Volume 3 Number 1

The Journal of Equipment Lease Financing™

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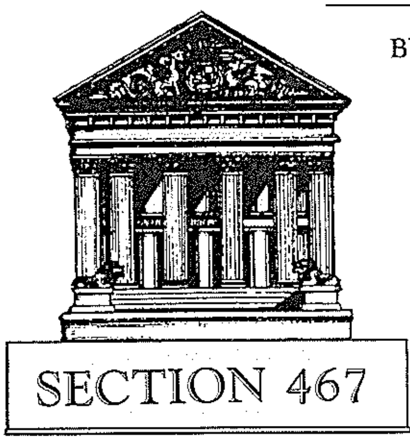
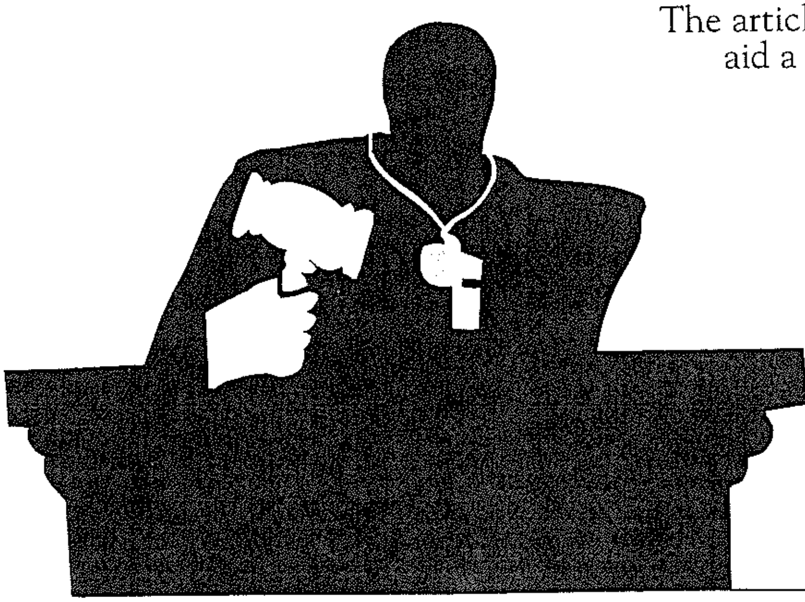


The article discusses the legal uncertainties encountered in leveraged leasing due to interpretations of changes in tax law over recent years. Specifically, the article examines Section 467 accrual accounting and even rent requirements; and also goes on to examine Section 7872 application, effects, and tax indemnity considerations; and Section 48(b)(2) definition of new Section 38 property.

The article examines a variety of techniques that can aid a lessor's recovery in the face of a Chapter 11 bankruptcy proceeding.



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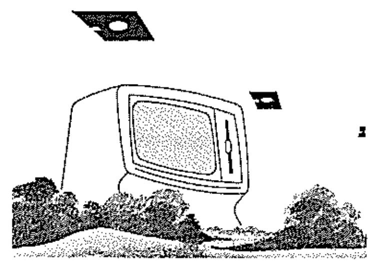

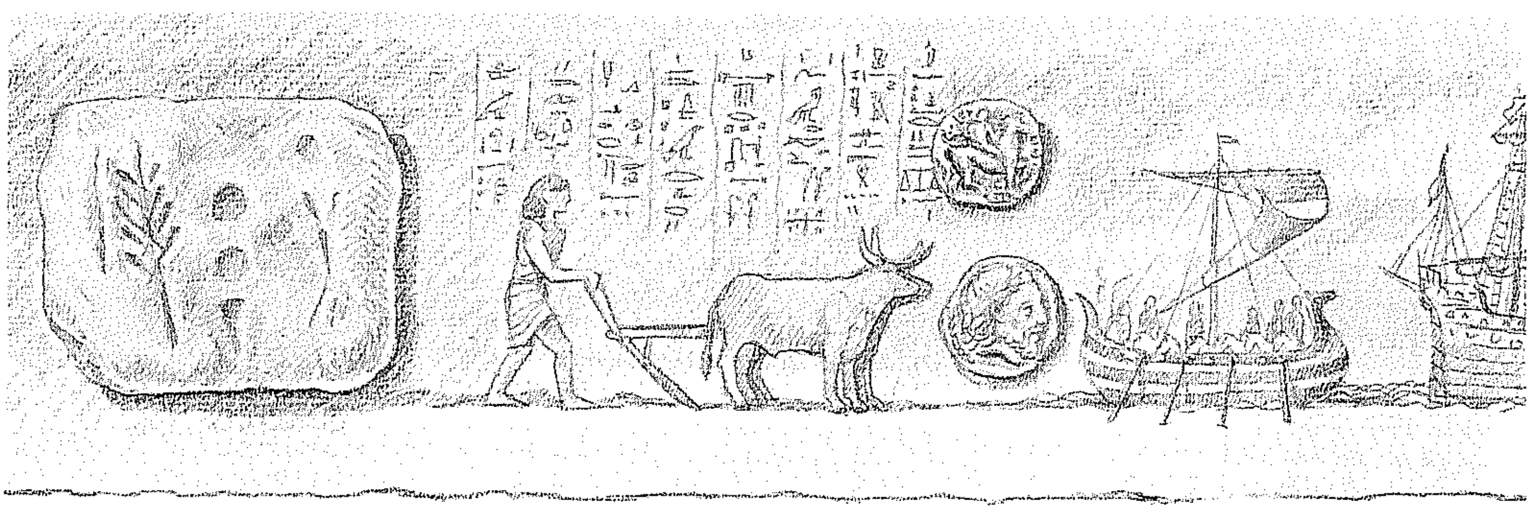

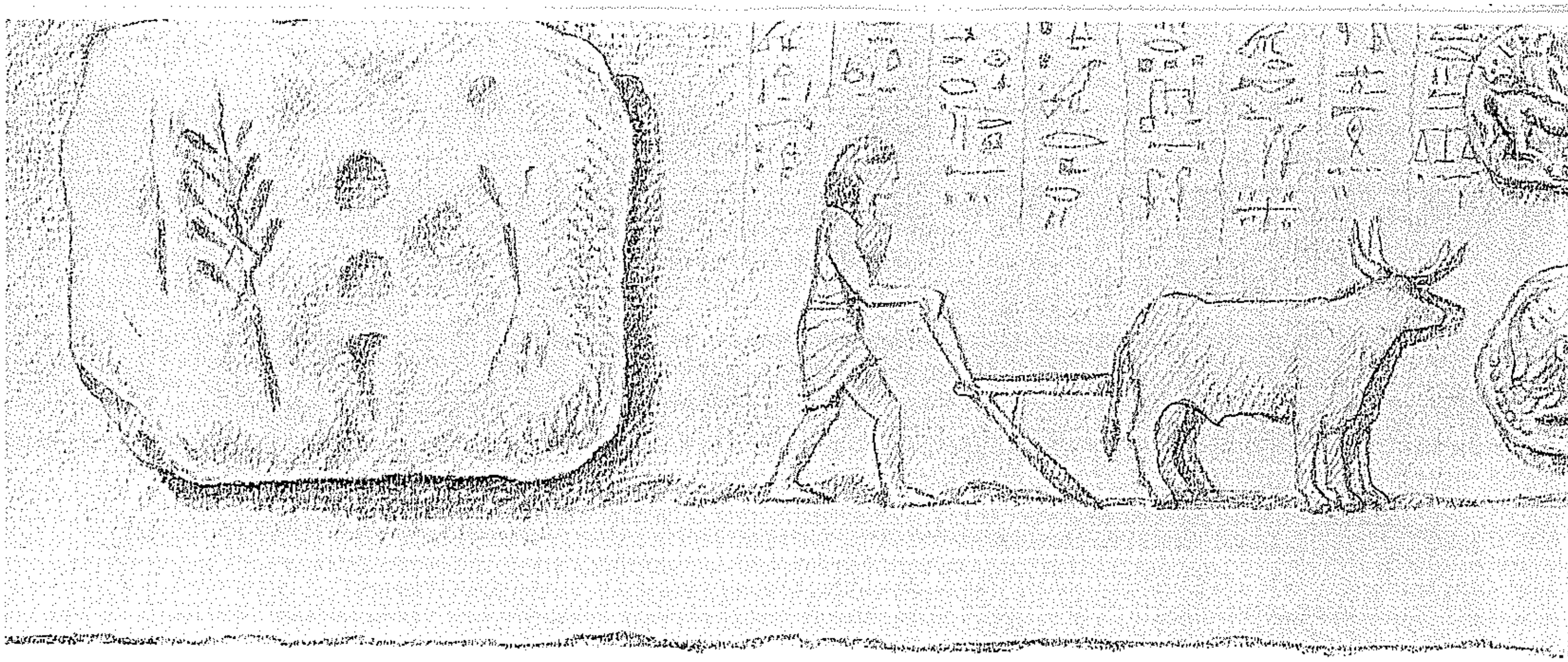

History of Equipment Leasing

by Peter K. Nevitt and Frank Fabozzi

Leasing of personal property has experienced rapid growth in the United States, Europe, and Asia over the past 20 years and is generally thought of as a relatively new device for financing capital equipment. However, leasing is actually a very ancient form of commercial transaction. Modern leasing has roots that date back thousands of years.

Leasing in Ancient Times

The earliest record of equipment leasing occurred in the ancient Samarian city of Ur in about 2010 B.C. These leases involved rentals of agricultural tools to farmers by the priests who were, in effect, the government officials. Ur was a thriving commercial center, and land as well as tools were leased. These transactions were recorded on clay tablets which were discovered in 1984.

Later, an ancient and powerful Babylonian king named Hammurabi, who ruled about 1750 B.C., acknowledged the existence of leases of personal property in his famous code of laws. The ancient Egyptians engaged in leases of both personal property and real property. The Greeks and Romans also leased personal property.

Ships have been chartered from the time of the ancient Phoenicians. Ship charters were actually very pure forms of equipment leases. Short-term time charters and trip charters were the same as operating leases in which a crew is provided with a ship. Long-term bareboat charters were equivalent to net finance leases since the charters were for most of the useful life of the asset and the lessee had many of the benefits and obligations of ownership. Net lease provisions in modern leases are known as "pay come hell or high water" clauses because such provisions originated in ship charter agreements. Shipowners, acting as lessors, and ship users (charter parties), acting as lessees, have been negotiating their various duties, rights, and obligations under ship charters for thousands of years. The issues that have arisen in such transactions over the years are not dissimilar from the issues that arise today in commercial leases of personal property.

For hundreds of years, personal property leasing was not recognized under English common law, although real property was leased extensively and sometimes involved very complex structures. Under English common law, the possession of personal property implied ownership. Eventually, the English courts recognized the need for commercial use of personal property by nonowners and developed a law of bailments based on European law. Personal property leases were called "bailments for hire" and "hire purchase agreements."

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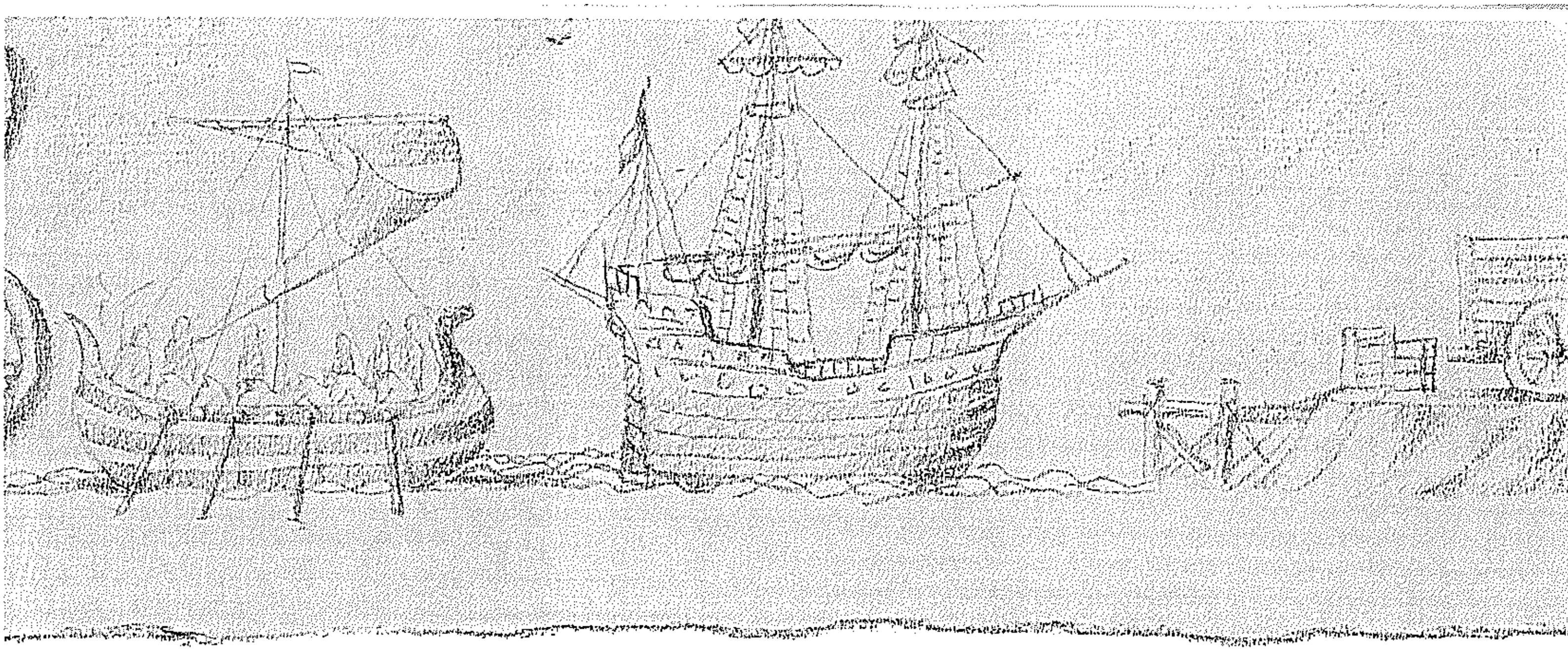


Early Leasing in the United States

The first recorded leases of personal property in the United States seem to have been leases of horses, teams of horses, buggies, and wagons by liverymen or livery stables in the 1700s. Modern equipment leasing in the United States had its significant beginnings in the 1870s in connection with the financing of barges, railroad cars, and railroad locomotives under equipment trust certificates.

Consumer leasing in the United States began on a large scale with leases of sewing machines by the Singer Sewing Machine Company. Singer sewing machines were sold for $5 down and $5 a month under an instrument resembling a conditional sale lease.

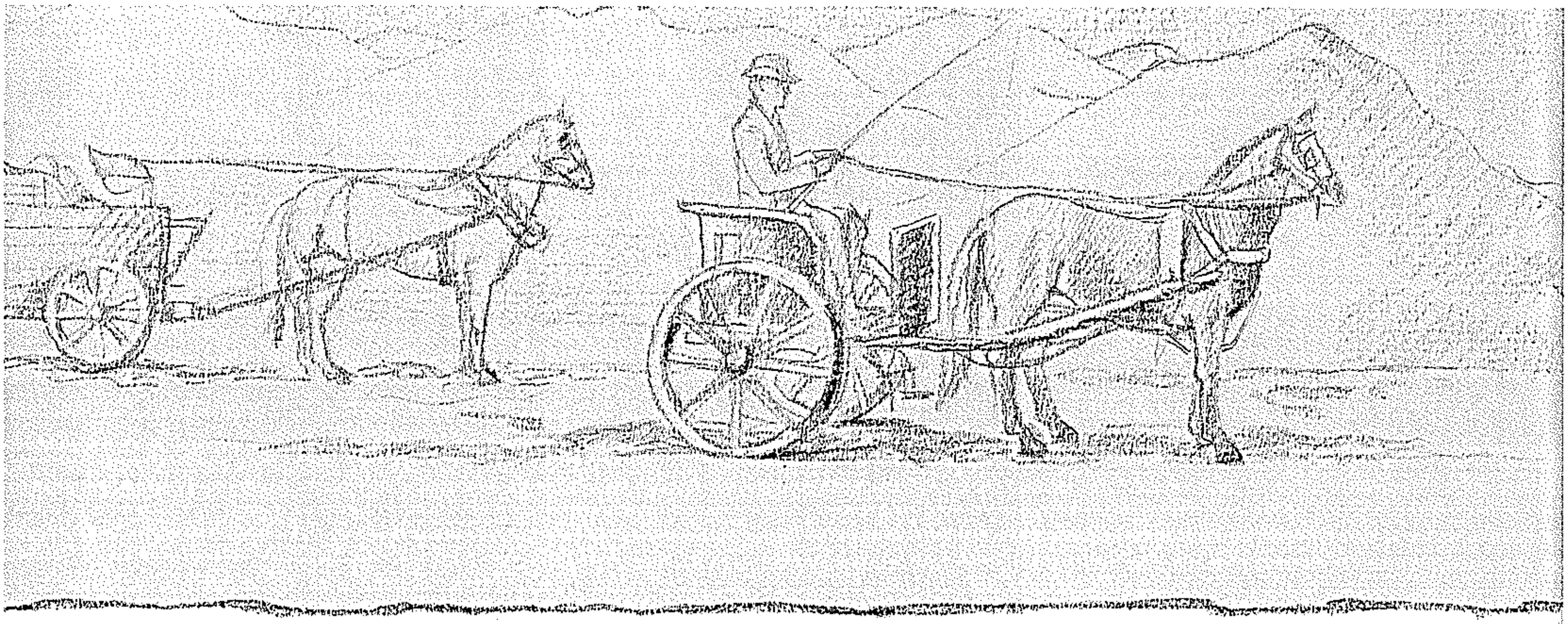
Early Railroad Equipment Leases

Railroad equipment was commonly financed during the 1800s under an arrangement whereby a railroad contracted with a manufacturer for the purchase of railroad cars, with the purchase price to be paid under a contract closely resembling a conditional sale contract. Typically, the equipment was financed over several years, with the purchase price paid in installments, plus interest, at set intervals over the term. Title passed to the railroad when the purchase price was entirely paid. From the standpoint of the railroad, needed equipment was acquired and paid for as it generated earnings. This type of financing was used by railroads because they could not qualify for conventional financing and were unable to provide a first mortgage as debt security.

Manufacturers of railroad cars, however, were not well capitalized or inclined to carry large amounts of receivables from railroads. Therefore, a railroad wishing to purchase railroad cars arranged through investment bankers to borrow funds from investors willing to finance the equipment. Upon delivery of the equipment, these investors transferred the funds needed to purchase the equipment to a bank or trust company acting on their behalf as agent. The bank or trust company then paid the purchase price to the manufacturer, took an assignment of the conditional sale agreement, and issued participation certificates to investors that were identical to the payment schedule called for under the conditional sale agreement. The bank or trust company held title to the equipment until the entire purchase price was paid, at which time title passed to the railroad. This method of financing was sometimes referred to as the "New York Plan."

There were serious drawbacks to this method of financing. Some state laws, particularly the laws of Pennsylvania, did not at that time recognize conditional sales, on the ground that the holder of title to property under a conditional sale contract was not protected against claims of creditors of the purchaser who lacked knowledge of the conditional sale arrangement. Presumably, a creditor of a railroad subject to a conditional sale arrangement, or even a purchaser of property from such a railroad, would have a claim against railroad cars placed in the custody of the railroad under a conditional sale contract if that creditor or purchaser was not aware of the contract. This gave rise to the "Pennsylvania bailment lease" and eventually to a new method of financing railroad equipment known as the "Philadelphia Plan."

Under the Philadelphia Plan, the railroad desiring to purchase equipment, or its representative, arranged through investment bankers for investors to purchase "equipment trust certificates" that provided for repayment of the principal amount of the certificates plus "dividends" equivalent to interest payments over a specified period of time. Instead of an assignment of a conditional sale contract, as under the New York Plan, investors contributed funds to a bank or trust company acting as trustee for the purchase of equipment trust certificates. Upon receipt of such funds, the bank or trust company purchased the equipment from the manufacturer and "leased" it to the railroad for a term of years that equaled the principal and "dividends" due on the equipment trust certificates. The lease and the



right to receive rentals were held by the trustee for the benefit of the holders of the equipment trust certificates. The creditor rights of the holder of an equipment trust certificate were usually bolstered by the direct guarantee of the railroad, which was enforceable in the event of a default on the lease and which enabled the equipment trust certificate holder to proceed directly against the railroad without having to exhaust its remedies under the "lease" agreement. As in the New York Plan, the railroad eventually acquired title to the equipment upon payment of all amounts due under the trust certificates. Investors generally preferred the Philadelphia Plan trust certificates to the New York Plan participation certificates.

Thus, the Philadelphia Plan, utilizing a direct lease, a trust, and equipment trust certificates, is the forerunner of modern-day conditional sale leasing.

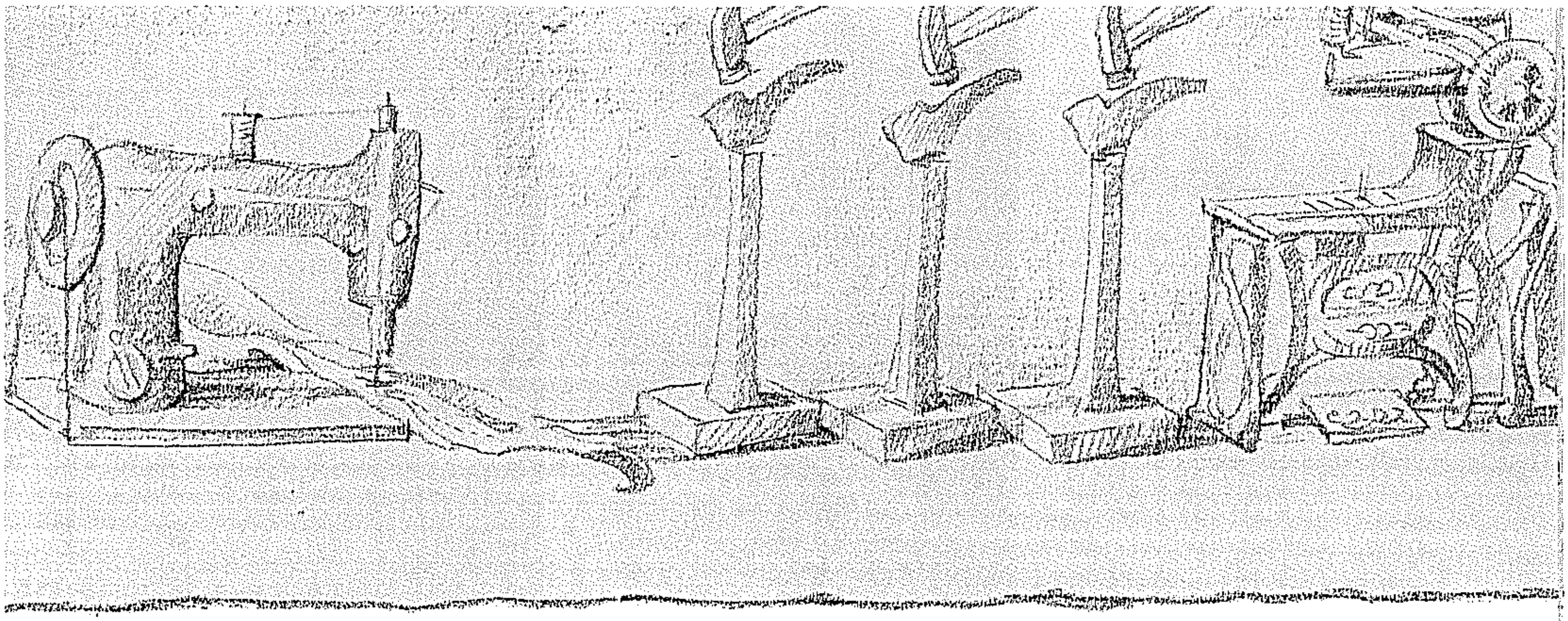
In the early 1900s, another form of railroad car leasing evolved in which the lessor retained title to the equipment at the end of the lease term. Railroad car leasing companies, such as GATX, Union Tank Car, and North American Car, rose from modest beginnings to be major owners and lessors of railroad cars by leasing them on a basis whereby they retained ownership of the railroad cars at the conclusion of the lease term. Although railroads were to some extent lessees under these arrangements, the major lessees were shippers who needed railroad cars dedicated to transporting their products. Also, such shippers often needed someone to manage the operation and maintenance of their cars. In many instances, shippers did not desire long-term leases, although in practice they regularly renewed their leases. In any event, a new industry arose in which railroad lessors purchased or manufactured railroad cars for lease to shipper lessees under arrangements whereby the lessor would maintain the cars and own them at the end of the lease term. These leases were among the first true leases and operating leases of equipment other than ships. It is also interesting to note that such railroad car lessors sometimes used Philadelphia Plan equipment trust certificates to finance their own fleets.

Early Equipment Leases Other than Leases of Railroad Stock

Vendor leasing began to evolve in the 1920s as manufacturers sought to encourage sales of their equipment. Manufacturers promoted sales of their products with installment sales contracts that were then discounted to banks and finance companies.

Leasing also was used by manufacturers seeking to maintain monopoly control over the use of machinery with unique characteristics that made it superior to other machinery performing the same function. In such situations, leasing was sometimes used as a substitution for a licensing arrangement. U.S. Shoe Machinery was an early user of leases to control its products.

During World War II, a new stimulus to leasing arose from the terms of government "cost-plus contracts" for the manufacture and production of war materials. The theory of cost-plus contracts was to limit the profit that a company could realize from manufacturing goods for the war effort. However, a manufacturer was permitted to make a small profit in excess of its costs. The government recognized that costs were beyond the control of a manufacturer due to shortages and difficulties in obtaining materials. Consequently, the establishment of costs for the purpose of computing the profits to which a manufacturer was entitled was very important. Manufacturers under cost-plus contracts did not want to invest in production equipment that could not be used at the end of the war. Such manufacturers were concerned that attempts to depreciate equipment of this kind over a fairly short period might not be recognized for purposes of figuring costs. Therefore, leases of production equipment for the life of a cost-plus contract became popular where doubt existed as to the manufacturer's ability to otherwise write off the equipment over the life of a contract. In some instances, the government acted as the lessor where large specialized machinery and tools



were leased to manufacturers. The same concept continues today where specialized equipment is required for a particular contract with a duration shorter than the life of the equipment. Cost-plus contracts also are used today by contractors working on projects located in remote locations where transportation of equipment from the construction site will not be feasible from a cost standpoint at the conclusion of a contract.

Another form of short-term lease that developed involved the lease of equipment with an operator, such as a truck with a driver or construction equipment with an operator. These leases were called "operating leases" because an operator was furnished. Over time, the term *operating lease* has come to refer to a wide variety of short-term leases. The Financial Accounting Standards Board eventually adopted a precise definition for operating leases and a special set of rules for both lessees and lessors to account for operating leases.

The car rental business had its origins in 1918 when Walter Jacobs acquired 12 Model T Fords and formed Rent-a-Car Inc., which he sold five years later to John D. Hertz. In 1941, an automobile dealer in Chicago named Zollie Frank commenced long-term fleet leasing of automobiles. He is generally credited with being the originator of automobile leasing as it is conducted today with a total volume of over $20 billion a year.

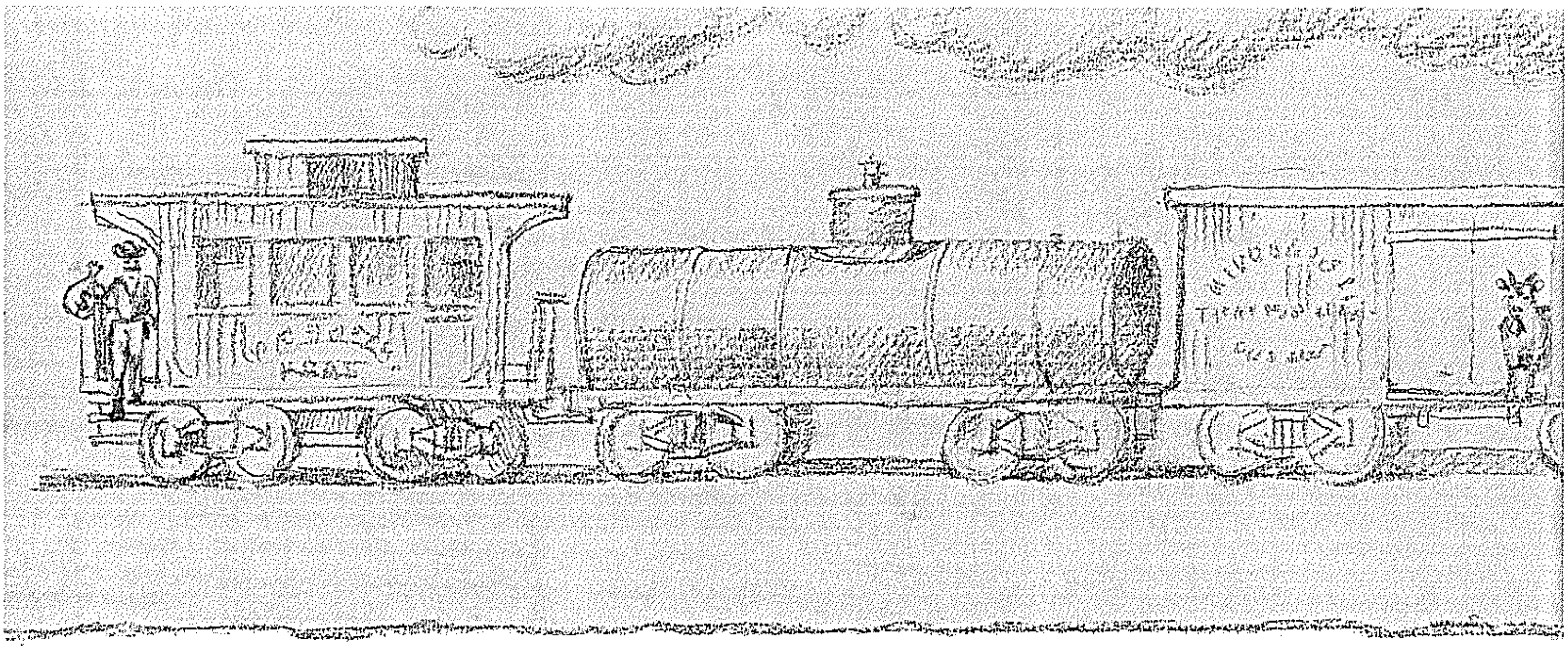
During the late 1940s, significant automobile leasing began on both an individual basis and a fleet basis. Short-term rentals by Avis, Hertz, and National Car Rental all grew rapidly during the 1950s. Airport locations by rent-a-car companies changed the entire character of that business. Automobile leases were the first introduction to equipment leasing for many businessmen.

Early True Lease Structures

The first significant long-term true leases of equipment occurred in the late 1940s. These were leases of railroad equipment. Certain insurance companies were willing to assume a residual risk in railroad equipment at the end of a lease term and to reflect the expected residual value by lowering lease rentals during the lease term. The railroad lessee under such an arrangement had to rationalize the loss of the residual value at the end of the lease term and accept the modern-day underlying rationale for true leasing, that the use of the equipment rather than ownership makes economic sense to a lessee where a lower rental rate reflects a reasonable value for the residual. Sometimes the residual risk to the lessee in such leases was protected by a purchase option at a price higher than a nominal price. Tax benefits did not produce a positive cash flow for the lessor in these early transactions and were not a factor in the lease pricing.

However, the railroads taking advantage of such true lease arrangements benefited in that rental obligations under these leases were not classified as fixed charges, as was interest on equipment trust certificates or conditional sales. Also, the financing was off-balance sheet, outside the restrictions of loan covenants, and not considered to be after-acquired property under open-end basket security provisions of indentures whereby assets acquired after an indenture was in effect would be deemed to be subject to the security interest granted under the earlier lending agreement. In addition, certain restrictions on the issuance of new securities under the Interstate Commerce Act could be avoided by using the lease device.

In 1949, the Equitable Life Assurance Society developed an imaginative arrangement for financing railroad cars that was an early forerunner of modern leveraged leasing. Equitable purchased railroad cars from a manufacturer on terms under which Equitable paid 80% of the cost on delivery and 20% in installments over a five-year period. Equitable simultaneously leased the railroad cars to a railroad for 15 years at rents that were sufficient to retire the 20% debt balance owed by Equitable to the manufacturer over the five-year term of the debt and also to return Equitable's 80% investment with profit over the 15-year lease term. Equitable's payments on the 20% debt balance to the manufacturer were contingent



upon receipt of payments under the lease. The manufacturer did not have a lien on the equipment except for an option to repurchase it for an amount equal to Equitable's investment in the event of a default by the lessee. The lease was drafted as a net lease in a manner that shielded Equitable from ownership risks.

Banks also began utilizing trust structures to invest in lease equity positions in railroad equipment financial leases. Legal title to the equipment was held by a trustee because federal and state laws were then interpreted to prohibit banks from leasing.

Modern Equipment Leasing Companies

In 1954, U.S. Leasing Corp. became the first company formed to engage in general equipment leasing along the general lines on which such businesses are conducted today. The leases were net leases in which the lessee paid all the expenses of maintenance, insurance, taxes, and so forth, associated with equipment ownership. The lessee generally retained a nominal purchase option. Lease rental payments were sufficient to cover the cost of the lessor purchasing and financing the purchase of the leased equipment. In 1956, Boothe Leasing Corp., a spin-off of U.S. Leasing personnel, was formed to engage in general equipment leasing. (Boothe Leasing Corp. was acquired by the Greyhound Corp. in 1962 and is now known as Greyhound Leasing and Financial Corp.) In 1957, Chandler Leasing was formed. (It was acquired by Pepsi-Cola in 1967.) General Electric Credit Corp., Commercial Credit Corp., and National Equipment Leasing Corp. began to engage in the leasing of personal property in the 1950s. These companies and a few others were the forerunners of the hundreds of equipment leasing companies that exist today. Their alumni span the industry.

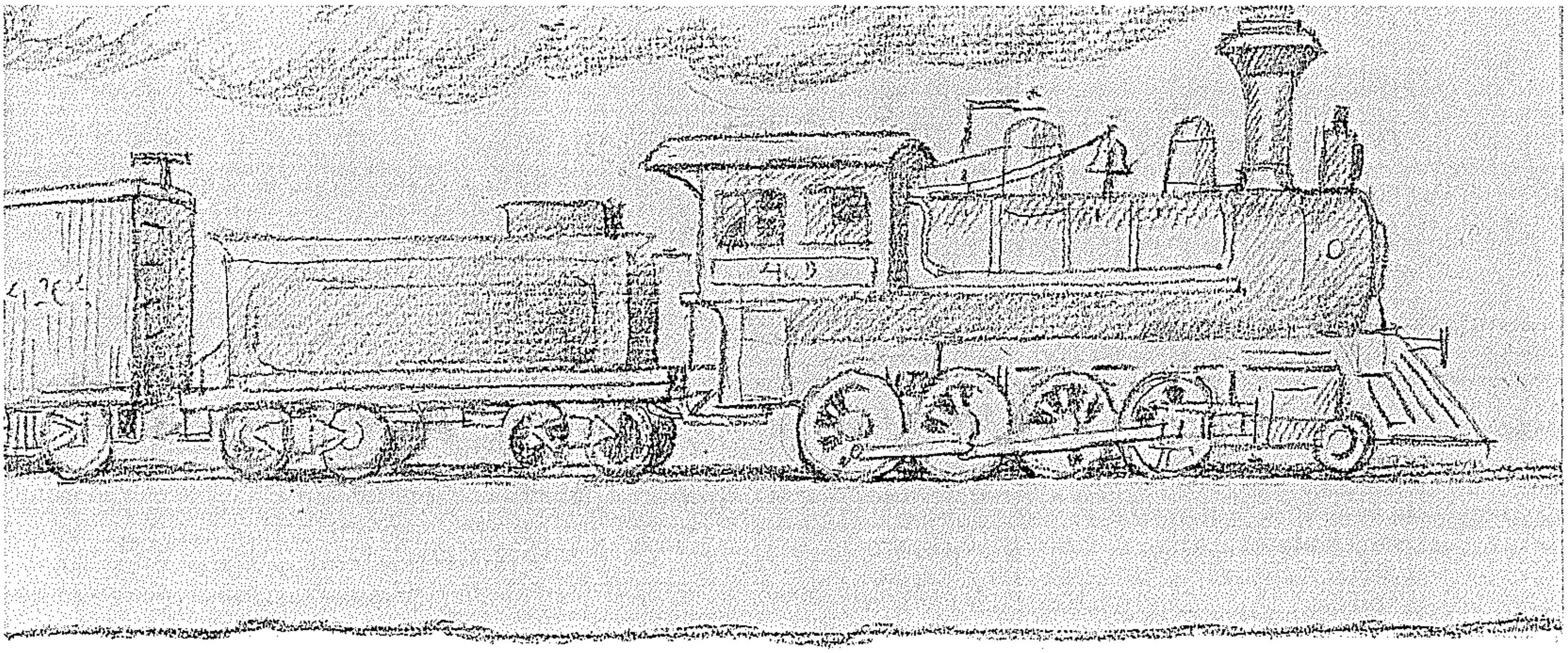
The groundwork for use of nonrecourse leveraged debt in true leases dates from 1947, when the U.S. Supreme Court held in the landmark case of *Crane v. Commissioner*, 331 U.S. 1, that the owner of qualifying property could include in his property cost amounts that had been borrowed on the security of the property and that the owner was not personally obligated to repay. This was not terribly significant until the potential tax benefits for lessors under equipment leases were increased by accelerated depreciation provisions in the Internal Revenue Code of 1954.

National Equipment Leasing Corp. was among the first to recognize the possibilities of leveraging these tax benefits, and in the middle 1950s it arranged some limited partnerships of individual investors to assume equity positions in equipment leases. Debt was provided by institutional lenders. National acted as a trustee.

General Motors adapted the National Equipment structure to lease diesel railroad engines that it manufactured. The equipment was leased directly to the railroads, utilizing a General Motors subsidiary formed for that purpose, with recourse on the subsidiary's debt limited to the assets of the subsidiary consisting of the rents and rights under the lease agreement.

Leasing from 1960 to 1970

The American Association of Equipment Lessors (AAEL) was formed in 1962 as a trade association to promote leasing and to monitor federal and state laws and regulations affecting leasing. The pioneer leasing companies represented at the initial meeting to form the AAEL and their representatives at this meeting were as follows: D.P. Boothe of Boothe Leasing Corp., based in San Francisco. Boothe Leasing Corp. later became Greyhound Leasing and Financial Corp. Spencer Clawson of Security Leasing Co., based in Salt Lake City. This company is now part of Equitable Life. Robert Sheridan of Nationwide Leasing, based in Chicago. Edward F. Monahan of Indiana-Michigan Corp. of Chicago, now based in Oak Brook, Illinois. Ed Herman and Ben Kelts of Chandler Leasing Corp. of Waltham, Massachusetts, later Pepsico Leasing Corp. Daniel Cavanaugh of American



Industrial Leasing Co., New York. Henry Shoenfeld of U.S. Leasing Corp. of San Francisco. Carl Hutman of Public Service Leasing, based in Baltimore, Maryland. Patrick H. Pringel of First National Leasing Corp., based in Milwaukee. Henry Shoenfeld of U.S. Leasing Corp. attended as an observer. Ellis Lyons was present as legal counsel.

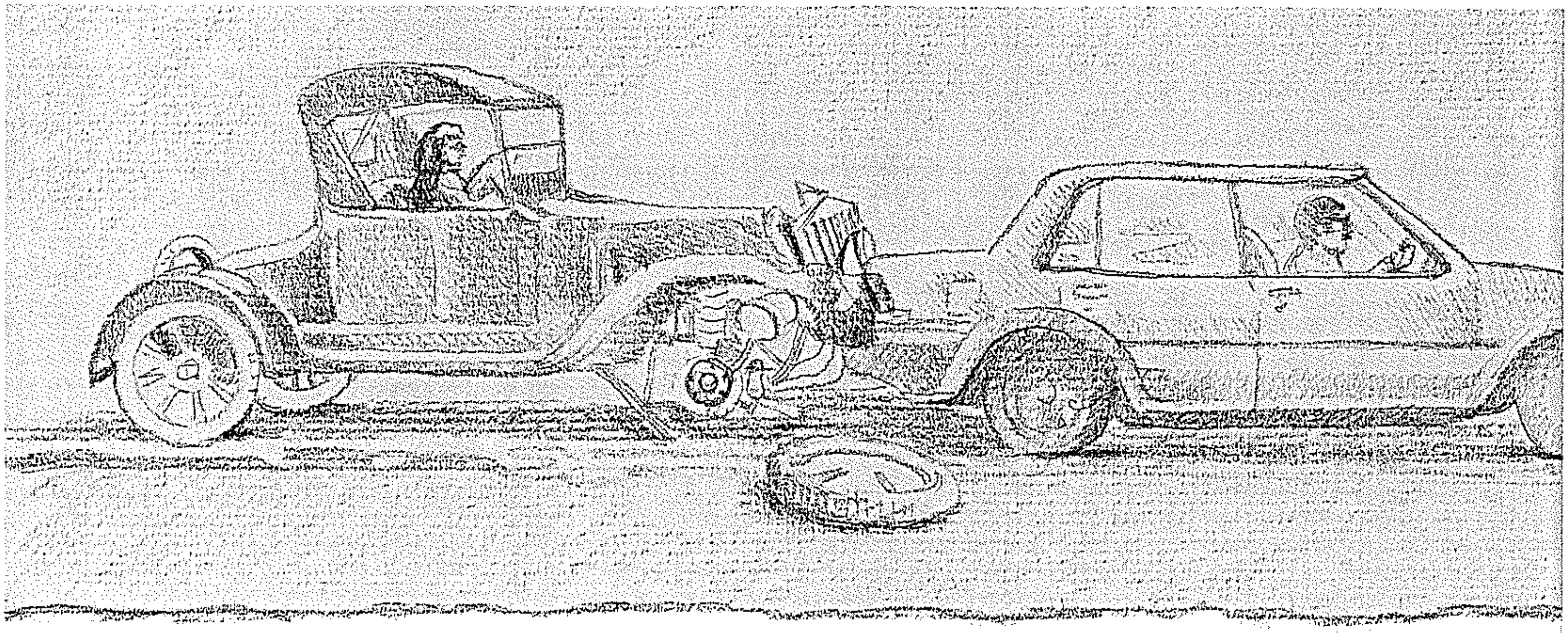
In the early 1960s, both Greyhound Leasing and Financial Corp. and General Electric Credit Corp. began to engage in largescale leasing in which they assumed a residual risk that they passed through to the lessee in the form of lower rents than would have been payable under a conditional sale agreement. The leases were made to airlines and railroads as well as to other equipment lessees. They were net leases that sometimes contained purchase options of 15 to 25%. Nevertheless, tax counsel at the time was of the opinion that the downside residual risk made them "true leases." Tax benefits from accelerated depreciation were claimed by Greyhound and General Electric Credit Corp. These leases were upheld as true leases after sometimes lengthy audit by the Internal Revenue Service.

A stimulus to tax-oriented leasing was provided in 1962, when Congress inadvertently changed the whole character of the equipment leasing business by passing income tax legislation designed to foster investment in capital equipment. The stimulus took the form of a 7% investment tax credit (ITC) and an increased deduction for tax depreciation. Greyhound and General Electric Credit discovered (to their surprise) that as lessors and owners of equipment they were entitled to substantial tax benefits under committed true leases in which the lessee did not have a right to acquire the equipment at the end of the lease term for a nominal purchase option. They also became aware that they could substantially reduce rentals to lessees in future leases by passing through a portion of the tax benefits to lessees. These lower rentals made leasing more attractive for lessees that had little taxable income to shelter and consequently could not claim the tax benefits on their own tax returns. Most airlines and railroads were in this situation. Other major finance companies such as Commercial Credit Corp., CIT, and Ford Motor Credit quickly recognized the implications of the new tax laws and became active in tax-oriented leasing.

Another important stimulus to equipment leasing was provided in 1963, when the U.S. comptroller of the currency issued a ruling that permitted national banks to own and lease personal property.[1] Prior to that time, banks had invested in equipment trust certificates and discounted receivables under financial leases written by independent leasing companies. The profitability of tax-oriented true leases written by Greyhound and General Electric Credit had not gone unnoticed by the major commercial banks lending to those companies. Since such banks, like the parent companies of Greyhound Leasing and Financial Corp. and General Electric Credit Corp, had substantial tax liability to shelter, they recognized tax-oriented true leases of equipment as an attractive product to offer for financing equipment. The initial leasing efforts of banks were aimed at the railroads, which were in perpetual need of equipment, and at the airlines, which were rapidly adding routes and acquiring jet aircraft to meet their expansion needs. Most railroads and airlines were not in a taxpaying position to claim the ITC or accelerated depreciation associated with equipment ownership.

The entry of banks into the leasing business was responsible for the standard method used today for computing lease yields on a pretax basis after taking cash flows from tax benefits into account. This method was introduced because banks wanted to compare lease yields with loan yields. Brokers seeking to sell lease transactions to banks saw the advantage of providing a method for easy comparison of leases to loans and therefore promoted the pretax-posttax yield analysis method. Before banks got into leasing, more conventional methods of calculating return on investment or equity were used by nonbank leasing companies.

A very major event of the late 1960s was the development of modern



leveraged lease structures in which the lessor provided only a portion of the purchase price of the asset, borrowed the remainder of the purchase price from institutional lenders on a nonrecourse basis, but claimed tax benefits on 100% of the purchase price of the leased equipment. Lessors computed their yields, including expected residual values, on their equity investments rather than the entire equipment cost, thus enabling lessors to offer more attractive lease rates to lessees than were offered under unleveraged true leases. This major breakthrough in pricing made leasing attractive to a much broader market and significantly stimulated the growth of leasing.

Tax-oriented leasing suffered some setbacks in the 1960s, when Congress first suspended the investment tax credit in 1966, then reinstated it in 1967, and again repealed it in 1969, before enacting it for the last time in 1971.

In the late 1960s, individual investors began to become involved as equity participants in limited partnerships structured with nonrecourse debt. With individuals in 70% tax brackets, banks and finance companies found themselves in danger of being unable to compete from a price standpoint with syndicates of individual lessors offering leveraged lease financing. However, with the reenactment of the ITC in 1971, Congress imposed restrictions that effectively limited the availability of investment tax credit to individuals and eliminated syndicates of individuals as significant investors in leveraged leases until the early 1980s, when changes in the tax laws improved conditions for individuals acting as lessors.

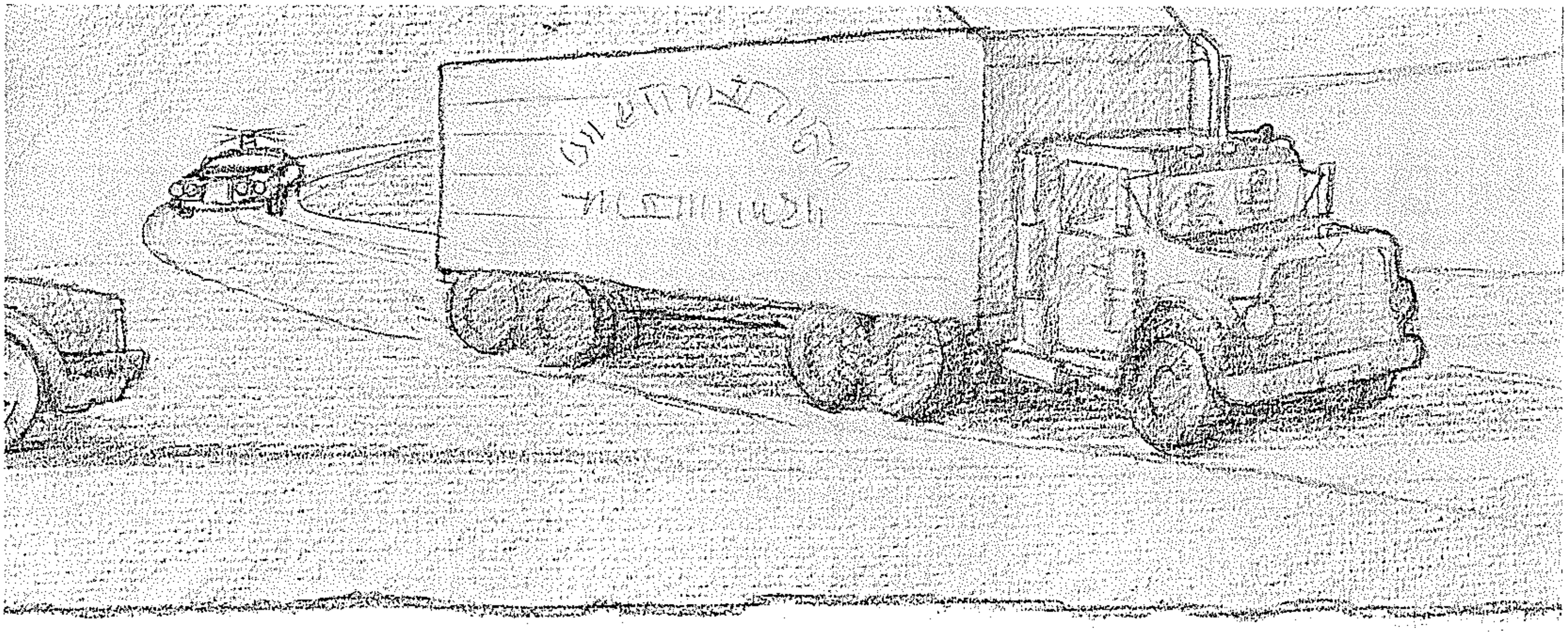
In another leasing development of the 1960s, IBM and Xerox began to significantly utilize equipment leases as a marketing strategy for realizing maximum revenue from their products. IBM and Xerox recognized that substantial sums could be made from the financing of their equipment. Also, by adjusting the prices of rentals and purchase prices, the mix of machines rented or purchased could be varied to produce a more orderly growth of reported profits. In addition, the strategy offered a means to remove obsolete machines from the marketplace and control the resale market. IBM and Xerox assumed the risk of property taxes and the cost of insurance and provided maintenance, all as a "bundled" charge for rental. From the customer's standpoint, the short-term lease rate was reasonable, was off-balance sheet, and offered protection against obsolescence due to fast-developing technology. Other manufacturers of computers, copying equipment, and office equipment offered similar terms in order to meet the competition of IBM and Xerox.

Vendor leasing by manufacturers of all kinds of equipment came into wide use during the 1970s as equipment users began to demand financing as part of the purchase package.

Computer leasing by independent third-party leasing companies became popular during the 1960s. Computer leasing companies operated on the premise that they could purchase new IBM equipment, rent the equipment to users for short terms at less than IBM rentals, and still keep the equipment long enough after the initial lease terms to recover their investment and return a profit after the payment of all expenses. During the late 1960s, over 50 computer leasing companies engaged in the purchase and lease of IBM 360 computers. Unfortunately, the introduction of the IBM 370 computer resulted in the obsolescence of the 360 computers, a drastic reduction in rentals, and financial failure for many of these companies. It is interesting to note that a few companies tried the same pricing and leasing strategy with IBM 370 computers with much the same result. Residual insurance under Lloyd's "J" policies was used to support the residuals of some companies, with the result that Lloyd's suffered huge losses and has since been reluctant to offer residual insurance for any type of equipment.

The substantial leasing of computers and office equipment that occurred during the 1960s was a significant factor in the growth of leasing, since many companies were exposed to equipment leasing for the first time when they leased such equipment.

Until the early 1970s, however, leasing remained something of a



novelty for most companies. Although most airlines and railroads utilized leases in financing major portions of their equipment needs, most non-transportation companies still did not utilize leasing except for short-term operating leases of computers, office copiers, and transportation equipment. In most cases, these leases were not even handled by their finance departments, but instead were handled by the operating departments involved. Since leasing competed with conventional sources of financing, such as banks and insurance companies, those financial institutions often discouraged their nontransportation customers from using leases. Equipment leasing still was regarded as "last-resort financing" that a company did not use so long as conventional financing was available.

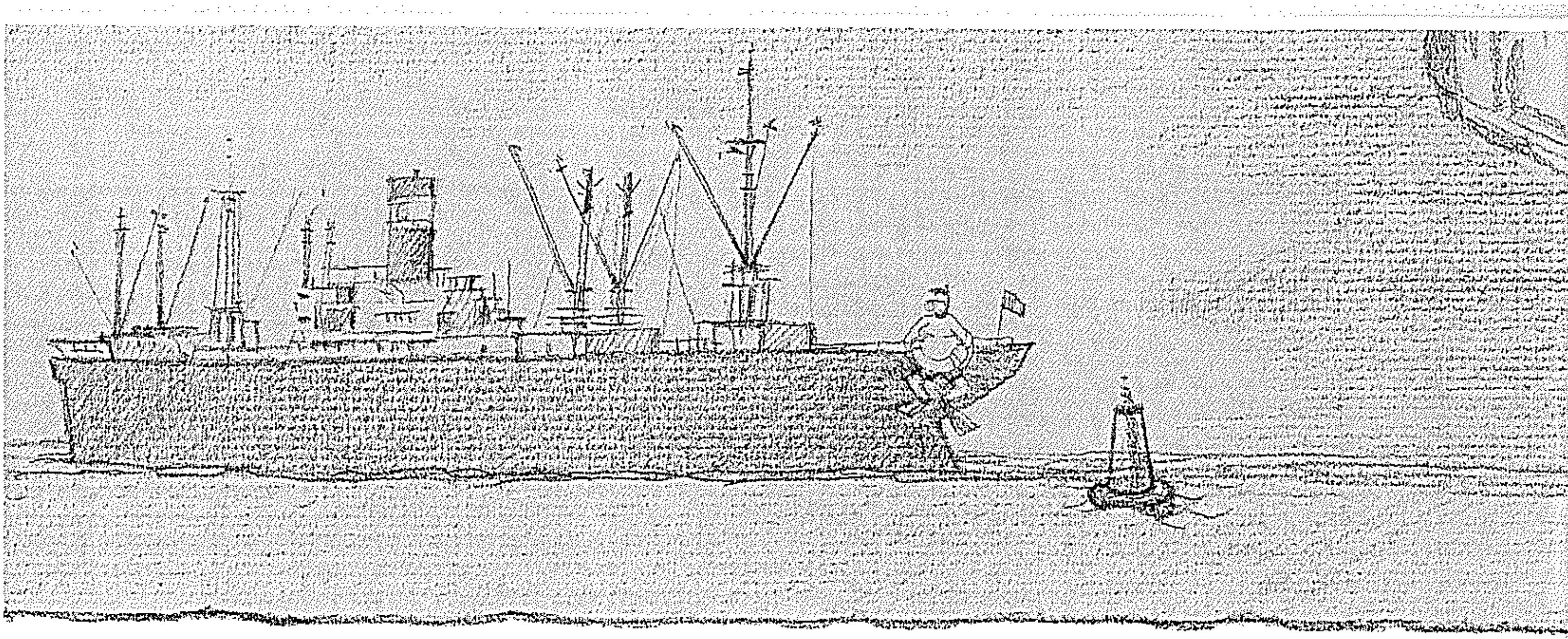
Bank Holding Company Legislation

The general attitude of banks toward leasing changed in 1970, when Congress amended the Bank Holding Company Act to permit banks to form holding companies and to engage in a number of activities in addition to lending. These permitted activities included equipment leasing. This legislation was enacted in response to a lobbying effort by banks to be permitted to engage in types of activities other than lending in order to compete with major finance companies that banks felt were making inroads into their traditional markets. Banks asked permission to compete on equal terms with major finance companies and offer the same broad range of services, including leasing, that were offered by the finance companies. The amendment of the Bank Holding Company Act in 1970, the amendment of Regulation Y in 1971, and the more specific amendment of Regulation Y in 1974 resulted from these efforts.

In response to this legislation, most large banks formed holding companies to engage in nonbanking activities. This was expensive. The formation of holding companies involved board of directors and stockholder approval, the expense of substituting new stock certificates, and large legal fees. As a result, bank managements became understandably concerned about quickly launching some new and profitable operations within their holding company structures to justify the expense. Since leasing was one of the permissible activities outlined in the Bank Holding Company Act and in Regulation Y, as amended in 1970 and 1971, since bank managements felt somewhat comfortable with leasing because of its similarity to lending, and since some banks had had some leasing experience under the earlier comptroller of the currency ruling, the establishment of subsidiaries of bank holding companies to engage in leasing suddenly became the vogue.

Bank holding company leasing subsidiaries offered true leases, purchase option leases, and conditional sale leases for all kinds of equipment. In some instances, small leasing companies engaged in money-over-money kinds of leasing were acquired by banks to gain portfolios and expertise. In other instances, banks hired persons with leasing experience to head up and manage their leasing operations. And in still other instances, banks staffed their new leasing corporations with bright young loan officers who relied heavily on brokers and finders for the generation of lease business.

Suddenly leasing became a very respectable method of financing equipment. Prior to the formation of bank holding company subsidiaries engaged in leasing, banks had generally encouraged their customers to view leasing as a source of funds to be used only by a company unable to borrow funds, as equivalent to a borrowing of last resort, and as something "nice companies didn't do." As bank holding companies entered the business, leasing became not only respectable but also a type of creative financing of which smart companies took advantage. Banks instructed their loan officers to encourage their customers to lease and to refer such business to their new leasing subsidiaries. Bank loan officers and other conventional lenders ceased downgrading leasing as a method of financing. Within the next few years, most companies in the United States were exposed to leasing and many companies began using leases on a regular basis to finance major equipment needs.



In 1979, the comptroller of the currency revised the regulations describing the leasing activities permitted by banks and bank subsidiaries. These detailed regulations were pretty much identical to Regulation Y, which applied to bank holding companies, and certainly endorsed the proposition that equipment leasing was a good and legitimate business for banks.

Whereas in the early 1970s few financial officers had been exposed to leasing, by the late 1970s most financial officers were very familiar with leasing and seriously had considered leasing even if they had not, in fact, used leasing to finance equipment.

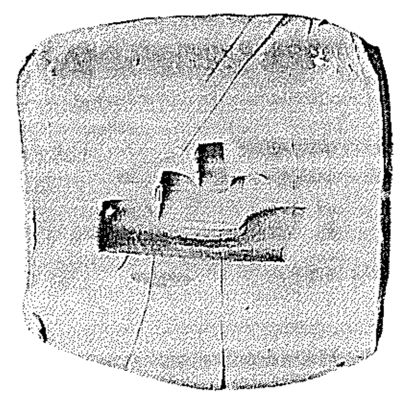
Development of Accounting Standards for Lessees & Lessors

The rapid growth of tax-oriented true leases in the 1960s and early 1970s raised serious questions as to the correct accounting for such transactions. Although *APB 5*, issued in 1964, required a lessee to capitalize a lease if it contained a nominal purchase option and was comparable to a purchase, accounting for leases by lessees was not uniform or consistent. In 1972, the Securities and Exchange Commission brought the matter to a head by threatening regulatory action if the accounting profession failed to clarify the situation. Consequently, *APB 31*, issued in 1973, required footnote disclosure of minimum and contingent rent obligation for the current year and succeeding years. The SEC was still not satisfied and continued to pressure the newly formed Financial Accounting Standards Board (FASB) for comprehensive lessee and lessor accounting rules. In 1976, the Financial Accounting Standards Board issued *FAS 13*, which set forth comprehensive guidelines for lease accounting by both lessees and lessors.

At the time *FAS 13* was issued, lessees and lessors were very fearful that its requirement that lessees capitalize leases under certain circumstances would discourage leasing and reduce volume. However, the net effect was just the opposite. The guidelines were fairly drawn and liberally interpreted by the accounting profession. The net result was that *FAS 13* provided much greater uniformity in reporting and defining lease accounting. Consequently, *FAS 13* gave greater respectability and acceptability to leasing. Over the next few years, the FASB issued several statements, interpretations, and technical bulletins explaining and interpreting *FAS 13*. Nevertheless, the basic provisions of *FAS 13* have remained unchanged, which has provided continuity and additional respectability for leasing and lease accounting.

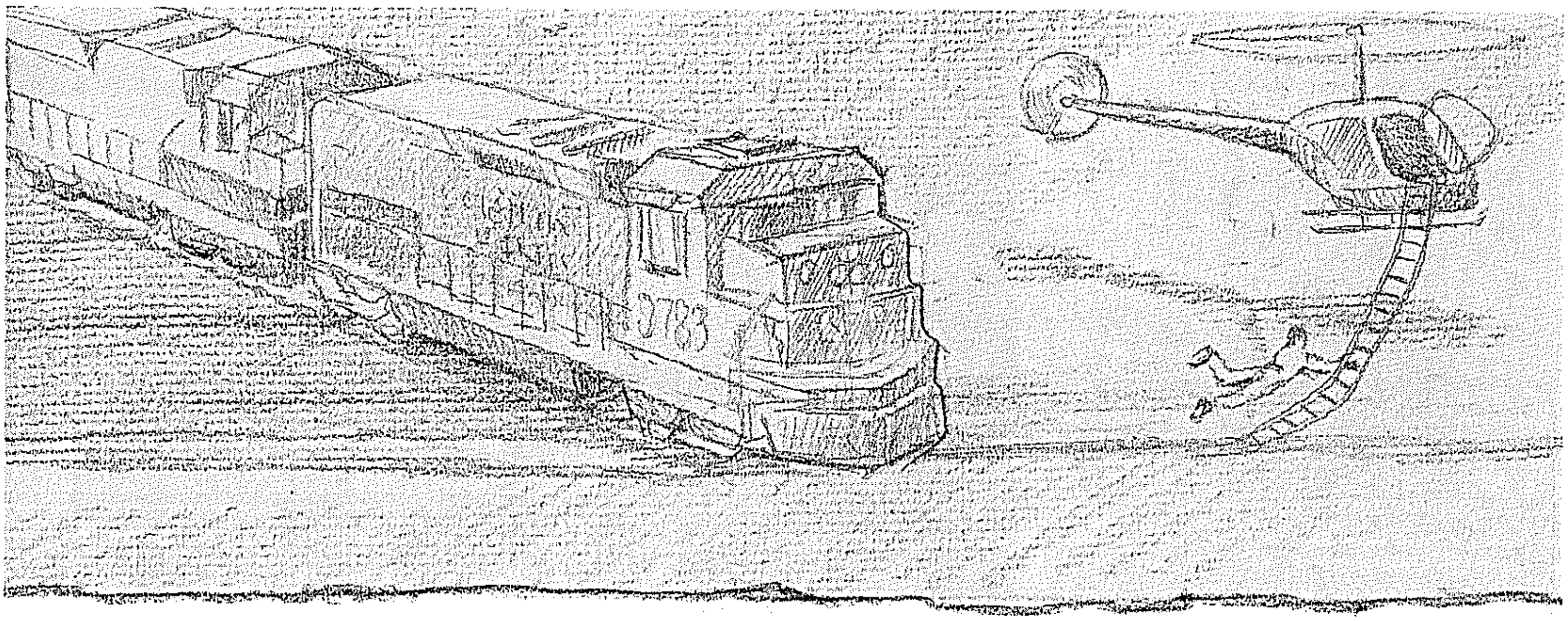
Increased Tax Benefits during the 1970s

During the 1970s, Congress became concerned regarding the adequacy of tax deductions for depreciation in view of the inflationary cost of new equipment. In response to this problem, Congress in 1971 shortened the depreciable lives of equipment (ADR guidelines), permitted accelerated depreciation, and restored the 7% ITC, which had been repealed in 1969. Congress recognized that companies unable to directly utilize the tax benefits of depreciation deductions and the ITC because they were not in a taxpaying position indirectly could obtain most of the tax benefits associated with equipment ownership through true leases in which the lessor claimed such benefits. Later, in 1975, Congress increased the ITC from 7% to 10%. The increased tax benefits enacted by Congress in 1971 and 1975 made leasing more attractive for lessees unable to claim such benefits directly.



Tax Law Clarifications during the 1970s

As leasing volume began to experience rapid growth in the early



1970s, the Internal Revenue Service (IRS) was besieged with requests for private revenue rulings pertaining to proposed transactions. There was no statutory law or case law defining true leases. The Internal Revenue Service had issued Revenue Ruling 55-540 in 1955, which provided guidance on simple true leases, but this ruling was very general and of little help to lessees, lessors, or their tax counsel in addressing the complex structures of leveraged leases that were beginning to arise with great frequency.

The Internal Revenue Service found itself in a very uncomfortable position. It was besieged with ruling requests. Large, complex commercial transactions were entered into conditioned upon obtaining favorable rulings, which created tremendous pressure for approval as deadlines approached. The ability of the Internal Revenue Service to respond was further hampered by the small IRS staff available to review and act upon ruling requests.

Furthermore, an unhealthy "old boy" network was developing. Since private rulings were not publicized at that time, a tax counsel with knowledge of recent private tax rulings through experience or contacts with other tax counsel was at a tremendous advantage in anticipating what structures the IRS would approve. Tax counsel with such inside knowledge was at a distinct advantage in arguing with the IRS for approval based on private ruling precedents.

In response to this situation, the IRS issued Revenue Procedure 75-21 setting forth guidelines for obtaining favorable tax rulings on leveraged lease transactions. If the guidelines of Revenue Procedure 75-21 were met, a favorable ruling was assured. Further clarifications of Revenue Procedure 75-21 were contained in Revenue Procedures 75-28, 76-30, and 79-48.

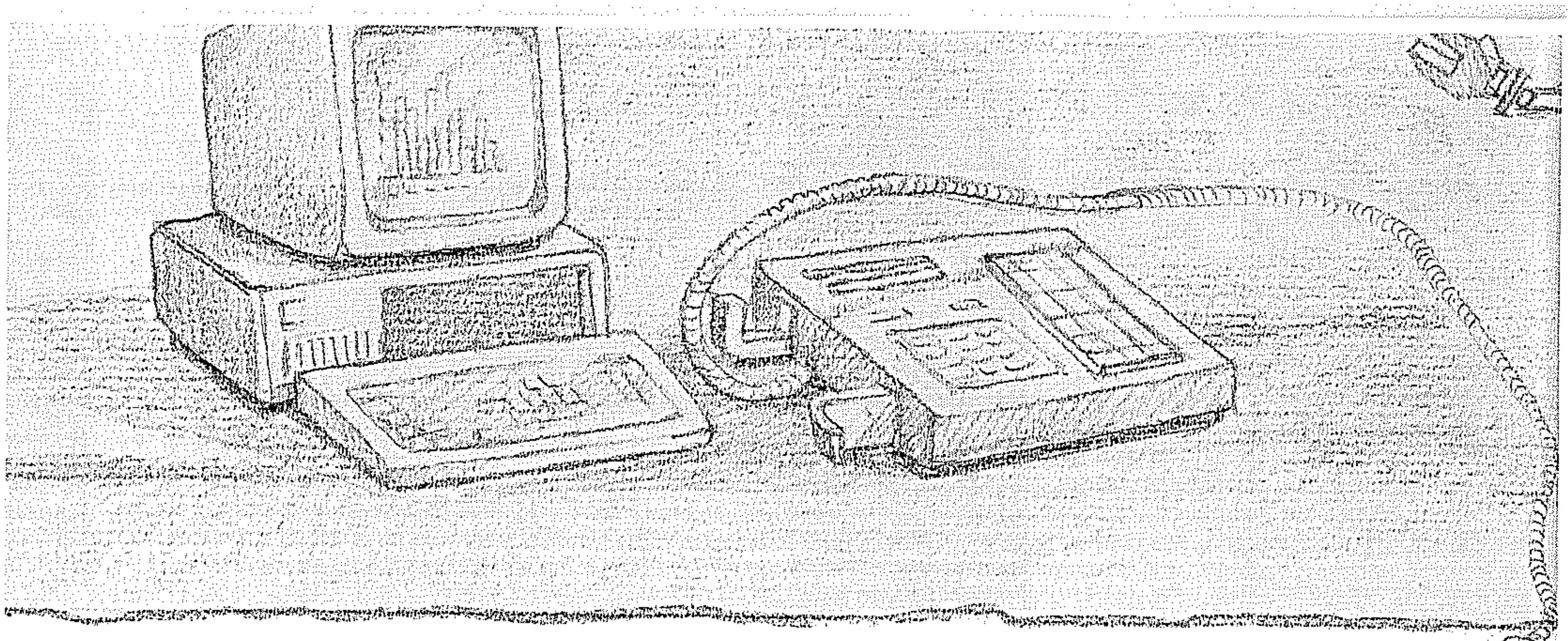
Lessees and lessors were very apprehensive regarding Revenue Procedure 75-21. They feared that it would be difficult to comply with the lengthy and complex requirements. The procedure made requesting a ruling difficult and expensive by requiring vast amounts of detailed information. Also, since Revenue Procedure 75-21 set forth requirements that tax counsel regarded as stricter than the requirements of statutory or case law, lessees and lessors were concerned that Revenue Procedure 75-21 might assume the importance and substance of tax regulation criteria for true lease status for both leveraged and nonleveraged leases. Furthermore, there was the risk that the guidelines of Revenue Procedure 75-21 would be used as requirements for true leases by Internal Revenue agents in conducting tax audits.

However, most of the concerns initially expressed regarding Revenue Procedure 75-21 have failed to materialize. In most cases, it has been possible to comply with the guidelines without undue problems for either the lessee or the lessor. In most cases, lease transactions are completed without obtaining a favorable tax ruling because the parties feel comfortable that their transactions comply with Revenue Procedure 75-21.

Consequently, Revenue Procedure 75-21 actually helped and encouraged leasing by standardizing requirements for a true lease and by eliminating the expense and uncertainty of obtaining a tax ruling or negotiating complex tax indemnity or unwind agreements.

The Frank Lyon Case

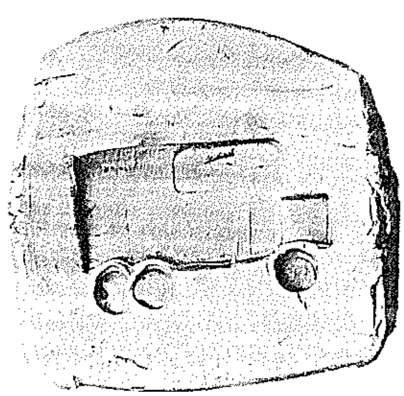
In a landmark decision in 1978, the U.S. Supreme Court, in the case of *Frank Lyon & Co. v. United States,* 435 U.S. 561, considered the criteria for a true lease and particularly the significance of a purchase option in determining whether a lease constituted a true lease. The court affirmed the general rule that a lease would be characterized as a true lease for federal tax purposes if the parties intended to enter into a lease rather than a loan. The court indicated that this could be determined by ascertaining whether at the time of the execution of the lease it was reasonable to suppose that the lessor would retain a substantial economic or proprietary interest in the leased property. The court declared that key factors indicating the intent of the parties are the parties' estimates at the time of the



execution of the lease that the value and remaining economic life of the leased property will be substantial rather than nominal.

The *Frank Lyon* case went on to hold that since the trial court had made a factual finding that the option price was a reasonable estimate of fair market value at the time the option was exercised, the appellate court could not conclude that the option would be exercised.

The net effect of the ruling in the *Frank Lyon* case has been to give considerable comfort to the position that a true lease can contain a fixed-price purchase option despite the fact that Revenue Procedure 75-21 indicates that a favorable ruling will not be given to a lease containing a fixed-price purchase option. However, any fixed-price purchase option would appear to have to take into consideration the 20% at risk rules and inflationary factors as a minimum safe level for a fixed-price purchase option. Tax counsel relying on the *Frank Lyon* case have given favorable opinions on true lease status for leases containing options in the range of 40 to 50% of the original cost.

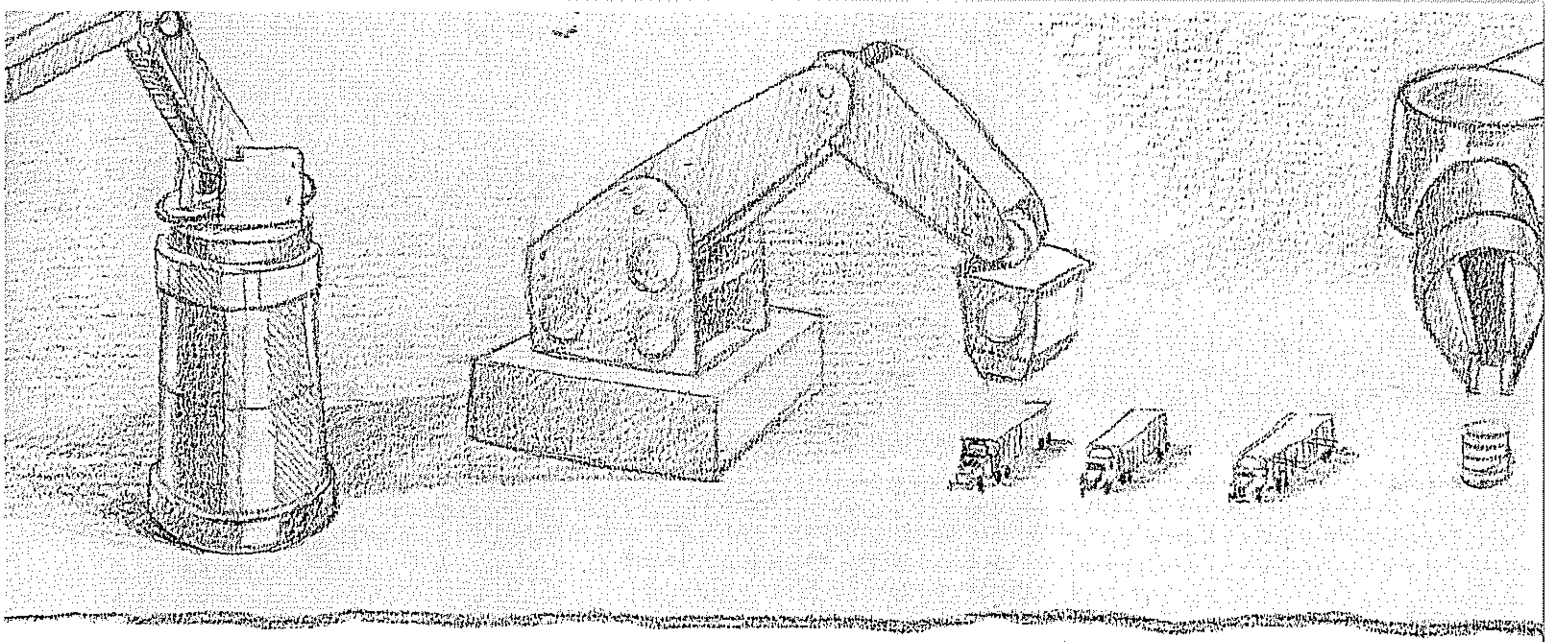


Economic Recovery Tax Act of 1981

The Economic Recovery Tax Act of 1981 (ERTA) contained provisions that dramatically changed equipment leasing and financing until those provisions were repealed in 1982 and 1983.

For many years, Congress had been concerned with providing business with more effective incentives for capital spending. The 10% ITC coupled with accelerated tax depreciation achieved this result for companies with annual federal tax liability large enough to take advantage of such tax benefits. However, a great many creditworthy companies did not have sufficient tax liability to claim the ITC and tax depreciation deductions. These included most companies engaged in heavy capital spending programs, such as steel companies, automotive companies, railroads, airlines, mining companies, forest products companies, and utilities. These were the very industries that many congressmen were most interested in helping. Furthermore, these industries formed an effective lobby to obtain government subsidies. Tax-oriented leasing companies had provided true leases as an indirect means for nontaxpaying, capital-intensive companies to obtain and enjoy the benefits of the ITC and tax depreciation on their equipment acquisitions. However, as previously discussed, the tax laws and regulations required lessors under true leases to retain certain attributes of ownership that were objectionable to many lessees. In true leases, lessees were not permitted by Revenue Procedure 75-21 to have bargain purchase options, to lease limited-use property, to finance any part of the purchase price, or to lease equipment for more than 80% of its useful life. Although leasing had grown dramatically during the 1970s, these requirements, and particularly the inability to have a bargain purchase option, discouraged many companies from using true leases to obtain indirectly the advantages of tax benefits associated with equipment ownership. Many of the companies that did utilize true leases nevertheless resented the lack of a bargain purchase option.

Alternatives to true leases for the pass through of ITC benefits to companies not in a taxpaying position had been informally considered from time to time by Congress. One method was ITC refundability, whereby a company unable to utilize the ITC would instead be paid an equivalent amount by the Internal Revenue Service when it filed its income tax return claiming such credit. A similar proposal



involved ITC certificates that would be issued by the Internal Revenue Service to a company entitled to ITC but unable to obtain the benefit of tax credits when filing its own return. These certificates then could be sold at a price near their face value to corporations able to claim such benefits. Serious flaws in both of these approaches, however, were the difficulties in administering such programs so as to provide timely ITC refunds while at the same time preventing fraud. Also, these proposals did not result in a transfer of tax depreciation deductions.

Safe Harbor Leasing

In 1981, Congress devised and included in ERTA the safe harbor leasing of equipment as a new and clever method for paying amounts equivalent to ITC and tax depreciation to companies unable to claim such benefits. Safe harbor leasing permitted relatively free transferability of tax benefits from lessees to nominal lessors. In safe harbor leases of equipment acquired by lessees, nominal lessors were held responsible for proof of the legitimacy of their claims for the ITC and depreciation. The definition of a lease for which a lessor could claim tax benefits was broadened to include leases with fixed-price bargain purchase options, leases in which the lessee lent the lessor up to 90% of the purchase price, leases for longer terms than those authorized in true leases, and leases of limited-use property. Furthermore, permission was given for a streamlined form of safe harbor lease called a tax benefit transfer lease (TBT lease) in which rental payments exactly equaled and offset debt payments. Under a TBT lease, compensation for tax benefits could be paid by the nominal lessor to the lessee in a single lump-sum payment at the beginning of the lease. TBT leases were, in effect, simply sales of tax shelter by lessees to lessors.

Safe harbor leasing made it easy for any corporation with tax liability to act as a nominal lessor. It was also possible for almost any equipment purchase to be structured as a safe harbor tax-oriented lease in which a nominal lessor could claim the ITC and tax depreciation and pay the lessee for such benefits either in a single lump-sum payment or in reduced rental payments.

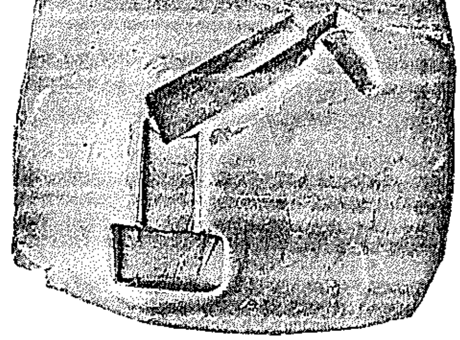
Safe harbor leasing was enthusiastically received and utilized by companies unable to use tax benefits currently. A large volume of equipment was leased under the new law. Most safe harbor leases were structured as TBT leases that, in substance, were sales of tax shelter.

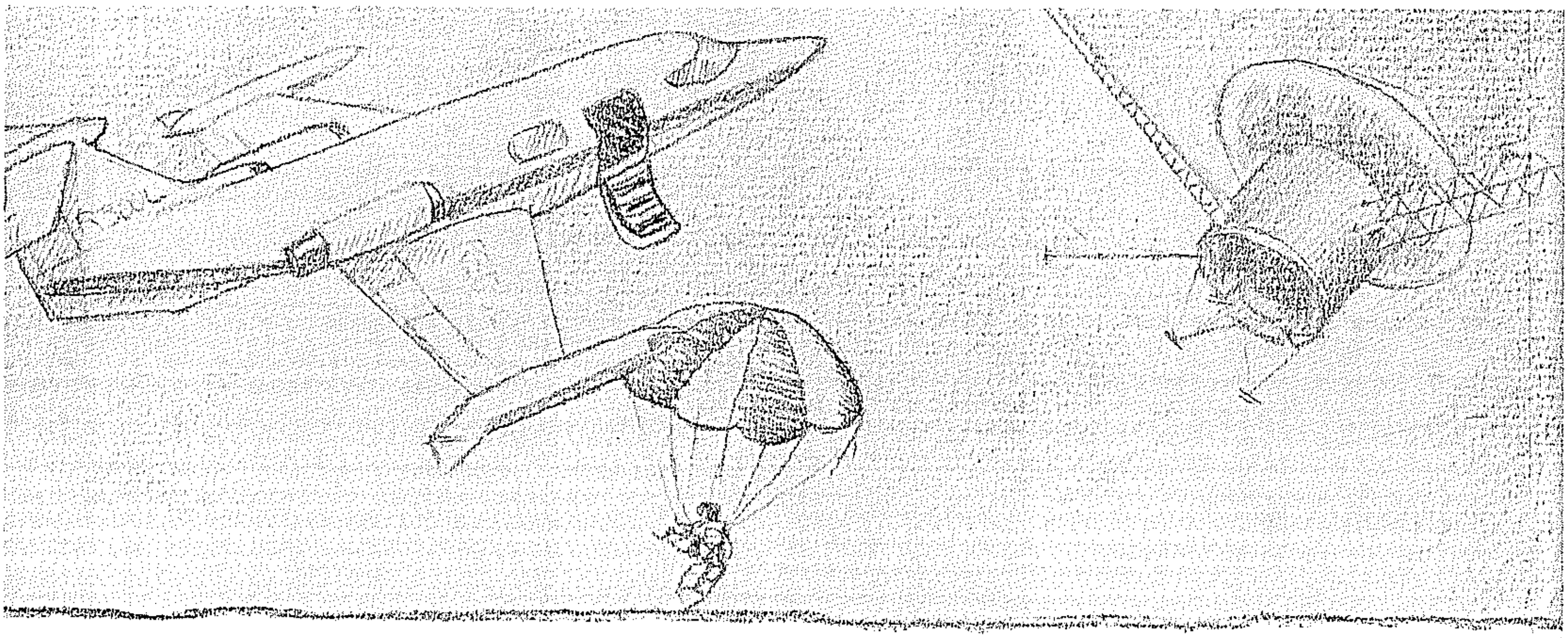
Increased Tax Benefits under ERTA

ERTA also contained provisions that dramatically increased tax benefits to owners of equipment, including lessors. ACRS depreciation permitted most equipment to be depreciated in five years on an accelerated basis. ITC vested in just five years (for five-year ACRS property) at the rate of 2% per year.

Increased Lease Volume by Individual Lessors

Prior to ERTA, equipment leasing was not a particularly attractive tax shelter for individual lessors as compared to alternative investments. ITC was not available to individuals except on short-term leases, and depreciation deductions alone were not large enough to make such leases competitive with leases offered by corporate lessors. ACRS deductions changed the economics of leasing for individual lessors and made leases offered by individuals attractive where ITC was not a factor. This gave rise to limited partnerships and some fairly





exotic structures for equipment leases that were competitively priced.

Tax Equity and Fiscal Responsibility Act of 1982: Repeal of Safe Harbor & Introduction of Finance Leases

The overall results of safe harbor leasing under ERTA proved to be very controversial. The volume of safe harbor leasing was larger than expected. The revenue loss to the Treasury Department was higher than projected. Most of the benefits were channeled to large creditworthy lessees, while many small and medium-sized eligible companies were unable to take advantage of the legislation. Some large taxpaying corporations were able to substantially reduce their taxes by acting as nominal lessors in safe harbor leases.

This led many commentators to characterize safe harbor leasing as wasteful, unfair, and a raid on the federal Treasury. Such criticism caused Congress to have serious second thoughts regarding the merits of this legislation. Furthermore, the rising federal deficits made the safe harbor leasing provisions an attractive target for revision to provide a source of increased tax revenue.

As a result, Congress enacted the Tax Equity and Fiscal Responsiblity Act of 1982 (TEFRA), which contained provisions that discontinued safe harbor leasing by: (1) Repealing and phasing out safe harbor and TBT leasing in 1982 and 1983. (2) Substituting and establishing a new type of tax-oriented lease, called a finance lease, effective January 1, 1984.

In establishing finance leases as a part of TEFRA, Congress provided a compromise lease structure. It eliminated the excessive liberalization of safe harbor leasing but provided a solution to the major objection that many lessees had to true leases by eliminating the requirement for a fair market value purchase option or a fixed-price purchase option based on estimated fair market value.

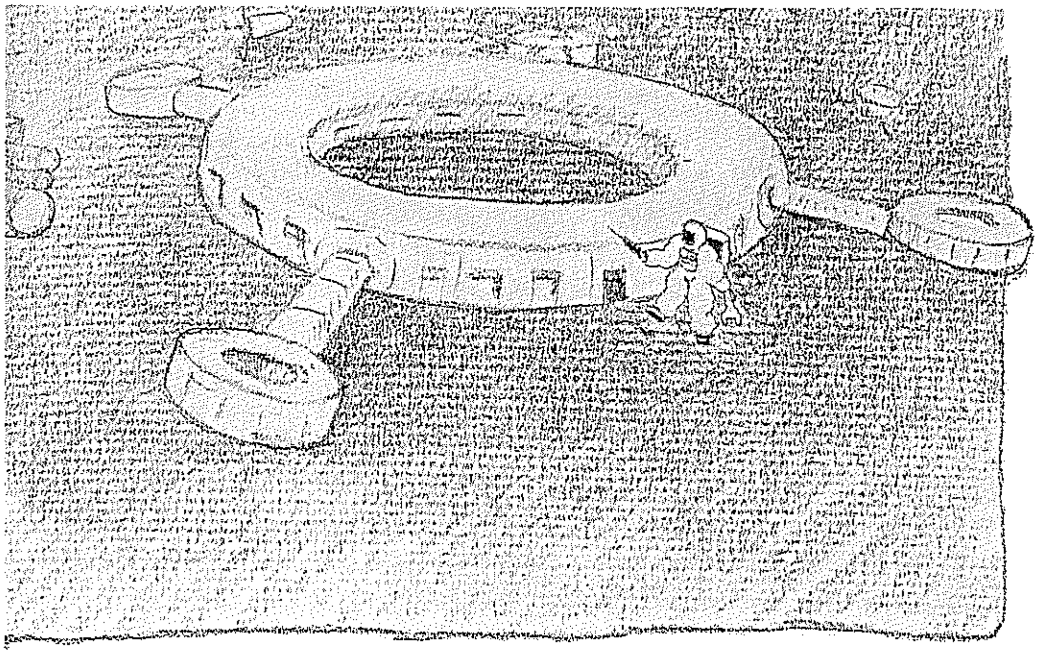
Finance leases differed from true leases in two major respects: (1) A finance lease could include a fixed-price purchase option equal to 10% or more of the purchase price, whereas a true lease could contain only a fair market value purchase option. (2) Special-purpose or limited-use property could be leased under a finance lease, whereas such property could not be leased under a true lease.

Congress imposed certain restrictions on using finance leases or claiming tax benefits attributable to finance leases in 1984 and 1985. These restrictions were aimed at phasing in finance leases slowly and raising tax revenue in those years: (1) During 1984 and until September 30, 1985, the lessor in a finance lease could claim only 20% of eligible ITC in the year that the property was placed in service and 20% in each of the next four years. (2) A lessor could reduce its federal income tax by only 50% in each of the years 1984 and 1985 as a result of tax benefits generated from finance leases or safe harbor leases, including depreciation attributable to such leases entered into in earlier taxable years. This limitation expired for property placed in service after September 30, 1985, in taxable years beginning after that date. (3) The amount of equipment that a lessee could lease using finance leases in 1984 and 1985 was limited to 40% of otherwise eligible property in each year. There was no limit on the amount of eligible property that a lessee could lease after 1985. (4) Only corporate lessors could offer finance leases.

True lease structures were not changed by ERTA and TEFRA. Moreover, the legislative history of TEFRA reviewed in detail the Internal Revenue Service guidelines for a true lease set forth in Revenue Procedure 75-21, and by implication endorsed those criteria.

Treasury Attempt to Liberalize Tax Rules Rebuffed

The Treasury Department made no secret of the fact that it favored



safe harbor leasing and was disappointed with the congressional repeal of safe harbor leasing.

In 1983, the Treasury Department sought to indirectly resurrect safe harbor leasing by liberalizing the requirements for true leases through regulations permitting fixed-price purchase options at fairly nominal amounts and reducing at-risk investment requirements. Although these regulations were never formally proposed, drafts were leaked and openly discussed. This effort to liberalize the requirements for true leases was stopped as a result of communications to the Treasury by the House Ways and Means Committee. Chairman Dan Rostenkowski (D-IL) and other congressmen expressed strong displeasure with the proposed regulations, which they felt were contrary to the expressed intent of Congress in repealing safe harbor leasing.

Deficit Reduction Act of 1984

In 1983 and 1984, Congress became increasingly concerned about the mounting federal budget deficit. As a result, it passed the Deficit Reduction Act of 1984, which was aimed primarily at raising revenue by raising taxes. Finance leases, which were to become effective on January 1, 1984, were identified by Congress as revenue losers and were consequently postponed for four years, until January 1, 1988. All of the special phase-in rules applicable to finance leases that had been due to take effect in 1985 and subsequent years were likewise postponed for four years.

True tax-oriented leases to foreign airlines, foreign companies, or government entities, 50% of the income of which was not subject to U.S. income tax, also were made ineligible for tax-oriented leases. True tax-oriented leases to not-for-profit corporations such as hospitals were restricted to certain short-life equipment.

On the other hand, TRAC leases containing terminal rental adjustment clauses for registered vehicles were made eligible for true lease treatment by the Deficit Reduction Act of 1984. This change created significant new tax-oriented lease opportunities for lessees and lessors.

Congress again approved true leases by favorable reference and implication in its committee reports. Furthermore, the committee reports contain language intended to prevent the Treasury Department from issuing regulations liberalizing the requirements for true leases.

The Deficit Reduction Act of 1984 contained very little to discourage leases of equipment by individuals. In the meantime, however, the Internal Revenue Service became concerned about claimed abuses in the structures of equipment leases by individuals and instituted an audit drive aimed at overturning and discouraging such equipment leases if they lacked economic substance.

Tax Simplification Proposal

In December of 1984, the U.S. Treasury Department proposed a tax simplification plan for consideration by Congress. Among other things, this proposal would eliminate ITC, eliminate ACRS, and index interest rate deductions to the excess over the inflation rate. If adopted, these proposals would eliminate tax-oriented leasing as conducted today. Interestingly enough, the proposals did not eliminate or index deductions for payments, which might provide a new incentive for leasing. However, it seems likely that any tax legislation passed by Congress in response to the Treasury proposal will be severely modified. Any changes apparently will not be effective until 1986.

After 1985

If the past is prologue, the future of leasing seems assured.

Numerous threats to the leasing business have arisen in the past. On each occasion, the industry has faced up to the challenge, adjusted to the new rules, and emerged stronger than ever. Changes have created new opportunities as well as problems. The people engaged in leasing have been quick to take advantage of the opportunities.

Footnotes

1. Interpretive Ruling No. 400, 12 CFR Sec 7.300, since revised.