PART XI: EQUIPMENT LEASING

7820. What is equipment leasing?

The equipment leasing business provides equipment to users who want the equipment but, for various reasons, prefer not to purchase it. Ordinarily, the user arranges with an equipment leasing company to have the leasing company buy the equipment from the manufacturer and lease it to the user. The leasing company obtains financing for its purchase and generally secures the loan with a lien against the equipment and an assignment of the flow of rental income to the lender to amortize the loan. The equipment leasing company then sells the equipment (subject to the lease to the user and subject to the rights of the lender) to a limited partnership, a grantor trust, or to individual investors.

In a highly leveraged program, the flow of rental income from the lease is generally used to meet debt service and there is nothing available for cash distributions. These programs anticipate that the debt will be paid off at the expiration of the initial user lease and that the property will have residual value that can be realized through further leasing of the equipment or on the sale of the property. Thus cash distributions are projected for later years. Less highly leveraged programs, or unleveraged programs, are designed to provide for cash distributions to the investors from the start.

7821. What is a "wrap lease"?

An equipment leasing company may enter into a "wrap lease." After entering into the basic arrangement between manufacturer and user, and having arranged financing, the equipment leasing company sells the equipment (subject to the user lease and lender's rights) to an unrelated third party who in turn sells the equipment (still subject to the user lease and lender's rights) to a partnership or trust. The partnership or trust then *leases* the equipment (still subject to the user lease and lender's interest) back to the equipment leasing company. This second lease to the equipment leasing company is generally for a longer term than the leasing company's underlying lease to the user. This lease from the investors to the leasing company is termed a "wrap lease." (In effect, the second, longer lease to the leasing company is wrapped around the original lease to the user). In this arrangement, the leasing company both leases from the partnership, trust, or directly from the investors, and in turn leases to the user. (In other words, the leasing company is a lessor with respect to the user and lessee with respect to the partnership or trust).

7822. In general, what are the tax effects of equipment leasing programs?

The primary tax benefit of equipment leasing programs is tax deferral. Deductions for depreciation, interest, and expenses offset rental income from the program and, depending on the amount of deductions, may offset income from other sources. Because an equipment leasing program will generally be a passive activity, such excess deductions (losses) may normally offset only other passive income of the taxpayer (See Q 7831).

Depreciation and interest deductions will decline. Consequently, while there may be tax losses in early years that offset income from sources other than the program, in later years the investor will recognize taxable income that may substantially exceed cash available from the program ("phantom income"). The carryover of disallowed passive losses from earlier years may reduce or even eliminate the phantom income in later years.

Generally, limited partnerships and S corporations act as flow-through entities, and partners and shareholders report their share of the entity's income, deductions, and credits on their own tax returns (see Q 7703). (Electing large partnerships have somewhat different flow-through rules than regular partnerships (see Q 7704)). However, if a publicly traded partnership is taxed as a corporation, the income, deductions, and credits are reported by the partnership and do not flow-through to the partners. Electing 1987 partnerships are subject to both an entity level tax and the flow-through rules. In general, investment in a publicly traded partnership taxed as a corporation will be taxed as an investment in a corporation. See Q 7699 for the treatment of publicly traded partnerships.

7823. Will an equipment leasing arrangement be treated as a lease or a sale?

It is essential that the leasing arrangement be treated, for tax purposes, as a lease rather than a financing arrangement for a sale (or conditional sale) of the equipment, in order for the investor (or partnership or S corporation) to be considered owner of the equipment and eligible to deduct depreciation and other expenses, as well as to claim the investment tax credit, if available. The courts have used various tests that look at facts and circumstances to determine whether the arrangement is a lease or sale. The IRS has published some guidelines as to what it looks for when determining whether a transaction constitutes a lease. The courts have indicated that something less than what is set out in the guidelines may be acceptable but have otherwise provided little guidance.

IRS Guidelines

According to the IRS guidelines, the intent of the parties as to the nature of the arrangement is to be determined by examining the agreement in "light of the facts and circumstances existing at the time the agreement was executed."[1] Some factors indicating a conditional sale include:

(1) rentals for a short period of time relative to the life of the equipment, during which time the rent covers the normal purchase price plus interest;

(2) passage of title to the lessee after the payment of a stated amount of rentals;

(3) passage of title to the lessee after a payment at the termination of the agreement which, when added to rental payments, approximates the normal purchase price plus interest;

(4) payment of substantial rent over a short period of time relative to the life of the equipment, followed by payment of insignificant rent for use of the equipment over the balance of the useful life;

1. Rev. Rul. 55-540, 1955-2 CB 39.

(5) acquisition of equity by the lessee through "rental" payments;

(6) rental payments that exceed the current fair rental value;

(7) a purchase option that is nominal relative to the value of the property at the time when it may be exercised, as viewed from the time of entering into the agreement;

(8) a purchase option that is nominal when compared to the total payments to be made; and

(9) a portion of the periodic payments that is interest or equivalent to interest.

If even stricter requirements are met, the lessor in a leveraged lease transaction (other than for "limited use" property) can obtain from the IRS an advance ruling recognizing the lease as such unless all the facts and circumstances indicate a contrary intent by the parties. These requirements do not define whether a transaction is a lease or not for income tax purposes, and are not intended to be used for audit purposes. If these requirements are not met, the IRS will consider ruling in appropriate cases on the basis of the facts and circumstances.[1] The requirements are:

(1) A minimum, unconditional, at risk investment must be made by the lessor. At the beginning of and during the term of the lease, this investment must be equal to at least 20 percent of the cost of the property. The lease term includes all renewal or extension periods except for a renewal or extension at the option of the lessee that is for a fair rental value at the time of renewal or extension.

(2) The lessor must also maintain a minimum unconditional at risk investment at the end of the lease term. This is measured in two ways. First, a reasonable estimate of what will be the fair market value of the property at the end of the lease term must be equal to at least 20 percent of the cost of the property. Additionally, the remaining useful life of the property at the end of the lease term must be the greater of one year or 20 percent of the originally estimated useful life. Fair market value must be determined without including adjustments for inflation or deflation, and after subtracting from the fair market value the cost to the lessor for removal and delivery of the property to the lessor at the end of the lease term.

(3) Purchase and sale rights to the property must be restricted to some extent. A member of the "lessee group" (the lessee and others related to the lessee) must have no option to purchase the property at a price that is lower than fair market value at the time the option is exercised. A lessor may not have, at the time the property is first placed in use, a contractual right to require any person to purchase the property. The lessor must also state that he or she has no intention to acquire such a right. A subsequent acquisition of such a right could require a redetermination of lease

1. Rev. Proc. 2001-28, 2001-1 CB 1156.

characterization. A right to abandon the property to another person is treated as the right to require that person to purchase the property.

(4) A member of the lessee group may not furnish any part of the cost of the property or the cost of improvements, modifications, or additions to the property ("improvements") with certain exceptions:

(a) A member of the lessee group may pay the cost of an improvement that is owned by the lessee if it is readily removable without causing material damage to the leased property ("severable improvement"). The improvement may not be subject to a contract or option for purchase or sale between the lessor and the lessee at other than fair market value as determined at the time of sale. The improvement must not be necessary to make the property complete for its intended use at the beginning of the lease, unless it is of a kind customarily furnished by lessees of property of the kind leased. For example, a vessel would not be considered complete without a boiler, but would be considered complete without ancillary items such as radar, lines, or readily removable fittings.

(b) A member of the lessee group may pay the cost of an improvement that is not readily removable without causing material damage to the property ("nonseverable improvement") only if certain conditions are met:

(i) The improvement must not be necessary to make the property complete for its intended use by the lessee.

(ii) A member of the lessee group may not be compensated directly or indirectly for his or her interest in the improvement. For example, a lessor must not be required to purchase the improvement or to reimburse a member of the lessee group for the improvement; option prices or renewal rental rates must not be adjusted to reflect the improvement; and the lessor must not be required to share with a member of the lessee group proceeds from sale or lease of the property to a third party.

(iii) The improvement must not cause the property to become limited use property (see heading "Limited Use Property" below).

(iv) Unless the improvement is furnished to comply with health, safety, or environmental standards of a government, it must neither increase the productivity or capacity of the property to more than 125 percent over that when first placed in service, nor "modify the leased property for a materially different use."

(v) A de minimis rule exists exempting certain improvements totaling not in excess of 10 percent of the cost of the property. This is calculated with an adjustment for inflation.

(c) Maintenance and repairs required under the lease will not be treated as an improvement furnished by a member of the lessee group.

(d) The lease may provide adjustment for cost overruns.

(5) A member of the lessee group may not lend a lessor funds to acquire the property, nor may the member guarantee a lessor's indebtedness incurred in connection with the acquisition of the property. An exception applies to guarantees by a member of the lessee group of the lessee's obligation to pay rent, to maintain property, or to pay insurance premiums or similar obligations of a net lease.

(6) A lessor must demonstrate that it expects to profit from the lease, apart from tax benefits. This must be shown by an overall profit and a positive cash flow. To show an overall profit, rental payments from the property plus the residual investment in the property must exceed the sum of the lessor's disbursements in connection with the property and the lessor's equity investment in the property. Direct costs of financing the equity investment are included in the equity investment. To show positive cash flow, the rental payments from the property over the lease term must exceed by a reasonable amount the disbursements in connection with the property.

The requirements set out in Revenue Procedure 2001-28 were effective May 7, 2001. Prior to May 7, 2001, the requirements for advanced rulings were governed by Revenue Procedure 75-21,[1] the requirements of which were similar to those in Revenue Procedure 2001-28.

Limited Use Property

The IRS will not issue rulings concerning whether transactions are leases when the property is limited use property. Limited use property is property that is not expected to have any use to the lessor at the end of the lease term except through continued leasing or sale to a member of the lessee group. The reason given by the Service is that the lessee group will enjoy all the rights of use or ownership for substantially all of the property's useful life.[2]

Court Decisions

The courts have used various tests that look at facts and circumstances to determine whether an arrangement is truly a lease. In general, the tests examine whether the lessor has anything to lose (at risk) at the beginning, during, and at the end of the lease term; whether the lessee will acquire an equity interest in the property through his or her rental payments; whether the lessee will feel compelled to exercise an option to purchase the property; whether the lessor can make an economic profit; and whether the lessor is guaranteed a return of the investment.

1. 1975-1 CB 715.
2. Rev. Proc. 2001-28, 2001-1 CB 1156.

The tests have been variously described: looking to whether there is a "genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features";[1] looking at the totality of facts and circumstances;[2] looking at whether the lessor has an equity in property which he or she can prudently abandon[3] (although one court held that the "prudent abandonment" test was not to be used where a lessor paid fair market value for equipment);[4] looking at the provisions of a lease in the aggregate to determine whether the lessor bears the benefits and burdens of the lease;[5] and looking at whether the transaction is a sham.[6] An economic analysis of the transaction is often used.[7] A 1986 Tax Court case raised questions as to whether the investor in a leveraged equipment leasing program can assume the present burdens and benefits necessary for treatment as the owner of equipment that is purchased with nonrecourse debt to be serviced only through rental payments and the equipment is leased under a net lease.[8]

Because the courts have looked at the totality of facts and circumstances, the courts have provided little guidance as to what is acceptable. They indicate that something less than the IRS guidelines is acceptable. A well structured lease meeting the spirit of the guidelines was treated as a lease in *Estate of Thomas*,[9] even though the lessor maintained less than the 20 percent equity the IRS requires for an advance ruling under Revenue Procedure 2001-28, above, (requirement one). Treatment as a lease has been allowed for leases with purchase options permitting the lessee to purchase property for as little as 10 percent of the cost of the property.[10] This would allow a minimum unconditional at risk investment of 10 percent at the end of the lease term, which is substantially less than the 20 percent the IRS requires for an advance ruling under Revenue Procedure 2001-28, above (requirement two).

A lessee may have no option to purchase property at a price that is lower than fair market value at the time the option is exercised under requirement three of Revenue Procedure 2001-28, above. However, a fixed price option allowing the lessee to purchase the equipment at fair market value as determined at the lease commencement was permitted in *Lockhart Leasing Co. v. U.S.*[11] Other cases have discussed whether the exercise of an option by a lessee to purchase property was a foregone conclusion,[12] whether it would be imprudent for a lessee to abandon property subject to an option to purchase,[13] and whether there would be an obligation on a lessee

1. *Frank Lyon Co. v. U.S.*, 435 US 561, 78-1 USTC ¶9370 (U.S. 1978).
2. *Belz Investment Co. v. Comm.*, 72 TC 1209 (1979), aff'd 661 F2d 76, 81-2 USTC ¶9734 (6th Cir. 1981).
3. *Est. of Franklin v. Comm.*, 544 F2d 1045, 76-2 USTC ¶9773 (9th Cir. 1976); *Hilton v. Comm.*, 671 F2d 316, 82-1 USTC ¶9263 (9th Cir. 1982); *Rice's Toyota World, Inc. v. Comm.*, 752 F2d 89, 85-1 USTC ¶9123 (4th Cir. 1985).
4. *Est. of Thomas v. Comm.*, 84 TC 412 (1985).
5. *Sun Oil Co. v. Comm.*, 562 F2d 258, 77-2 USTC ¶9641 (3rd Cir. 1977).
6. *Rice's Toyota World, Inc. v. Comm.*, above.
7. *Hilton v. Comm.*, above; *Rice's Toyota World, Inc. v. Comm.*, above.
8. *Coleman v. Comm.*, 87 TC 178 (1986).
9. 84 TC 412 (1985).
10. *LTV Corp. v. Comm.*, 63 TC 39 (1974), *Northwest Acceptance Corp. v. Comm.*, 500 F2d 1222, 74-2 USTC ¶9619 (9th Cir. 1974).
11. 446 F.2d 269 (10th Cir. 1971).
12. *Belz Investment Co. v. Comm.*, 72 TC 1209 (1979).
13. *Martin v. Comm.*, 44 TC 731 (1965).

to exercise an option to purchase property "by dint of economics."[1] An option to buy leased equipment that is certain to be exercised (e.g., at a nominal price) will defeat lease characterization.[2] An option with a nominal renewal rate is likewise certain to be exercised.[3]

A profit test is required under Revenue Procedure 2001-28, above. However, at least one court has held that no minimum rate of return should be required. "Taxpayers are allowed to make speculative investments without forfeiting the normal tax applications to their actions."[4] But there must be a realistic opportunity of economic profit.[5]

Motor Vehicle Operating Leases–Terminal Rental Adjustment Clause

Terminal rental adjustment clauses will be disregarded for purposes of lease characterization in the case of a qualified motor vehicle operating agreement.[6] A terminal rental adjustment clause is a provision that calls for an additional payment by the lessee if the lessor is not able to obtain a stated amount upon the sale or other disposition of the property at the end of the lease term or a payment by the lessor if the lessor is able to obtain more than the stated amount. Terminal rental adjustment clauses also include provisions requiring a "lessee who is a dealer in motor vehicles to purchase the motor vehicles at a predetermined price and then resell such vehicle where such provision achieves substantially the same results."[7]

A qualified motor vehicle operating agreement is an agreement with respect to a motor vehicle (including a trailer) that meets the following requirements: (1) the sum of the lessor's recourse liability with regard to the lease and the net fair market value of property pledged as security for the leased property (other than property subject to the lease or financed directly or indirectly by property subject to the lease) must be greater than or equal to the amount borrowed to acquire the property subject to the lease, (2) the lessee must supply a sworn statement that the lessee intends for more than 50 percent of the use of the property to be in the trade or business of the lessee and that the lessee is aware he or she will not be treated as owner of the property for federal income tax purposes, and (3) the lessor must not have knowledge that the lessee's sworn statement is false.[8]

7824. What is the investment tax credit?

The investment tax credit is a direct credit against tax liability. Generally, the regular investment tax credit was repealed for property placed in service after 1985.[9] (The term "investment credit" has a substantially different meaning after 1990). The amount of the investment tax credit was generally 6 percent or 10 percent of the cost of property placed in service.

1. *M&W Gear Co. v. Comm.*, 54 TC 385 (1970).
2. *Oesterreich v. Comm.*, 226 F.2d 798 (9th Cir. 1955).
3. *Est. of Starr v. Comm.*, 274 F.2d 294 (9th Cir. 1959).
4. *Hilton v. Comm.*, above.
5. *Rice's Toyota World, Inc. v. Comm.*, above.
6. IRC Sec. 7701(h)(1).
7. IRC Sec. 7701(h)(3).
8. IRC Sec. 7701(h)(2).
9. IRC Sec. 49(a) prior to amendment by OBRA '90.

If the investment tax credit was taken with respect to leased equipment placed in service after 1985 (generally, transition property), the basis of the equipment was reduced by the amount of the credit taken.[1] Thus, the basis of the property for purposes of depreciation was reduced. However, if the lessor elected to pass the investment tax credit to the lessee, the lessor was not required to adjust the basis in the equipment.[2]

An amount equal to some of the tax offset by the credit previously taken under the investment tax credit may have been "recaptured" if the equipment was disposed of within five years after it was placed in service.[3]

If the credit was recaptured upon a disposition of equipment for which there was a basis reduction, the basis of the equipment for purposes of determining gain or loss was increased immediately prior to disposition by the recapture amount.[4]

7825. Can the owner of leased equipment take depreciation deductions? How large may the first year deduction be?

In determining the income or loss from the activity, an owner of leased equipment placed in service after 1980 may deduct its cost over a period of years–generally three, five, or seven years depending on the kind of equipment. (See Q 7823 concerning the ownership of leased property). For property placed in service after 1986, the amount of the deduction is generally determined by applying a declining balance method to the basis of the property[5] (see Q 620). Normally, the initial basis of the property is its cost. For property placed in service after 1981 and before 1987, the amount of the deduction was a percentage of the "unadjusted basis," generally, the cost of the property.[6] (For property placed in service after 1986, the Service has published tables that were prepared using the appropriate declining balance method, but that provide percentage figures to be applied to the unadjusted basis of the property in determining each year's cost recovery allowance).[7] For the temporary rules dealing with bonus depreciation and the rules in IRC Section 179 providing an election to expense a portion of the costs of acquiring equipment, see below.

Cost includes the principal amount of debt already encumbering the property or new debt incurred in acquiring the property, whether recourse or not.[8] However, the debt must be bona fide; it is not included in basis if the purchase price substantially exceeds the fair market value of the property that nominally secures the liability.[9] Basis for depreciation must be reduced by the portion of the basis that the taxpayer may have elected to treat as an expense (see below). The basis is further reduced by the basis adjustment attributable to the investment tax credit

1. IRC Sec. 50(c)(1).
2. See IRC Sec. 50(d)(5).
3. IRC Sec. 50(a).
4. IRC Sec. 50(c)(2).
5. IRC Sec. 168(b).
6. IRC Sec. 168(d), as in effect before the amendments made by TRA '86.
7. See Rev. Proc. 87-57, 1987-2 CB 687.
8. *Crane v. Comm.*, 331 U.S. 1 (1947).
9. Rev. Rul. 69-77, 1969-1 CB 59; *Est. of Franklin v. Comm.*, 76-2 USTC ¶9773 (9th Cir. 1976); *Odend'hal v. Comm.*, 84-2 USTC ¶9963 (4th Cir. 1984); see also *Prussin v. Comm.*, 88-2 USTC ¶9601 (3d Cir. 1988), nonacq. AOD 1991-09.

(see Q 7824). The basis for depreciation under the declining balance method is calculated each year as reduced by depreciation deductions allowable in previous years, while the unadjusted basis is generally determined in the first year that a property is placed in service and is not reduced by depreciation deductions.

Depreciation is limited in the year in which equipment is placed in service to the portion of the year in which the equipment is considered to be held under the following *conventions*. Equipment is generally treated as placed in service on the midpoint of the year in which placed in service. However, where 40 percent of depreciable property, other than residential rental property and nonresidential real property, is placed in service during the last three months of the year, equipment placed in service during any quarter of such year is treated as placed in service on the midpoint of such quarter. Property placed in service and disposed of in the same year is not taken into account under the 40 percent test and the mid-quarter convention.[1] The IRS provided relief from the mid-quarter convention if a taxpayer's third or fourth quarter included September 11, 2001.[2]

The mid-quarter 40 percent test is made without regard to the length of the taxable year. Thus, if property (with exceptions, as noted in the preceding paragraph) is placed in service in a taxable year of three months or less, the mid-quarter convention applies regardless of when the property was placed in service (i.e., 100 percent of property has been placed in service in the last three months).[3]

In the case of a short taxable year (i.e., a taxable year that is less than 12 months), the recovery allowance for equipment is determined by multiplying the deduction that would have been allowable if the recovery year were not a short taxable year by a fraction, the numerator of which equals the number of months in the short taxable year and the denominator of which is 12.[4] Proposed regulations under IRC Section 168(f)(5) (as in effect prior to TRA '86) provided that a taxable year of a person placing property in service did not include any month prior to the month in which the person began engaging in a trade or business or holding recovery property for the production of income.[5] Presumably, this principle would continue to apply after TRA '86.

A partner who purchases an interest in a partnership after it has commenced business can deduct depreciation attributable only to the period during which he or she owns the partnership interest.[6]

In the first year of investment in a partnership, a partner's depreciation deduction is generally prorated because of (1) the partnership's short taxable year and (2) the rules applicable when a partner purchases an interest after the partnership commences business. As a result, an

1. IRC Sec. 168(d).
2. Notice 2001-74, 2001-2 CB 551.
3. Rev. Proc. 89-15, 1989-1 CB 816.
4. Rev. Proc. 89-15, 1989-1 CB 816.
5. Prop. Treas. Reg. §1.168-2(f)(4).
6. IRC Sec. 706(d).

investor purchasing a partnership interest late in the year will find the first year depreciation deduction substantially limited.

The inability of a partner to take a full first year depreciation deduction if he or she invests late in the year has created considerable interest in forming equipment leasing programs as grantor trusts. Since for tax purposes the investor in a grantor trust is generally treated as the owner of the investor's proportionate share of the property contained in the trust (under IRC Sections 671 through 679), it is reasoned that the taxable year of each investor is used to determine whether the investor can take a full year depreciation deduction on his or her proportionate share. The taxable year of the investor, for depreciation purposes, does not begin prior to the month the investor begins engaging in a trade or business or holding depreciable or recovery property for the production of income.[1] If the investor engages in such activities for the full year, he or she is entitled to a full first year depreciation deduction (subject to the conventions discussed above). Otherwise, the investor is limited by a short taxable year and corresponding proration of the first year depreciation deduction. However, if the investor engages in a small amount of such activities prior to investment in the program with the purpose of obtaining disproportionately large depreciation deductions, the investor's taxable year (for purposes of the depreciation deduction) does not begin prior to investment in the program.[2]

S corporations are treated like partnerships for purposes of determining the first year depreciation deduction. The first year depreciation deduction is pro-rated over the year and the deduction is taken only for depreciation allocable to the part of the year the S corporation has been in business or that a shareholder owns his or her interest. Ownership through a co-tenancy or individual ownership is treated like a grantor trust for this purpose. A full first year depreciation deduction (subject to the conventions discussed above) is available to an investor who has throughout the year engaged in a trade or business or held depreciable or recovery property for the production of income.

Temporary Bonus Depreciation Rules

In TRA 2010, Congress provided for 100 percent bonus depreciation (i.e., expensing the full cost) for qualified property placed in service after September 8, 2010, and before 2012.[3] (ARTA 2012 extended the placed-in-service date through 2013 for a subset of qualified property that will continue to be eligible for 100 percent bonus depreciation: certain property with a longer recovery period, transportation property, and certain aircraft).[4] For other qualifying property placed in service after 2007 and before 2014 (unless Congress once again retroactively extends the date for qualification), the bonus allowance is 50 percent (i.e., one half of the cost of the property can be deducted in the year the property is placed in service), and the rest of the cost is recovered using the otherwise applicable cost recovery method.[5] In the latter case, the actual deduction in the first year will thus exceed 50 percent of the property's cost: the

1. Prop. Treas. Reg. §1.168-2(f)(4) (see above).
2. Prop. Treas. Reg. §1.168-2(f)(4) (see above).
3. See IRC Sec. 168(k)(5).
4. See IRC Sec. 168(k)(5), as amended by ATRA Sec. 331.
5. See IRC Sec. 168(k)(2).

allowance will include not only the bonus depreciation but also the appropriate percentage of the rest of the cost of the property.

Election to Expense

Bonus depreciation provisions have typically been enacted only during economically difficult times, and for short periods. In one form or another, however, IRC Section 179 has been around for a long time. Under that provision, a limited amount of the cost to acquire equipment can be expensed in the year when the equipment is first placed in service.[1] In the case of partnerships and S corporations, the election to expense a portion of capital costs is made at the partnership or S corporation level.[2] The deduction can apply to several pieces of property used in the active conduct of the trade or business.

The aggregate cost deductible under IRC Section 179 for taxable years beginning after 2007 and before 2010 could not exceed $250,000; for taxable years beginning in 2010 through 2013 the aggregate cost deductible cannot exceed $500,000; and for a taxable year beginning after 2013 (unless Congress retroactively extends the period during which the applicable figure is $500,000), the aggregate deductible cost cannot exceed $25,000.[3] For those three periods the deductible amount must be reduced by one dollar for each dollar of such investment above $800,000; $2 million, and $200,000, respectively.[4]

The amount expensed is limited to the aggregate amount of taxable income derived from the active conduct of any trade or business of the taxpayer. An amount that is not deductible because it exceeds the aggregate income from any trade or business may be carried over and taken in a subsequent year. The amount carried over that may be taken in a subsequent year is the lesser of (1) the amounts disallowed because of the taxable income limitation in all prior taxable years (reduced by any carryover deductions in previous taxable years); or (2) the amount of unused expense allowance for such year. The amount of unused expense allowance is the excess of (1) the maximum cost of property that may be expensed taking into account the dollar and income limitations; over (2) the amount the taxpayer elects to expense.[5] Married individuals filing separately are treated as one taxpayer for purposes of determining the amount that may be expensed and the total amount of investment in such property.[6]

The dollar limit applies to partnerships and S corporations and to their partners and shareholders (to the extent the deduction is allowed (see IRC Sec. 179(d)(8))). A partner or S corporation shareholder will reduce his or her basis in the partnership or S corporation to reflect the share of the cost of property for which an election to expense has been made whether or not such amount is subject to limitation at either the entity or partner/shareholder level.[7] Also, the partnership or S corporation will reduce its basis in the property by the amount of the

1. IRC Sec. 179, as amended by ATRA, Sec. 315.
2. Treas. Reg. §1.179-1(h)(1).
3. IRC Sec. 179(b)(1), as amended by ATRA Sec. 315.
4. IRC Sec. 179(b)(2), as amended by ATRA Sec. 315.
5. IRC Sec. 179(b)(3); Treas. Reg. §1.179-3.
6. IRC Sec. 179(b)(4).
7. Rev. Rul. 89-7, 1989-1 CB 178.

deduction allocable to each partner or shareholder without regard to whether such individuals can use all of the deduction allocated to them.[1] Recapture provisions apply if the property ceases to be used predominantly in a trade or business before the end of the property's recovery period.[2] Also, amounts expensed under such an election are treated as depreciation deductions for purpose of recapture on sale or disposition (see Q 7833).

7826. Is property leased to governments and other tax-exempt entities eligible for accelerated cost recovery?

Property leased to certain tax-exempt entities (tax-exempt use property) may not, in general, use the normal recovery periods and percentages.[3]

A tax-exempt entity includes the following:

(1) the United States, any State or political subdivision thereof, or any agency or instrumentality of any of the above;

(2) an organization (other than a farmers' cooperative) that is exempt from normal income tax;

(3) any foreign person or entity; and

(4) certain Native American tribal governments.[4]

The deduction for tax-exempt use property is determined by using a straight line method over the recovery period. The recovery period is the greater of the present class life (or 12 years for personal property with no present class life) or 125 percent of the lease term.[5] Property is assigned to various class lives for purposes of depreciation in Revenue Procedure 87-56.[6] Options to renew and successive leases may be aggregated with the original lease term for this purpose.[7]

Property is not tax-exempt use property if the tax-exempt entity uses it predominantly in an unrelated trade or business that is subject to income tax.[8] Property is considered used predominantly in an unrelated trade or business if it is used in the unrelated trade or business more than 50 percent of the time it is used during a taxable year. If only a portion of the property is used in an unrelated trade or business, the remainder may be tax-exempt use property.[9] Property leased to a foreign person or entity is not considered tax-exempt use property if more than 50 percent of the foreign person or entity's gross income is subject to United States income tax.[10]

1. Treas. Reg. §1.179-1(f)(2).
2. IRC Sec. 179(d)(10); Treas. Reg. §1.179-1(e).
3. IRC Secs. 168(g)(1)(B), 168(h).
4. IRC Sec. 168(h)(2).
5. IRC Secs. 168(g)(2), 168(g)(3).
6. 1987-2 CB 674 (Rev. Proc. 83-35, 1983-1 CB 745, for property placed in service before 1987).
7. IRC Sec. 168(i)(3)(A).
8. IRC Sec. 168(h)(1)(D).
9. Temp. Treas. Reg. §1.168(j)-1T(A-8).
10. IRC Sec. 168(h)(2)(B).

Property subject to a short-term lease is not treated as tax-exempt use property. A short-term lease is a lease that is for a term which is less than three years, and (if the leased property has a class life) less than the greater of 1 year or 30 percent of the property's class life.[1] The Internal Revenue Service may aggregate options to renew and successive leases with the original lease term for this purpose. The Tax Court has held that a lease term is determined by the "realistic contemplation of the parties at the time the property is first put into service."[2]

Informal agreements to extend a lease term are included with the original lease term. Options to renew possessed by the lessor or lessee are included in the original lease term, whether exercised or not. Successive leases entered into at the same time concerning the same or substantially similar property may be treated as one lease. The leases will not be aggregated merely because the lessor and lessee entered into a new lease at fair market rental value at the end of the original lease term.[3]

For leases entered into after April 19, 1995, an additional time during which the lessee may not be the lessee will nevertheless be included in the lease term if the lessee (or a related person) retains an obligation to pay rent or make a payment in the nature of rent with respect to such period. A payment in the nature of rent is a payment intended to substitute for rent or to pay or supplement the rental payments of another. For example, a payment in the nature of rent includes payments required to be made for such other period if (1) the leased property is not leased; (2) the leased property is leased for terms that do not meet certain conditions; or (3) there is a failure to pay rent. In addition, for leases entered into after April 25, 1996, if property is subject to one or more leases (including subleases) entered into as part of one transaction (or series of related transactions), the lease term includes all periods described in any of such leases.[4] No inference is intended with respect to leases entered into prior to such dates.[5]

For transfers made after April 19, 1995, if tax-exempt use property is transferred (directly or indirectly) in a like-kind exchange under IRC Section 1031 (see Q 614) among related persons and a principal purpose of the transfer or any related transaction is to avoid or limit the application of the alternative depreciation system for tax-exempt use property, property received in exchange for tax-exempt use property (tainted property) must be depreciated under the alternative depreciation system for tax-exempt use property using the same methods and periods previously used for the transferred tax-exempt property. Generally, this rule applies to the extent the basis of the tainted property does not exceed the basis of the transferred tax-exempt use property.[6] No inference is intended with respect to transfers prior to such date.[7]

Deductions related to tax-exempt use property may be further limited to the amount of income from the property.[8]

1. IRC Sec. 168(h)(1)(C).
2. Temp. Treas. Reg. §1.168(j)-1T(A-17), adopting *Hokanson v. Comm.*, 730 F2d 1245, 84-1 USTC ¶9217 (9th Cir. 1984).
3. Temp. Treas. Reg. §1.168(j)-1T(A-17).
4. Treas. Reg. §1.168(i)-2.
5. TD 8667, 1996-1 CB 22.
6. Treas. Reg. §1.168(h)-1.
7. TD 8667, 1996-1 CB 22.
8. See IRC Sec. 470.

7827. Is property used outside the United States eligible for accelerated cost recovery?

The normal recovery periods and methods may not be used for recovery property used predominantly outside the United States.[1] For property placed in service after 1986, a straight line method is used over the present class life of the property (12 years if no present class life)[2] (See Q 620). For property placed in service before 1987, a declining balance switching to a straight line method was used over the present class life of the property (12 years if no present class life), unless an election was made for recovery property to use a straight line method over a different recovery period. The recovery period elected for pre-1987 property used predominantly outside the United States could not have been shorter than the present class life.[3] Property is assigned to various class lives for purposes of depreciation in Revenue Procedure 87-56.[4]

Property is considered used predominantly outside the United States if it is physically located outside the United States during more than 50 percent of the taxable year. If the property is placed in service after the start of the taxable year, the 50 percent determination is made for the period beginning when first placed in service and ending on the last day of the taxable year. This restriction applies whether the property is used predominantly outside the United States by the lessor or lessee. The determination is made with respect to the taxable year of the lessor.[5]

There are certain listed exceptions to the restriction on use of normal recovery periods and methods for property used predominantly outside the United States.[6] These include generally: aircraft, rolling stock, vessels, motor vehicles, and containers used partly in the United States for transportation or commerce; property used predominantly in certain possessions of the United States; certain U.S. communication satellites; submarine cable systems linking the United States and other countries; certain property used for exploring, developing, removing, or transporting resources from certain waters or land thereunder; and certain property used to generate energy for use in the United States. These may use normal periods and methods even if used outside the United States for more than 50 percent of the year.

7828. Can the owner of leased equipment deduct interest on amounts borrowed to purchase the property?

Yes. The owner of leased equipment may generally deduct each year amounts paid for interest on indebtedness incurred to purchase the equipment. The interest may be deducted only over the period to which a prepayment relates, not when prepaid.[7] However, the interest will generally be subject to the passive loss rules (see Q 7831).

1. IRC Sec. 168(g)(1)(A).
2. IRC Sec. 168(g)(2).
3. IRC Sec. 168(f)(2), as in effect prior to amendment by TRA '86.
4. 1987-2 CB 674 (Rev. Proc. 83-35, 1983-1 CB 745, for property placed in service before 1987).
5. Prop. Treas. Reg. §1.168-2(g)(5).
6. IRC Sec. 168(g)(4).
7. IRC Secs. 461(g)(1), 461(h).

7829. What expenses can the owner of leased equipment deduct?

The owner of leased equipment may deduct each year "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business" and all ordinary and necessary expenses paid or incurred during the taxable year (1) for the production and collection of income; (2) for the management, conservation, or maintenance of property held for the production of income; or (3) in connection with the determination, collection, or refund of any tax.[1] However, such expenses will generally be subject to the passive loss rules (See Q 7831).

Routine repair and maintenance expenses are deductible in the year paid or incurred as business expenses or expenses for the production of income, but the cost of improvements must be capitalized (added to the owner's basis in the property) and recovered through cost recovery or depreciation deductions.[2] Although new repair regulations have somewhat changed the terminology, prior regulations provided a good rule of thumb: repair expenses are those "which neither materially add to the value of the property nor appreciably prolong its life, but keep[s] it in an ordinary, efficient operating condition."[3] In contrast, capital improvements to a unit of property better the unit of property, restore it, or adapt it to a new or different use.[4]

Where equipment is leased on a "triple net lease" basis, the lessee pays insurance, taxes, and expenses necessary to maintain the property. Consequently, the lessor will have none of those expenses to deduct.[5]

Start-up expenditures incurred prior to the start of a trade or business must normally be capitalized. However, a taxpayer may elect to deduct (subject to the passive loss rules) up to $5,000 of start-up expenses (reduced by the amount that such expenses exceed $50,000). The remainder of the start-up expenses may be deducted over the 180-month period beginning with the month the trade or business begins.[6] Syndication costs are not eligible for this amortization.[7] If the business or trade is disposed of before the end of the amortization period, the remaining deferred expenses may be deducted under the loss provisions of IRC Section 165.[8]

Moreover, a partnership or corporation may elect to deduct (subject to the passive loss rules) up to $5,000 of organizational expenditures (reduced by the amount that such expenses exceed $50,000). The remainder of the organizational expenditures may be deducted over the 180-month period beginning with the month the corporation or partnership begins business.[9] Syndication costs must be capitalized.[10] If the partnership is liquidated before the end of the

1. IRC Secs. 162(a), 212.
2. IRC Sec. 263(a).
3. Treas. Reg. §1.162-4T.
4. Treas. Reg. §1.263(a)-3(d).
5. See *James v. Comm.*, 899 F2d 905, 90-1 USTC ¶50,185 (10th Cir. 1990).
6. IRC Sec. 195.
7. Sen. Fin. Com. Rpt. on P.L. 96-605 (Misc. Rev. Act of 1980).
8. IRC Sec. 195(b)(2).
9. IRC Secs. 709, 248; Treas. Reg. §1.248-1(b); §1.709-1(b)(3).
10. Rev. Rul. 85-32, 1985-1 CB 186; Treas. Reg. §1.248-1(b)(3)(i); §1.709-1(a).

amortization period, the remaining deferred expenses are a partnership deduction in its final taxable year under the loss provisions of IRC Section 165. If a partnership is abandoned before the end of the amortization period, the remaining deferred expenses are not deductible prior to liquidation.[1]

7830. Does the "at risk" limitation on losses apply to individual investors in an equipment leasing program? If so, what effect will it have?

Yes, the "at risk" rules will apply unless the investment is in an entity taxed as a C corporation, other than a closely-held corporation (generally, more than 50 percent control by 5 or fewer owners). The "at risk" rules will not apply to a closely-held corporation's equipment leasing activities if 50 percent or more of the corporation's gross receipts are attributable to equipment leasing[2] (See Q 7912).

In general, the "at risk" rules limit the deduction an investor may claim for the investor's share of net losses generated by an equipment leasing program to the amount he or she has at risk in that program. The rules do not prohibit an investor from offsetting his or her share of the deductions generated by the program against the income received from that program. For a detailed explanation of the operation of the at risk limitation, see Q 7914 to Q 7917.

Put as simply as possible, an investor is initially "at risk" to the extent that the investor is not protected against the loss of money or other property he or she contributes to the program. For the specifics as to how an investor's "amount at risk" is calculated, see Q 7913.

7831. Are equipment leasing activities subject to the passive loss rules? If so, what is the effect to an investor in an equipment leasing program?

Yes, rental activities will generally be considered passive activities subject to the passive loss rules. Even if substantial services are provided, so that the equipment leasing activity is not considered a rental activity, the investor usually will not materially participate in the program. As a result, the investor in such a program will generally be subject to the passive loss rules (see Q 7918 to Q 7929). However, an entity taxed as a C corporation typically is not subject to the passive loss rules (see Q 7918).

In general, the rules limit the amount of the taxpayer's aggregate deductions from all passive activities to the amount of aggregate income from all passive activities; passive credits can be taken against only tax attributable to passive activities. The rules are applied separately in the case of a publicly traded partnership; aggregation is permitted only within the partnership. The rules are intended to prevent taxpayers from offsetting salaries, interest, dividends, and other positive income with losses from passive activities. The benefit of the disallowed passive losses and credits is not altogether lost, but rather is postponed until such time as the taxpayer has additional passive income or disposes of the activity (See Q 7918 to Q 7929).

1. Rev. Rul. 89-11, 1989-1 CB 179.
2. See IRC Secs. 465(a)(1), 465(c)(4).

7832. When is deferred rental income included in income?

Cash basis taxpayers generally include rental payments in income in the taxable year in which they are actually or constructively received. Leasing programs have sometimes used deferred or stepped rent schedules in order to delay receipt of income until later years of the program, with the effect of increasing loss deductions in early years. However, lessors under certain deferred or stepped payment lease agreements entered into after June 8, 1984, are required to report rental income as it accrues, as well as interest on rent accrued but unpaid.[1] Agreements are subject to this rule if at least one amount allocable to the use of the property during a calendar year is to be paid after the close of the following calendar year, or if there are increases in the amount to be paid as rent under the agreement. This accrual requirement does not apply if the aggregate value of the money and other property received and to be received for use of the property is $250,000 or less.[2] These rules are discussed in further detail in Q 7769.

7833. How is gain or loss on sale of leased equipment treated?

The amount realized on the sale or other disposition of property in excess of adjusted basis is gain; if the amount realized is less than adjusted basis, it is loss.[3] The basis of property is generally its cost reduced by the portion of cost which the taxpayer elects to treat as an expense (see Q 7825) and by the basis adjustment attributable to any investment tax credit (see Q 7824).[4] Also, the basis is reduced each year by the amount of the depreciation taken so that the *adjusted* basis in the property reflects accumulated depreciation deductions. If depreciation is not deducted, the basis must nonetheless be reduced by the amount of depreciation allowable.[5] If the investment tax credit is recaptured in connection with property as to which a basis adjustment was required, then the basis is increased by such recaptured amount.[6]

Where leased equipment has been depreciated, gain on the sale of the property must be treated as ordinary income to the extent of all depreciation deductions allowed.[7] The gain in excess of the recaptured ordinary income is "IRC Section 1231" gain; loss is "IRC Section 1231" loss. See Q 7772 for an explanation of the treatment of IRC Section 1231 gains and losses. See Q 586 if the equipment is sold on the installment method.

7834. What items does an equipment leasing program generate which require that adjustments be made to or tax preferences added to alternative minimum taxable income?

The investor may have the following adjustments to alternative minimum taxable income (AMTI) or tax preferences in connection with investment in an equipment leasing program that passes losses and deductions through to the investor:

1. IRC Sec. 467(a).
2. IRC Sec. 467(d).
3. IRC Sec. 1001.
4. IRC Secs. 1012, 1016(a).
5. IRC Sec. 1016(a).
6. IRC Sec. 50(c)(2).
7. IRC Sec. 1245.

(1) Passive activity losses (determined by taking into account the adjustments to AMTI and tax preferences) are not allowed in calculating AMTI.[1]

(2) Generally, in calculating AMTI, equipment must be depreciated using a 150 percent declining balance method switching to the straight-line method at a time to maximize the deduction over the regular recovery periods.

Property is assigned to various *class lives* in Revenue Procedure 88-22.[2] These class lives can also be found in IRS Publication 946.

1. IRC Sec. 58(b).
2. 1988-1 CB 785.