 11 Hous. & Dev. Rep. (BNA) 89 (July 4, 1983) (restrictions on leasing could be basic part of tax package Senate Finance Committee drafting in accordance with mandated revenue increase in fiscal year 1984 budget resolution, Dole indicated; Treasury predicts sale-leaseback transactions may deprive federal government of several billions of tax dollars); Sale-Leaseback Bill Clears House Tax Panel With New Transition Rules, IDB Ban, 11 Hous. & Dev. Rep. (BNA) 174 (August 1, 1983) (“House staff estimate the bill’s provisions could raise roughly $2.5 billion to $3 billion over the next two years and the funds could be counted toward the $73 billion revenue increase called for in the fiscal 1984 budget resolution”); Growth of Tax-Exempt Financing Stirs Battle on Revenues and Rights, Wall St. J., Nov. 7, 1983, § 2, at 37, col. 4 (reason for flurry of legislative activity, critics say, is huge federal deficit; “[t]here wouldn’t be so much activity if all members of Congress weren’t looking so hard for additional revenues”) (quoting Heather Ruth, executive director of the Public Securities Association).

103. DESCRIPTION OF H.R. 3110, supra note 1, at 12-14; DESCRIPTION OF S. 1564, supra note 1, at 12-16; DESCRIPTION OF H.R. 4170, supra note 1, at 62-65; Tax Aspects, supra note 1, at 22-27.
leaseback transactions, such as lack of economically “neutral” conditions making ownership of property less favorable than leasing; the “indirect federal subsidy” created by tax-exempt entities indirectly receiving the benefits of depreciation deductions, investment credits and deductions for interest and other expenses ordinarily unavailable to tax-exempt entities; and, if such a subsidy is to be granted, whether leasing arrangements are an efficient method of providing federal assistance to tax-exempt entities; (2) issues facing governmental entities in particular, such as budgetary distortions caused by shifting federal agency capital and operating costs to the Treasury and “privatization” of public services in transactions not involving net leases; and (3) the generally negative public perceptions created by the sale of highly visible assets, particularly by tax-exempt entities. This section will examine these tax policy considerations.

A. Economic Issues of Neutrality, Subsidy and Efficiency

The neutrality principle examines whether tax-exempt entities, like taxpaying corporations or syndications, should be able to enjoy the benefits of tax deductions. When a tax-exempt entity uses property through a sale-leaseback transaction or similar arrangement, reduced rents pass depreciation deductions and investment credit incentives from the owner of the property to the tax-exempt entity. Since tax-exempt entities would not otherwise qualify for these tax benefits, the lack of neutrality of the current tax structure is a powerful economic motivation for leasing property rather than owning. The Committees recommend that in order to reduce or eliminate this tax-driven advantage to leasing over purchasing, depreciation deductions be decreased and denial of ITCs to tax-exempt entities be more strictly enforced.

104. DESCRIPTION OF S. 1564, supra note 1, at 12-16; TAX ASPECTS, supra note 1, at 22-27.

105. TAX ASPECTS, supra note 1, at 23-24. The Joint Committee maintains that there are critics of its policy, as expressed in the final bills produced, who believe that tax-exempt entities should be eligible for the benefits of accelerated depreciation and ITC. Id. The “principle of neutrality” is offered in rebuttal to demonstrate that any such tax benefit for tax-exempt entities would need to be balanced by tax burdens. Id.

106. Id.

107. DESCRIPTION OF S. 1564, supra note 1, at 12-13; DESCRIPTION OF H.R. 3110, supra note 1, at 12; TAX ASPECTS, supra note 1, at 27-28. Neutrality is also an issue where a governmental unit that might have otherwise issued bonds at a tax-exempt interest rate to purchase property finds the tax-subsidized financing rate of a sale-leaseback transaction to be lower. TAX ASPECTS, supra note 1, at 23. Thus, tax-exempt entities are driven to lease by the advantage given them through their tax-exempt status and, in this way, the tax code is not neutral but in fact creates a distortion in the after-tax price of capital in favor of leasing. Id.
Since sale-leaseback transactions allow pass-through of tax benefits such as depreciation deductions and investment tax incentives to tax-exempt entities which are otherwise ineligible for these tax benefits,\textsuperscript{108} the federal government indirectly subsidizes the operations of tax-exempt entities engaging in these transactions.\textsuperscript{109} The Committees believe that this supplies an excessive and unregulated tax benefit to participants.\textsuperscript{110}

While these leasing arrangements are legal under the present tax structure and are an important form of financial assistance to tax-exempt entities, the Committees argue that sale-leasebacks are inefficient vehicles for the provision of federal revenues.\textsuperscript{111} The structural complexity presently demanded of sale-leasebacks, and the danger of recharacterization by the IRS, are perceived as making the transaction costs extremely high, which in turn inflates rental payments by the tax-exempt entities and reduces the benefits derived.\textsuperscript{112}

B. Governmental Entity Issues of Budgetary Distortions and Privatization

The Committees argue that sale-leaseback transactions by governmental units distort the governmental budgetary process.\textsuperscript{113} Transfers of expenses from capital “purchasing” budgets to current “operating” budgets disguises the long-term nature of the lease commitment, thus reducing accountability.\textsuperscript{114} The costs of leasing property are shifted

\textsuperscript{108} Tax Aspects, supra note 1, at 22. See also Description of H.R. 4170, supra note 1, at 62 (it is a “fundamental principle that the tax system exists to collect from taxable entities, not to make payments to tax-exempt entities”).

\textsuperscript{109} Description of H.R. 3110, supra note 1, at 12.

\textsuperscript{110} Description of H.R. 4170, supra note 1, at 65.

\textsuperscript{111} Id.

\textsuperscript{112} Description of S. 1564, supra note 1, at 13; Description of H.R. 3110, supra note 1, at 13; Description of H.R. 4170, supra note 1, at 65. The committees list “lawyers, investment bankers, leasing companies, and other agents or investors” as the parties most likely to siphon off the benefits granted by the tax code and which should flow through to the lessee as lower rents. Description of H.R. 3110, supra note 1, at 13. See Nation’s Municipalities, supra note 62 (“enormous ‘transaction cost’ associated with sale-leaseback deals—legal fees, appraisals, engineering studies and more”).

\textsuperscript{113} Description of H.R. 3110, supra note 1, at 13; Description of S. 1564, supra note 1, at 14; Tax Aspects, supra note 1, at 25. Since all state and local governments are tax-exempt entities for federal income tax purposes, combined with their enormous holdings of property, they represent a large percentage of the potential drain of revenue loss to the U.S. Treasury through leasing. Id. at 26-27.

\textsuperscript{114} Description of S. 1564, supra note 1, at 13-14; Description of H.R. 3110, supra note 1, at 12; Tax Aspects, supra note 1, at 25; Description of H.R. 4170, supra note 1, at 64-65. See also supra notes 72-77 and accompanying text for discussion of accounting issues in sale-leaseback transactions.
from agency budgets to the federal Treasury through the indirect federal subsidy.\textsuperscript{115} Control normally exercised through the appropriations process is lost as leasing replaces direct outlays with indirect tax benefits which do not require specific appropriations.\textsuperscript{116} This makes it difficult to evaluate the amount, recipient, and ultimate use of the assistance provided. If the disbursement of funds is also shifted from the agency’s procurement account to another account, such as operations and maintenance, then scrutiny and control are further reduced.\textsuperscript{117}

Privatization of public sector services is defined by the Joint Committee as the present federal policy of involving private parties in traditional areas of public services in an effort to provide these services more economically.\textsuperscript{118} The Committee cites critics who believe that

\begin{footnotes}

\textsuperscript{115} Public borrowing is subject to many legal controls which vary with the form of debt incurred. These controls are a consideration of municipalities choosing between various cash-generating financing devices. For instance, municipal debt limits may be avoided under the current financing and tax structures by shifting costs within a governmental budget. There is a division of authorities on whether property should be valued at its full value where the debt ceiling is set by a specified ratio of debt-to-property value. \textit{Compare} State v. Spring City, 123 Utah 471, 260 P.2d 527 (1953) (bonds issued in excess of debt limit were void) \textit{with} People v. Doyle and Associates, Inc., 374 Mich. 222, 132 N.W.2d 99 (1965) (lease-back agreement held to violate constitutional limits on county borrowing power) and Breslow v. School District of Balwin Tp., 408 Pa. 121, 182 A.2d 501 (1962) (holding debt ceilings controlled by assessed values, not by generally higher real value). For a summary of limitation standards see Bowmar, \textit{The Anachronism Called Debt Limitation}, 52 \textit{Iowa L. Rev.} 863 (1967); \textit{Note, Municipal DebtLimitations in Pennsylvania}, 15 \textit{Vill. L. Rev.} 612 (1970).

\textsuperscript{116} Description of S. 1564, \textit{supra} note 1, at 14; Description of H.R. 3110, \textit{supra} note 1, at 12; \textit{Tax Aspects, supra} note 1, at 25; Description of H.R. 4170, \textit{supra} note 1, at 64-65.

\textsuperscript{117} Description of S. 1564, \textit{supra} note 1, at 14-15. The Joint Committee argues that the appropriations process provides limited and controllable federal aid to tax-exempt entities, above and beyond their tax exemption, adjustable to current priorities from year to year. Description of H.R. 3110, \textit{supra} note 1, at 13. Control is further derived, the Committee argues, through a record of federal assistance through appropriations, while tax benefits are merely a non-payment type of benefit with no record created. \textit{Id.} Appropriations can, moreover, be debated and decided in a political forum in order to best reflect community needs. Description of H.R. 4170, \textit{supra} note 1, at 65.

\textsuperscript{118} Description of S. 1564, \textit{supra} note 1, at 14; \textit{Tax Aspects, supra} note 1, at 24. This concept is a key example of the sharp reversal of the Reagan Administration on the issue of leasing. \textit{See, e.g., Lamm, Comments: Public Resource Management under the Reagan Administration, in Urban Land Policy for the 1980s, The Message for State and Local Governments, 91, 96-100 (G. Lefcoe ed. 1983)} (Reagan Administration has reversed its position with respect to the four critical services derived from leasing: (1) purchasing (will seldom be any greater advantage available to a private, taxpaying lessor than to governmental agency with large procurement budget); (2) financing (in most cases, particularly on federal level,
the cost advantages of privatization derive from the “greater expertise of private providers, as well as their ability to bypass negotiations with public labor unions, requirements of the Davis-Bacon Act, facility design or other criteria specified by public agencies.” The Committee refutes these contentions by maintaining that “relative expertise in the supply of services is irrelevant in certain leasing transactions,” particularly where there is no change in the responsibility for providing services.

C. Public Perceptions

Federal or other governmental units participating in the “selling of tax-write offs” where “large lessors are able to reduce their tax payments to the Treasury by engaging in leasing transactions” are perceived by the Committees as contributing to a negative public impression and possibly leading to “lower taxpayer compliance.”

Conversely, the Joint Committee concedes that with property such as equipment and most vehicles, which are standardized in design and easily moved, the lease term will generally be short and may be cost-effective for government agencies. While financing remains the crucial element, the services of purchasing and reselling are provided better by private lessors, thus making short-term lease situations strong candidates for sale-leaseback transactions in the Committee’s view. For a discussion of the efficiency of tax-exempt financing as a subsidy and allocation of funds, see Comment, Tax Exempt Financing of Health Care Facilities as a Component of the Market Approach to Health Care Cost Containment, 11 FORDHAM URB. L. J. 603, 652 n.300 (1983).

119. DESCRIPTION OF S. 1564, supra note 1, at 14. This issue highlights the fact that the Administration has dropped its attempt to privatize public services and reduce the role of the federal government in local activities. It is interesting to note in this regard that this argument was dropped by the House Ways and Means Committee when the report on H.R. 4170 was prepared. See DESCRIPTION OF H.R. 4170, supra note 1.

120. Id.

121. Id.

122. TAX ASPECTS, supra note 1, at 26; DESCRIPTION OF H.R. 4170, supra note 1, at 65; DESCRIPTION OF H.R. 3110, supra note 1, at 12; DESCRIPTION OF S. 1564, supra note 1, at 14. See also A Tax Bill That Imperils Historic Preservation, Bus. Wk., Oct. 24, 1983, at 153, col. 1 (“[t]he trouble is, a sale of any true historic property is a disadvantage to the public in the long run”) (quoting Richard M. Rosan, president of the Real Estate Board of New York, arguing for leasing over complete sale); Nation’s Municipalities, supra note 62, at 7 (“there is a sticky public policy question associated with ‘selling off our assets—why should taxpayers see the facilities they paid for sold off, and then have to pay rent to utilize them?’”) (quoting Philip E. Aarons, president of New York City’s Public Development Corporation).
issue is particularly problematic where sale-leasebacks are perceived as taking advantage of tax loopholes which allow federal subsidies to flow to such highly visible groups as private universities, specific political subdivisions such as New York City, and foreign governments and persons.

The general use of these transactions in so many various forms gives credence to the opposing view that a properly explained and publicized sale-leaseback of a controversial property can succeed. See How Cities Are Selling Tax Write-Offs, Bus. Wk., April 5, 1982, at 95, col. 1 (even though sale-leaseback deals could arouse citizen concern about private ownership of public facilities, particularly if viewed as a means of borrowing without voter approval, city officials remain fairly optimistic, since all it might take to keep creating the deals is “a little bit of a public relations campaign”) (quoting Robin W. Dougherty, Philadelphia’s Assistant Director of Finance); Harris, Wanna Buy The Brooklyn Bridge? 129 FORBES, March 15, 1982, at 59, col. 1 (City Manager of Oakland, California defused “political powder keg” of sale-leaseback of city’s civic auditorium and museum by spending “many an hour” explaining the deal, which was the only hope of preserving and renovating the structures); Pitfalls of City Sale-Leaseback Deals Include Tax Violations, Political Pressure, 10 Hous. & Dev. Rep. (BNA) 1134 (May 23, 1983) (people suspicious of sale-leaseback transactions have made receiving approval from review boards difficult. Such transactions are expected, however, to remain a part of governor’s capital plan) (quoting Jeffrey Apfel, New York Governor’s office).

But compare this position with that of the National Association of Independent Colleges and Universities and the American Council on Education, calling for refinement of the proposed legislation to allow “economically productive transactions” while barring “sterile transactions” that are “productive of nothing but tax benefits.” College Leasing Deals Are Target Of Proposal to Clamp Down on ‘Costly Tax Shelters’, 26 CHRON. OF HIGHER EDUC. 13 (June 29, 1983) (“[t]his case is particularly offensive in that the tax benefits being sold are attributable to property that was paid for with federal grant money”) (quoting President Reagan in his veto message of legislation proposed to enable North Carolina art school to enter sale-leaseback transaction).

123. See, e.g., Tax-Leasing Twist, supra note 9, at 57 (Bennington College sale-leaseback of $8.5 million campus to limited partnership of alumni described as “typical”; also notes Towson State University arrangement to use sale-leaseback transaction to finance new dormitories); College Leasing Deals Are Target of Proposal to Clamp Down on ‘Costly Tax Shelters’, 26 CHRON. OF HIGHER EDUC. 13 (June 29, 1983). Seven other national education groups endorsed this statement, including the National Association of College and University Business Officers, Association of Jesuit Colleges and Universities, and the Association of State Colleges and Universities. Id.

124. Nation’s Municipalities, supra note 62, at 7 (“[t]he Treasury Department views this as a potential problem and wants to nip it in the bud . . . [i]f they take away the benefits, I think it will hurt cities”) (quoting Jack Freeman, consultant to New York City on sale-leaseback transactions). A noted exception that granted the New York City Convention Center. See N.Y. Times, Oct. 21, 1983, at 1, col. 1 (Sen. Moynihan (D. N.Y.) proposed amendment to proposed federal legislation to provide additional time for closing Convention Center deal). See also County Officials Oppose Sale-Leaseback Bill, Further Curbs on Tax-Exempt Bonds, 11 Hous. & Dev. Rep. (BNA) 182 (Aug. 1, 1983) (members of National Association of Counties adopted resolutions “opposing any new or additional restrictions on sale-leaseback transactions . . . calling for federal legislation authorizing a comprehensive survey
IV. Recommendations

The use of sale-leaseback transactions by tax-exempt entities wishing to maximize their budgets while continuing to maintain services and make needed infrastructure improvements is predominately an issue of tax policy. The search for politically acceptable ways to reduce the federal deficit is bringing these tax policy questions to renewed prominence. Legislators desiring to curb the use of sale-leaseback transactions by tax-exempt entities should recognize, however, that the economic conditions which brought tax-exempt entities and investors together in these transactions are still present.

The sale-leaseback is a viable and important financing instrument for tax-exempt entities trying to maintain service quality despite reduced federal funding. While Congress should permit sale-leaseback transactions to continue for the general public welfare, an increased focus on maintaining service quality through budgetary restraint is also necessary.

Id. The NCSL specifically opposes changes to federal law that would make depreciation schedules for assets leased by governments longer than schedules for private industry, provided the sale of tax benefits is not the sole motive for a transaction. NCSL said it would support lease transactions that generate new investment from new construction or substantial rehabilitation, but would favor restrictions on deals that do not reinvest proceeds in the projects or which are intended to refinance existing assets.

125. See, e.g., DESCRIPTION OF S. 1564, supra note 1, at 16; DESCRIPTION OF H.R. 3110, supra note 1, at 14; Tax Aspects, supra note 1, at 16-17; DESCRIPTION OF H.R. 4170, supra note 1, at 61. The Committees find justification for the use of sale-leaseback tax benefits if the foreign entity is taxable by the U.S. Treasury on the total income generated by property leased from a U.S. lessor. DESCRIPTION OF H.R. 4170, supra note 1, at 61. They view as a federal subsidy to a foreign entity, however, situations in which only a very small proportion of the income is taxable by the U.S., or if the entity is exempt by virtue of doing no business in the U.S. DESCRIPTION OF S. 1564, supra note 1, at 16. Policy considerations provide greater justification for allowing the use of these tax benefits where goods are U.S.-produced, since these benefits "might be justified as an export incentive." Id. Clearly, this would not apply for leases of foreign-produced goods. See also Boeing and Others Fight Moves by Congress to End Big Tax Advantages on Jet Leasings, Wall St. J., Oct. 19, 1983, at 33, col. 4 (outlining impact of legislation when sale-leaseback transactions foster overseas sale by U.S. manufacturers; Boeing affected by possible loss of sales accounting for $900 million in lost tax revenues to U.S. Treasury); cf. Tax Aspects, supra note 1, at 25-26 ("[i]n the event of war, the interests of the lessor and the defense agency might differ considerably about the deployment of the property," leading to protracted contract litigation as to rights and obviously posing a serious threat to national defense).

126. See, e.g., Fuller, supra note 46, at 63 ("[i]t is a truism in tax law that when taxpayers devise new forms of transactions that combine economic and tax advan-
back transactions, it should prescribe specific guidelines governing their use. While this financial device has flourished for decades without guidance from Congress or the IRS, this has only been at high cost and risk.

Legitimizing sale-leaseback transactions between certain tax-exempt entities and taxpayers under carefully designed and implemented guidelines will enable Congress to resolve the issues raised by the expanding use of this financial device. With certainty of financial and tax consequences as the centerpiece of a series of tests to be

tages while avoiding the tax disadvantages usually associated with such a transaction, the government will seek to deny those advantages and recategorize the transaction. amend to Sale-Leaseback Bill Will Allow Continued Use of Rehab Tax Credit With IDBs: Cities Protest, 11 Hous. & Dev. REP. (BNA) 48-49 (June 20, 1983) ("Everytime we get creative, the Treasury Department wants to close down the whole program") (quoting Vincent J. Thomas, mayor of Norfolk, Va.). These remarks were made as part of a resolution adopted without debate at the 1983 U.S. Conference of Mayors meeting in Denver opposing this proposed legislation. The resolution criticized the legislation as "injurious to the economic development activities and prospects of cities, jeopardizing important infrastructure investments and traditional service contracts and imposing additional burdens on already strained city budgets." N.Y. Times, Oct. 21, 1983, at 1, col. 1 ("[w]e have found [through a sale-leaseback with option to repurchase in 30 years] a creative and prudent solution to the problem of the center's cost overruns") (quoting William J. Stern, chairman of New York State's Urban Development Corporation, which is building the New York City Convention Center).

127. See supra notes 90-93 and accompanying text. The court decisions have provided little guidance, and the IRS audit guidelines are not a neat body of rules for formation of sale-leaseback transactions, but serve merely as a method for IRS internal evaluation in suspect cases. For proposals to modify the current general laws and tax regulations of sale-leaseback transactions, see Burke, Why Some Sale and Leaseback Arrangements Succeed While Others Fail, 26 J. Tax'n 130 (1967); Fuller, supra note 46; Harmelink & Schurtz, supra note 25; Kaster, Tax Criteria for Structuring Sale-Leasebacks, 9 Real Est. Rev. 39 (Fall 1979); Morris, Sale-Leaseback Transactions of Real Property—A Proposal, 30 Tax Law. (A.B.A. Sec. of Tax'n) 701 (1977); Schurtz, supra note 33; Note, Problems of Judicial Interpretation of Real Estate Sale and Leaseback Taxation: Description, Analysis, and Proposed Revision, 33 Tax Law. 237 (1979); Note, supra note 13; note 124 and accompanying text.

128. See supra note 112 and accompanying text for discussion of transaction costs of sale-leaseback transactions.

129. See supra notes 79-80 and accompanying text for discussion of financial and tax consequences of a successful audit by the IRS.

130. As a guide for promulgating legislation regulating sale-leaseback transactions by tax-exempt entities, Congress could use the rules that existed governing safe-harbor leases. See I.R.C. § 168(f)(8) (1976); Staff of the Joint Committee on Taxation, 97th Cong., 2d Sess., Analysis of Safe-Harbor Leasing (Joint Comm. Print 1983); Depreciation Guide, supra note 4, at ¶ 133; Tax Handbook, supra note 4, at ¶ 2006. Safe-harbor leases were technically sham sale-leaseback transactions that, if they met certain criteria, granted the purchaser the benefit of ACRS depreciation and the ITC on the asset. Depreciation Guide, supra note 4, at ¶ 133. These controversial transactions were repealed for leases entered into after 1983, and thus enjoyed a lifespan of only about two years. Id.
promulgated by Congress and the IRS, the fundamental issues of ownership, control, and accountability would become manageable and straightforward.

The unintended, indirect federal subsidy currently allowed to tax-exempt entities through sale-leaseback transactions\(^3\) could become a useful funding mechanism if pragmatic controls were contained in clear federal guidelines. Sale-leaseback transactions should be limited to carefully prescribed categories of tax-exempt entities which demonstrate substantial gains in efficiency from the leasing process. Such a limitation would reduce federal revenue losses, return purchasing decisions to a more "neutral" position by making efficiency of production the focus of analysis and encourage productive debate of leasing and "privatization" versus ownership issues.

In addition, accounting rules should be incorporated into the new guidelines to remove the distortions created in the capital and operating budgets of government agencies.\(^1\) Further, the inefficiency of high transaction costs associated with structuring a sale-leaseback transaction\(^2\) would be sharply reduced by moving from the current case-by-case approach to an administrative approach based on well-

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131. See Description of S. 1564, supra note 1, at 12; Description of H.R. 3110, supra note 1, at 12. A similar federal tax subsidy occurs in equity-financed investments in equipment. Description of H.R. 3110, supra note 1, at 12. ACRS and ITC essentially allow, through expensing of the property, a write off of the entire cost of the equipment in the year it is placed in service. See I.R.C. §§ 46 & 179 (1976). The present value of the income from the asset will be equal to the present value of the deductions and credit, thereby creating a tax exemption through expensing. If debt financing is used to purchase equipment, the deductions allowed for interest payments are added to the above deductions creating a negative tax since the deductions often exceed the income generated by the asset. Description of S. 1564, supra note 1, at 12. According to the Joint Committee, since tax-exempt entities are ordinarily denied this subsidy, they must lease in order to benefit from it, and hence there exists a "tax-driven advantage to leasing." Id. at 13.

132. See supra notes 114-17 and accompanying text for discussion of the distortions created in government agency budgets and the resulting loss of accountability caused by the use of leasing rather than ownership. A properly constructed set of guidelines could detail a separate filing and accounting system for leasing which would require reporting of total procurement costs in an easily reviewable part of the agency's budget. These costs could be broken down into total and yearly expenditures, giving notice and recording the public and tax-exempt purposes served by the property, and the amount of assistance assignable to various aspects of the property. The guidelines should set forth rules which a tax-exempt entity must meet to be eligible to engage in sale-leaseback transactions. In this way, the compliance with these guidelines would ensure use of the device only in those situations deemed appropriate by Congress.

133. See supra note 112 and accompanying text for discussion of the transaction costs associated with sale-leasebacks.
defined rules.\textsuperscript{134} Negative public perceptions, clearly manifested by hostility to the sale of public facilities by governmental units and Congressional fear of low taxpayer compliance due to a mistrust of the tax system, would be greatly reduced by promulgation and consistent administration of official guidelines.\textsuperscript{135}

V. Conclusion

Sale-leaseback transactions have provided tax-exempt entities with a useful method of raising revenue to maintain services despite generally reduced federal funding, mounting operating and maintenance costs, scarcity of effective financing devices and the political difficulties associated with raising taxes. While Congress has uncovered abuses connected with use of this financial device, it should remain a viable financing alternative for many qualified tax-exempt entities.

Rather than enact the proposed legislation making sale-leaseback transactions virtually impossible for all tax-exempt entities, Congress should compose specific guidelines for use by tax-exempt entities wishing to undertake these transactions. The certainty resulting from such guidelines will resolve the fundamental issues of ownership, control and accountability, while allowing the use of sale-leasebacks to provide stability for the present and leverage for the future.

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\textsuperscript{134} See \textit{supra} note 112 and accompanying text noting the loss of benefits to tax-exempt entities from sale-leaseback transactions due to substantial transaction costs incurred in the formation of these deals in the effort to avoid recharacterization by the IRS. These costs would, however, be greatly reduced were these transactions carefully defined and regulated through guidelines since fewer professionals would be needed in the formation process.

\textsuperscript{135} See \textit{supra} note 122 and accompanying text for discussion of the methods used by tax-exempt entities to overcome any negative public perceptions associated with the use of these transactions. Were Congress to sanction and control their use, sale-leaseback transactions would become more acceptable to the public.

The theory that sale-leasebacks are fancy ways of borrowing money without issuing mortgages reflects in large part the fact that mortgages are the older and more familiar financing device. If sale-leasebacks had come first, however, the IRS might approach mortgages with suspicion, asserting that they are slick devices to sidestep the tax consequences of 'conventional' sale-leasebacks
