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The American Jobs Creation Act of 2004 – Leases to Tax-Exempt Entities

On October 22, 2004, President Bush signed into law the American Jobs Creation Act of 2004 (the "Act"). Originally proposed nearly two years ago to repeal the extraterritorial income exclusion deemed an illegal subsidy by the World Trade Organization, the Act evolved into sweeping legislation that makes extensive changes to the Internal Revenue Code (the "Code"). The Act, among other things, establishes new rules that significantly limit the availability of deductions associated with leases to tax-exempt entities. This memorandum explains a number of the more important provisions of the Act that impact tax-exempt leasing.¹

Overview

The new regime applies broadly to any leased property where a tax-exempt entity uses the property ("Tax-Exempt Use Property"),² unless four specified criteria are satisfied (referred to herein as, "Tax-Exempt Leases"). These limitations apply to the amount of depreciation deductions calculated under existing rules, which subject such property to a less accelerated depreciation regime than would apply if used by a taxable entity. The Act also reduces the tax benefits derived from Tax-Exempt Leases by modifying the recovery period for qualified technological equipment (commonly referred to as, "QTE")³ and certain intangible property, as well as by expanding the definition of lease term.

While these provisions have been described as necessary to stop "abusive" leasing transactions involving sale leasebacks of subways, bridges, tunnels and other infrastructure by U.S. municipalities and foreign governments (so called "SILO"

¹ Certain other provisions of the Act are discussed in separate memoranda, which are available on the Sidley Austin Brown & Wood LLP website at www.sidley.com.

² Tax-Exempt Use Property is any property that is "tax-exempt use property" under §168(h) (which generally includes all tangible property and certain non-residential real property leased to or used by a tax-exempt entity), plus (1) computer software, (2) certain patents, copyrights and contract rights, (3) all §197 intangibles, and (4) QTE (as defined herein) subject to leases of 5 years or less. This definition applies for purposes of the new deduction limitation regime and changes related to the Pickle Recovery Period (discussed below).

³ QTE is defined as computers and related peripheral equipment, high technology telephone station equipment installed on a customer's premises and high technology medical equipment.

transactions), their impact is much broader, potentially affecting any lease to a domestic municipality or other governmental unit, any charity or other organization not subject to U.S. income tax, any foreign individual or entity or any Indian tribal government (each, a “tax exempt entity”).

Limitations on allowable deductions

The most significant change to the tax-exempt leasing rules is the loss limitation regime established under new §470 of the Code. Section 470 applies to all deductions associated with a Tax-Exempt Lease and limits the amount of such deductions that a taxpayer can take each year to the amount of gross income generated by the lease in that year. Any deductions not allowed to be taken for that year (the “Tax-Exempt Use Loss”) are carried forward and treated as deductions related to the lease in the following year, subject to the same limitations.⁴ The Tax-Exempt Use Loss is determined separately for each leasing transaction.

The result is that the tax benefits derived from leasing are eliminated in the case of Tax-Exempt Leases. Accordingly, it can be expected that the enactment of §470 generally will result in higher rental costs for tax-exempt entities.⁵ In contrast, under prior law, these benefits were reduced by virtue of the leased asset being subject to less accelerated depreciation deductions than if the user was a taxable entity, but were not entirely eliminated.⁶

New §470 generally applies to any lease of Tax-Exempt Use Property, except if the lease satisfies all of the following criteria: (1) the lessee does not monetize its obligations or any purchase option above a certain amount; (2) for leases with terms longer than 5 years, the taxpayer makes and maintains a substantial equity investment in the leased property and the lessee does not have more than a minimal risk of loss; and (3) for assets with class lives longer than 7 years (other than any fixed-wing aircraft or vessels), the lessee does not have a fixed price purchase option. Once a lease is subject to the §470 disallowance rule, it will be treated as a Tax-Exempt Lease for its entire term, regardless of whether it satisfies the exemption criteria in any subsequent years.

Monetization

This requirement places restrictions on the extent to which the lessee can arrange for certain types of credit-support (as described below) to assure payment of its obligations under the lease or provide the funds to exercise any purchase option (referred to as “monetization”). An example of such an arrangement would be if the lessee paid a lump sum to a bank in exchange for the bank making periodic payments equal to the rent payable over the lease term.

In general, the lessee cannot monetize its obligations under the lease or any purchase option in an amount that exceeds 20 percent of the taxpayer’s basis in the leased property at the beginning of the lease. This requirement must be satisfied at all

⁴ Under rules similar to those applicable to passive activity losses, a taxpayer generally is permitted to take any remaining Tax-Exempt Use Loss when the taxpayer completely disposes of its interest in the property.

⁵ The economic benefits of lease financing are based on the taxpayer’s ability to use the excess deductions generated by accelerated depreciation (and any other deductions in excess of rental income) to offset its income from other business activities, which, in turn, translates into lower rental costs for the lessee.

⁶ Property leased to a taxable entity would generally be subject to depreciation under the modified accelerated cost recovery system (“MACRS”), whereas, under §168(g), tax-exempt use property is required to be depreciated on a straight line basis under the alternative depreciation system (“ADS”) over a recovery period equal to the longer of the property’s class life or 125 percent of the lease term (the so called, “Pickle Rules”). MACRS uses shorter recovery periods and typically computes the deductions using either the 200 percent or 150 percent declining balance method.

times throughout the lease term and takes into consideration the aggregate amount of monetization at any given point in time (including any interest or other income earned with respect thereto). The Secretary has authority to promulgate regulations permitting a higher level of monetization where necessary due to the credit-worthiness of the Lessee, provided that the amount of monetization never exceeds 50 percent of the taxpayer's initial basis in the property.

An obligation or purchase option is considered monetized if funds are set aside, expected to be set aside⁷ or are subject to certain types of "arrangements," in each case, for the benefit of the lessor, any lender or the lessee in connection with satisfying the lessee's obligations or providing the funds to exercise any purchase option. A prohibited arrangement is any defeasance arrangement, loan by the lessee to the lessor or any lender, deposit arrangement, letter of credit collateralized with cash or cash equivalents, payment undertaking agreement, guaranteed investment contract, financial guaranty insurance or any similar arrangement, regardless of whether the arrangement provides credit support.

In addition, there are certain types of arrangements the mere existence of which will cause the lease to fail this requirement, regardless of the level of monetization. These are arrangements involving circular cash flows or which insulate the taxpayer's equity investment from risk of loss, which includes any arrangement involving (1) a loan (other than a deemed loan under §467) from the lessee to the taxpayer or any lender, (2) a lender otherwise involved in the transaction receiving a deposit, issuing a letter of credit or entering into a payment undertaking agreement, or (3) any credit support for the taxpayer which renders the taxpayer's claim senior to the claim of any lender involved in the transaction.

Substantial Equity Investment

The taxpayer must make and maintain a substantial equity investment in the leased property. For this purpose, a taxpayer generally does not make or maintain a substantial equity investment unless (1) at the time the lease is entered into, the taxpayer makes an unconditional at-risk equity investment in the property of at least 20 percent of the property's adjusted basis, (2) the 20 percent equity is maintained throughout the lease term, and (3) the fair market value of the property throughout the term is reasonably expected to be at least 20 percent of the property's basis at the beginning of the lease term. For this purpose, the fair market value of the property at the end of the lease term is reduced to the extent that a person other than the taxpayer bears a risk of loss with respect to the property value.

This requirement does not apply to leases with terms of 5 years or less.

Risk of Loss

The tax-exempt lessee generally may not assume or retain more than a minimal risk of loss, other than the obligation to pay rent and insurance premiums, to maintain the property and other similar conventional obligations of a lessee under a net lease. Examples of prohibited arrangements include put options, residual value guarantees, residual value insurance and service contracts. However, residual value protection provided to the taxpayer by a manufacturer or dealer of the leased property is not treated as a risk of loss borne by the lessee if such protection is provided in the ordinary course of the manufacturer's or dealer's business. In addition, leases will not fail to satisfy this requirement solely by reason of lease provisions involving extraordinary events not expected to occur at the time the lease is entered into, such as provisions requiring the lessee to pay

⁷ Amounts are treated as set aside or expected to be set aside based on what a reasonable person would conclude under the facts and circumstances.

stipulated loss value in the event of a casualty loss or event of default.

For this purpose, a tax-exempt lessee assumes or retains more than a minimal risk of loss if, as a result of obligations assumed or retained by, on behalf of, or pursuant to an agreement with the tax-exempt lessee, the taxpayer is protected from either (1) any portion of the loss that would occur if the fair market value of the leased property were 25 percent less than its expected fair market value at the time the lease is terminated, or (2) an aggregate loss in excess of 50 percent of the loss that would occur if the fair market value of the leased property were zero at lease termination. The Secretary has authority to promulgate regulations specifying additional circumstances where the tax-exempt lessee will be considered to retain or assume more than a minimal risk of loss.

This requirement does not apply to leases with terms of 5 years or less.

Purchase Options

Finally, the tax-exempt lessee may not have an option to purchase the leased property, other than for fair market value as determined at the time of exercise.

This requirement does not apply to leased property with a class life of seven years or less, fixed-wing aircraft and vessels.

Longer depreciation recovery period for certain QTE and intangibles

The Act also modifies the depreciation recovery period applicable to QTE subject to a Tax-Exempt Lease with a term greater than 5 years. In such case, the recovery period is equal

to the longer of the property's class life or 125 percent of the lease term (the "Pickle Recovery Period"). Under prior law, the Pickle Recovery Period did not apply to any QTE lease to a tax-exempt entity, which meant that the applicable recovery period was always 5 years.⁸

The impact of the longer recovery period is ameliorated to some extent by an expanded application of the exemption for leases with terms not greater than 5 years. Under the new law, the term of the lease does not include any renewals at fair market value (determined at the time) when determining eligibility for the exemption, so long as the aggregate period of any such excluded renewals does not exceed 24 months. Where the lease term falls within the 5-year period, depreciation for the leased QTE is taken under MACRS using a 5-year recovery period.

In addition, in the case of any computer software, certain patents, copyrights and contract rights and §197 intangibles subject to a Tax-Exempt Lease, the Act generally requires cost recovery deductions under §167 or §197, as applicable, to be taken over the Pickle Recovery Period. This provision, however, does not apply to "short-term leases," which refers to leases with terms that are (1) less than 3 years and (2) less than the greater of 1 year or 30 percent of the property's present class life.⁹

Lease term includes term of certain service contracts

For purposes of applying the Pickle Recovery Period (i.e., to calculate 125 percent of the lease term), the Act expands the definition of "lease term" to include all service contracts and other similar arrangements that follow a lease of property to a

⁸ Nonetheless, a lease term of 5 years or less was desirable because the the depreciation deductions would be calculated using the 200 percent declining balance method under MACRS, rather than on a straight-line basis under ADS.

⁹ The second clause does not apply to nonresidential real property and property without a class life.

tax-exempt entity and that are part of the same transaction (or series of transactions) as the lease.¹⁰ Service contracts and other similar arrangements include arrangements by which the property is used to provide services as a source of repayment of the capital investment in the property. Under prior law, the term of a service contract was not required to be included so long as it qualified under §7701(e) as a bona fide service arrangement.

Effective Date

The Act generally is effective for all leases to tax-exempt entities entered into after March 12, 2004. In the case of the provisions relating to computer software, patents, copyrights and other contract rights, and §197 intangibles, the Act is effective for leases entered into after October 3, 2004.

Section 470 does not apply to any property located in the United States that is subject to a lease with respect to which a formal application (1) was submitted for approval to the Federal Transit Administration (an agency of the Department of Transportation) after June 30, 2003, and before March 13, 2004, (2) is approved by the Federal Transit Administration before January 1, 2006, and (3) includes a description and the fair market value of such property.

If you have any questions regarding this memorandum, please contact Thomas A. Humphreys at 212.839.5853, Anne Levin-Nussbaum at 212.839.5551, or any other member of the Sidley Austin Brown & Wood LLP Tax Group.

¹⁰ The “lease term” also includes the stated term of the lease and any options to renew the lease or other periods of time during which the lessee could be obligated to make rent payments or assume a risk of loss related to the leased property.

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