

Exhibit No. ___ (DPK-6)
Docket No. UE-050684
Witness: Danny P. Kermode

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

**WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION,**

Complainant,

v.

**PACIFICORP, d/b/a Pacific Power &
Light Company, Respondent.**

DOCKET NO. UE-050684

**EXHIBIT TO
TESTIMONY OF**

Danny P. Kermode

**STAFF OF
WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION**

RE: PACIFICORP GENERAL RATE CASE

Excerpt from the Hearing before the Subcommittee on Oversight of the Committee
On Ways and Means, House of Representatives, Ninety-Seventh Congress, First
Session (December 15, 1981) containing a "*Description of Safe Harbor Leasing
Provisions Under the Accelerated Cost Recovery System,*" prepared by The Staff of the
Joint Committee on Taxation

November 3, 2005

**SAFE HARBOR LEASING PROVISIONS OF THE
ECONOMIC RECOVERY TAX ACT OF 1981**

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HEARING
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
OF THE
COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES
NINETY-SEVENTH CONGRESS
FIRST SESSION

DECEMBER 15, 1981

Serial 97-43

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SAFE HARBOR LEASING PROVISIONS OF THE ECONOMIC RECOVERY TAX ACT OF 1981

TUESDAY, DECEMBER 15, 1981

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, D.C.

The subcommittee met at 10 a.m., pursuant to notice, in room 1100, Longworth House Office Building, the Honorable Charles B. Rangel (chairman of the subcommittee) presiding.

[Press release announcing the hearing and background material follow:]

[Press Release of December 11, 1981]

HON. CHARLES B. RANGEL (D-N.Y.), CHAIRMAN, SUBCOMMITTEE ON OVERSIGHT, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES A HEARING ON DECEMBER 15, 1981, ON THE SAFE HARBOR LEASING PROVISIONS OF THE ECONOMIC RECOVERY TAX ACT OF 1981

The Honorable Charles B. Rangel (D-N.Y.), Chairman of the Subcommittee on Oversight of the Committee on Ways and Means, announced today that the Subcommittee will conduct a hearing on Tuesday, December 15, 1981, on the safe harbor leasing provisions of the Economic Recovery Tax Act of 1981 (ERTA). The hearing will convene at 10 a.m. in room 1100 of the Longworth House Office Building.

The Economic Recovery Tax Act of 1981 created a safe harbor for leasing transactions under Section 168 of the Internal Revenue Code. The safe harbor guarantees that a transaction will be characterized as a lease for purposes of allowing investment credits and cost recovery allowances to the nominal lessor. These provisions were never considered by the Committee on Ways and Means, since they were a part of the Administration's substitute proposal which was adopted by the House.

The purpose of the hearing will be (1) to inform the Members as to the practical application of the provisions, by soliciting testimony on how the transactions are being structured and (2) to ascertain the extent to which the provisions are being utilized.

Witnesses at the hearing will be limited to John E. Chapoton, Assistant Secretary of the Treasury for Tax Policy and a panel of invited witnesses.

For those who wish to file a written statement or supply additional materials for inclusion in the printed hearing record, five copies are required and may be submitted at any time prior to the close of business December 31, 1981, to the attention of John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515.

DESCRIPTION OF SAFE HARBOR LEASING PROVISIONS UNDER THE ACCELERATED COST
RECOVERY SYSTEM

(Prepared by the Staff of the Joint Committee on Taxation, December 12, 1981)

INTRODUCTION

The Subcommittee on Oversight of the House Ways and Means Committee has scheduled a public hearing on December 15, 1981, on the subject of the safe harbor leasing provisions that were enacted as part of the Economic Recovery Act of 1981.

The purpose of the hearing is to gather information on the functioning of the leasing provisions since the tax bill was enacted. (See Finance Committee press release No. 81-187, dated December 4, 1981.) The only witnesses scheduled to be heard at the December 10 hearing are representatives of the Treasury Department.

This document, prepared in connection with the hearing, provides an overall description of the safe harbor leasing provisions under the 1981 Act. The first part is a discussion of background (prior law and general reasons for the change). This is followed by an explanation of the provisions, including examples of how the provisions work in certain instances. The third part discusses pros and cons relating to the safe harbor leasing provisions. Finally, Appendix 1 presents an example of a sale-lease-back under present law; and Appendix 2 is a brief description of investment tax credit "strips."

I. Background

PRIOR LAW

The benefits of depreciation deductions and investment credits attributable to property generally are available only to the owner of the property. In many cases, companies in a tax loss position and thus unable to use currently the tax benefits of owning equipment have been able to obtain a portion of those benefits indirectly by leasing the equipment from companies having sufficient taxable income to use the tax benefits. The use of the tax benefits by the leasing company was reflected in reduced rental payments charged to the loss company. The determination of whether these "lease financing" transactions should be treated for tax purposes in accordance with their form as leases or whether they should be recharacterized as in substance conditional sales or financing arrangements required a case-by-case analysis.

If a transfer of property were treated as a lease, reasonable rental payments by the lessee would be deductible by a lessee using the property in a trade or business. Also, since ownership under a lease remains with the lessor, the lessor would be entitled to recover its cost through depreciation and investment tax credits. The rental payments received by the lessor would be taxable at ordinary income rates.

On the other hand, if the transfer were a financing arrangement or conditional sale by the nominal lessor rather than a lease, the transferee of the property would not be able to deduct its payments as rent. The lessee could claim depreciation and investment tax credits since it would be treated as the owner of the property by virtue of the sale. For a lessee that is unable to utilize the tax benefits, the cost of acquiring the equipment would be higher than if the lessor took the benefits and passed them through to the lessee in the form of lower rents. For the lessor, no depreciation or investment credit would be allowed. Any difference between the lessor's basis in the property and the amount received from the lessee would be treated as gain from the sale of the property. Assuming the asset is a capital asset and has been held for more than 1 year, the gain would generally be capital gain (except for the portion treated as imputed interest under section 483, which is taxable at ordinary income rates). Installment reporting of the gain may be available to the seller.

For purposes of obtaining an advance letter ruling, the Internal Revenue Service in a series of Revenue Procedures (Rev. Procs. 75-21, 75-28, and 76-30) has established guidelines for determining whether a transaction is a lease or merely a financing arrangement by the nominal lessor.

Included among the requirements for a transaction to be a true lease under the IRS guidelines are the following:

1. The lessor must have a 20-percent minimum at risk investment in the property throughout the lease term;
2. The lessor must have a positive cash flow and a profit from the lease independent of tax benefits;
3. The lessee must not have a right to purchase the property at less than fair market value;

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4. The lessee must not have an investment in the lease and must not lend any of the purchase cost to the owner; and
5. The use of the property at the end of the term of the lease by a person other than the lessor must be commercially feasible.

REASONS FOR CHANGE

Under the depreciation rules that existed prior to enactment of the Economic Recovery Tax Act of 1981 (the Act), many corporations were in a loss position and thus unable to utilize fully the tax benefits of depreciation deductions. Deductions that could not be used in a taxable year generated a net operating loss, which had to be carried back 3 years and forward 7 years. Since, in most instances, the deductions permitted under the Accelerated Cost Recovery System (ACRS) will be more accelerated than those permitted under prior law depreciation rules, the net operating losses of companies previously in a loss position would be increased and companies that previously were marginally profitable for tax purposes could be thrown into a loss position.

Although the flexibility provisions under ACRS and extension of the carryover period for net operating losses to 15 years will enable some companies to avoid loss of tax benefits, many capital intensive companies still will be unable to utilize fully their tax benefits. Moreover, even if the tax benefits can be carried over and used in later years, in present value terms the tax benefits are reduced. The leasing provisions are designed to address this issue.

II. Explanation of Provision

OVERVIEW OF SAFE HARBOR PROVISIONS

The Act provides a safe harbor that guarantees a transaction will be treated as a lease, rather than a financing arrangement, even though the transaction does not comply with the Internal Revenue Service guidelines for obtaining an advance letter ruling, and even though the transaction would not otherwise be a true lease. To be eligible for the safe harbor, the following requirements must be met:

1. All parties to the agreement must elect;
2. The nominal lessor must be (a) a corporation (other than a subchapter S corporation or a personal holding company), (b) a partnership all of the partners of which are one of those corporations, or (c) a grantor trust with respect to which the grantor and all beneficiaries of the trust are corporations or a partnership comprised of corporations;
3. The lessor must have a minimum at-risk investment in the property at all times during the lease term of at least ten percent of the adjusted basis of the property;
4. The lease term must not exceed the greater of 90 percent of the property's useful life or 150 percent of the ADR midpoint life of the property; and
5. The property must be "qualified leased property."

Treasury issued temporary regulations interpreting the safe harbor provisions on October 23, 1981 (46 FR 51907). Those regulations were clarified by a second set of temporary regulations on November 13, 1981 (46 FR 56148).

FACTORS DISREGARDED

If a transaction meets the safe harbor requirements, the transaction will be treated as a lease entered into by the parties to the agreement and the nominal lessor will be treated as the owner for Federal tax purposes. Thus, the nominal lessor will be entitled to the associated cost recovery allowances and investment credit. The following factors will therefore not be taken into account in determining whether a transaction is a lease:

1. The fact the lessor or lessee must take the tax benefits into account in order to realize a profit or cash flow from the transaction;
2. The fact the lessee is the owner of the property for State or local law purposes (e.g., has title to the property and retains the burdens, benefits, and incidents of ownership, such as payment of taxes and maintenance charges with respect to the property);
3. The fact that no person other than the lessee may be able to use the property after the lease term;
4. The fact the property may (or must) be bought or sold at the end of the lease term at a fixed or determinable price or the fact that a rental adjustment is made

upward or downward to reflect the difference between the expected residual value of the property and the actual sales price;

5. The fact the lessee, or a related party, has provided financing or has guaranteed financing for the transaction (other than for the lessor's minimum 10 percent investment); and

6. The fact the obligation of any person is subject to any contingency or offset agreement.

The new provision is a significant change overriding several fundamental principles of tax law. Traditionally, the substance of a transaction rather than its form controls the tax consequences or a transaction. In addition, a transaction generally will not be given effect for tax purposes unless it serves some business purpose aside from reducing taxes. Because the leasing provision was intended to be only a transferability provision, many of the transactions that will be characterized as a lease under the safe harbor will have no business purpose (other than to transfer tax benefits). When the substance of the transaction is examined, the transaction may not bear any resemblance to a lease.

The Treasury's temporary regulations contain examples of safe harbor leasing transactions that are permitted under the Act. One example illustrating a typical transaction assumes that corporation X acquires 5-year recovery property with a 10-year economic life worth \$1 million, but cannot use the tax benefits. X and corporation Y agree, pursuant to the safe harbor rules, that X will transfer the property in a paper transaction to Y but X will retain all economic benefits and burdens of ownership, including title for State law purposes. Y will then lease back the property to X for nine years at which time there will be a paper transfer of the property back to X for \$1. Y agrees to pay X \$200,000 in cash and to give X a note for \$800,000 plus interest at the market rate. In return, X agrees to pay rent in an amount exactly equal to Y's \$800,000 net obligation plus interest.

Looking at the substance of the transaction between X and Y, which is cast in the form of a sale-leaseback, there has been no change of ownership and there is no business purpose for the transaction. X is still in actuality the owner and user of the property and Y has no profit from the transaction excluding tax benefits. However, since the transaction is treated as a sale to Y and leaseback to X under the safe harbor provisions, the Federal income tax law will recognize the form of the transaction producing the following economic consequences.

For Y, the present value of the tax savings due to cost recovery allowances, ITC, and interest deductions will exceed the present value of the tax on the rental income producing a return on Y's initial investment solely from tax savings. For X, the transaction results in a reduction of cost of \$200,000, which is the amount of the up-front cash payment by Y.

MINIMUM AT-RISK INVESTMENT

In general, the requirement that a lessor maintain a ten-percent minimum at-risk investment in the property throughout the lease term means that the lessor must have an equity investment in the property. For this purpose, an equity investment includes only consideration paid and personal liability incurred by the lessor to purchase the property other than debt to the lessee or a person related to the lessee. Contrary to the Internal Revenue Service guidelines discussed above, the minimum investment rule is determined with respect to the adjusted basis of the property rather than its original basis.

QUALIFIED LEASED PROPERTY

"Qualified leased property" means recovery property (other than a "rehabilitated building") which meets one of three requirements. First, "qualified leased property" includes new section 38 property (i.e., property eligible for the investment tax credit) of the lessor which is leased within three months after the property was placed in service and which, if acquired by the lessee, would have been new section 38 property of the lessee. The original use of the property must commence with the lessor to be new section 38 property of the lessor. The lessor may use the property within the three-month period prior to the lease.

Second, with respect to a sale-leaseback transaction, "qualified leased property" includes property that was new section 38 property when acquired by the lessee. The sale to the nominal lessor and the leaseback to the lessee (the original user) must occur within three months after the property was placed in service by the lessee, and the adjusted basis of the lessor must not exceed the adjusted basis of the lessee at the time of the lease.

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2. Effect

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For new section 38 property placed in service after December 31, 1981, and before the date of enactment of the Act (August 13, 1981), property will be considered to have met the requirement that the property be leased within three months of the date the property was placed in service if the property was leased by November 13, 1981.

Third, qualified leased property includes qualified mass commuting vehicles (as defined in section 103(b) (9), as added by the Act financed in whole or in part by obligations the interest on which is excludable from income under section 103(a). Mass commuting vehicles qualify even though the property is used by a tax-exempt organization or governmental unit in an exempt function and, thus, does not qualify for the investment credit. However, only cost recovery allowances attributable to qualified mass commuting vehicles, and not investment credit, may be transferred under a safe harbor lease.

Since, except for the special rule for mass commuting vehicles, qualified leased property must be new section 38 property, the safe harbor rule will not apply, for example, for that portion of any property used by the lessee for personal purposes, used by a governmental unit, or used by a tax-exempt organization (other than in an unrelated trade or business).

AMOUNT AND TIMING OF DEDUCTIONS AND CREDITS

The Act also gives the Treasury authority to prescribe regulations necessary to carry out the purposes of the safe harbor, including (but not limited to) regulations consistent with those purposes that limit the amount and timing of deductions to the amount allowable without regard to the safe harbor rules. The Statement of Managers indicates that the conferees intended the amount and timing of cost recovery allowances in the hands of the lessor to be the same as they would have been in the hands of the lessee. As noted previously, temporary regulations interpreting these provisions have been issued.

III. Analysis

ARGUMENTS FOR SAFE-HARBOR LEASING

1. Extension of ACRS benefits to businesses without current taxable income

The ACRS system provides substantial deductions and tax credits in the early years of the life of a depreciable asset, often larger than will generally be usable against taxable income from the asset itself. Thus, to utilize fully the tax incentives from ACRS, a business needs taxable income from other sources. Businesses which will not be able to utilize fully their ACRS benefits will include not only unprofitable corporations, but also profitable corporations in a wide variety of circumstances (e.g., a corporation whose capital investment is growing rapidly). It is argued that safe harbor leasing (or a comparable mechanism) is necessary to extend to corporations without such taxable income those investment incentives which are available to other corporations under ACRS.

For a business which can utilize all its ACRS benefits currently, accelerated cost recovery deductions and the investment credit provided by ACRS lower the present value of tax liability on income produced by an asset. This increases the after-tax profitability of investing in the asset and thus stimulates additional investments by the business.

However, the incentive to invest can be smaller for a business which is not taxable but expects to have taxable income beginning in the future. For this business, the after-tax profitability of currently investing in an asset is reduced by the fact that it must carry over its unused ACRS deductions and credits. One way of characterizing this situation is to say that, after taking tax benefits into account, this firm must pay more for equipment than a firm with current tax liability will pay for the identical equipment.

A safe-harbor lease can offset much of this difference in investment incentives. The money paid to the nominal lessee (here, the currently nontaxable business) plus the rent deductions retained by the lessee in a safe-harbor sale-leaseback, in effect, takes the place of ACRS tax savings. If investment incentives are the same for all firms, the allocation of investment will be more efficient.

2. Effect on the concentration of corporate assets

It is argued that a greater concentration of assets in fewer corporations would result if safe-harbor leasing (or a comparable mechanism) were not allowed.

All else being equal, a currently nontaxable business with good prospects for future profitability will accumulate greater investment credit and net operating loss

carryovers due to ACRS, making it a more attractive object for acquisition by, or merger with, a profitable business that could currently use such unused tax benefits against its own tax liability. Similarly, taxpayers with net operating loss carryforwards and investment tax credits may seek to acquire other businesses with high taxable income. Safe-harbor leasing is one mechanism for checking this accumulation of unused credits and net operating losses in currently nontaxable businesses, thereby reducing the incentives for tax-motivated mergers and acquisitions.

3. *Efficiency of leasing under prior law*

There was considerable leasing activity under prior law, often with the intent of enabling more companies to make effective use of their tax benefits. However, the prior law was structured so that in many cases it was impossible for the lessor to pass through to the lessee all, or a significant portion of, those tax benefits. The present rules can be viewed as a way to make the tax leasing industry more efficient and permit competition of potential lessors to cause more of the tax benefits to be passed through to the user of the equipment.

4. *Administrative issues*

If it is assumed that there has to be some mechanism to make ACRS benefits available to businesses who are not currently taxable, the safe-harbor leasing provides certain administrative advantages relative to alternative systems, such as refundable tax credits. For example, it is argued that lessors will have an economic interest in making certain that investments are, in fact, made before tax benefits are claimed. The government will not have to rely merely upon audit by the IRS.

ARGUMENTS AGAINST SAFE-HARBOR LEASING

1. *Efficiency*

It is argued that safe-harbor leasing is not an efficient way to extend ACRS benefits to businesses not currently taxable.

In general, the total value of any sale-leaseback transaction to all parties in the transaction is the present value of reduced tax liability purchased by the lessor. This total is allotted among the lessee (purchase money received), the brokers and lawyers involved (fees and expenses, if any) and the lessor (the present value of reduced tax liability less purchase money and fees and expenses). Thus, in order to convey \$1 to the nontaxable corporation (the lessee) through safe-harbor leasing, the Treasury may have to forego more than \$1 in corporate tax revenue.

The actual division of benefits between lessees and others has not been publicly disclosed, and the staff will need information about actual transactions to be able to see how efficient safe-harbor leasing is in practice.

2. *Effect on perceptions of tax equity*

It is argued that widespread publicity of safe-harbor leasing transactions will diminish respect for, and voluntary compliance with, income tax laws by individuals who perceive that corporations are directly buying and selling reductions in corporate tax liabilities.

3. *Unintended beneficiaries*

A third argument against leasing is that the benefits are available to highly profitable taxpayers who pay little or no tax because of the operation of foreign tax credits, unrelated loss carryforwards or other tax benefits. Leasing thus gives such taxpayers a net negative effective tax rate.

4. *The credit judgment of the lessor*

Although leasing was presented to the committee as providing an independent credit judgment as to the advisability of making the investment in capital goods, it is unclear that lessors under the present statute are required to make such independent judgments.

IV. *Revenue Impact*

The safe-harbor leasing will have a substantial revenue impact. The revenue loss is expected to be \$3.1 billion in fiscal year 1982, \$3.6 billion in 1983, \$5.1 billion in 1984, \$6.7 billion in 1985 and \$8.5 billion in 1986.

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APPENDIX 1—NUMERICAL EXAMPLE OF SALE-LEASEBACK UNDER PRESENT LAW

PARTIES

Corporation X, the nominal lessee, which expects to have no income tax liability in future years.

Corporation Y, the nominal lessor, which expects to have income taxable at a 46-percent rate.

AGREEMENT

1. X purchases new equipment having a 10-year ADR life for \$1 million.
2. X sells the asset to Y for \$1 million. Y pays X \$200,000 cash and an \$800,000 note. The note is for 15 years (150 percent of ADR life) at 15 percent annual interest and is paid in equal annual installments of \$136,800 (that is, a level payment loan).
3. Y leases the equipment to X for 15 years and charges an annual rental of \$136,800, which exactly offsets the debt service. Thus, the only money which changes hands between X and Y is \$200,000 from Y to X.
4. At the end of the lease, Y sells the equipment to X for \$1.

RESULTS

1. X purchases a \$1 million asset for \$800,000. (X's rental payments and receipt of loan payments do not affect cash flow—because they are offsetting—or tax liability—because X is not in a taxable position.)

2. Y purchases for \$200,000 tax savings worth more than \$200,000. Y's tax savings year by year are shown below. Y has deductions for depreciation (column 2) and interest paid (column 3), and it has rental income (column 4). Y's net deduction and tax change are shown in columns 5 and 6, respectively. The present value of this stream (discounted at the after-tax rate of 8.1 percent, which corresponds to a pre-tax rate of 15 percent) is \$321,000. Thus, by paying \$200,000 to X, Y pays \$321,000 less in tax, a gain of \$121,000 in constant (present) dollars.

Another way to express Y's gain is as follows. If Y had purchased at par a 15-year, 15-percent bond for \$200,000, then Y would have (net of tax on interest income) \$643,300 after 15 years. On the other hand, if Y invests the tax savings of column 6 at 15 percent, then Y would have (net of tax on interest income) \$1,032,700 after 15 years, a gain of \$389,400 in comparable (future) dollars.

BENEFITS AND COSTS OF LEASING TO Y

[All amounts in \$1,000]

	Deductions				Change in tax
	Depreciation	Interest paid	Rental income	Net	
End of year:					
0.....	150	0	0	150.0	¹ -169.0
1.....	220	120.0	136.8	203.2	-93.5
2.....	210	117.5	136.8	190.7	-87.7
3.....	210	114.6	136.8	187.8	-86.4
4.....	210	111.2	136.8	184.4	-84.8
5.....		107.4	136.8	-29.4	13.5
6.....		103.0	136.8	-33.8	15.6
7.....		97.9	136.8	-38.9	17.9
8.....		92.1	136.8	-44.7	20.6
9.....		85.4	136.8	-51.4	23.7
10.....		77.7	136.8	-59.1	27.2
11.....		68.8	136.8	-68.0	31.3
12.....		58.6	136.8	-78.2	36.0
13.....		46.9	136.8	-90.0	41.4
14.....		33.4	136.8	-103.6	47.6
15.....		17.9	136.8	-119.0	54.7

¹ Includes regular investment tax credit of \$100,000. Lease is executed at end of taxable year.

Chairman RANGEL. The Subcommittee on Oversight will come to order.