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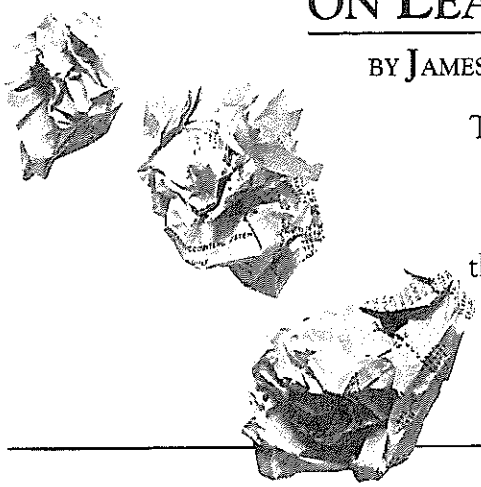
BY JAMES M. JOHNSON, PH.D.

TEFRA permits equipment owners to elect one of two ITC/depreciation options for tax purposes—each inferior to the package available under ERTA. This article examines the extent of TEFRA's inferiority by estimating the percentage increase in lessee rents necessary to "pass through" the tax benefit reduction. The article also establishes optimum TEFRA elections for three and five-year property.



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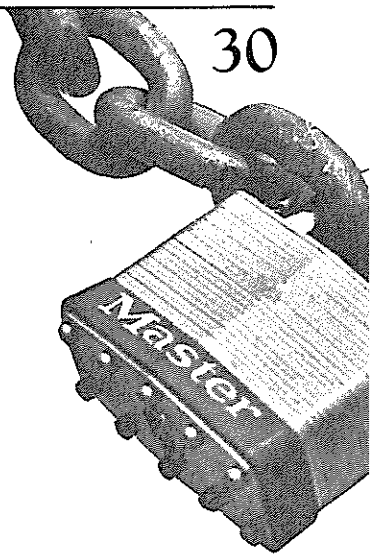

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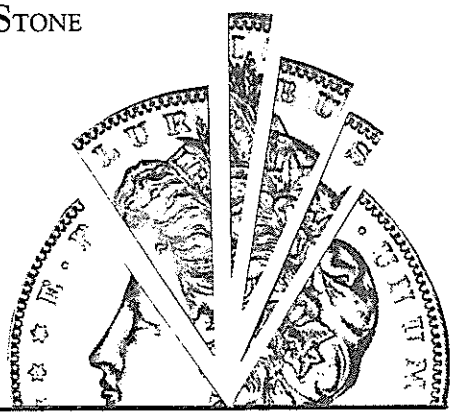

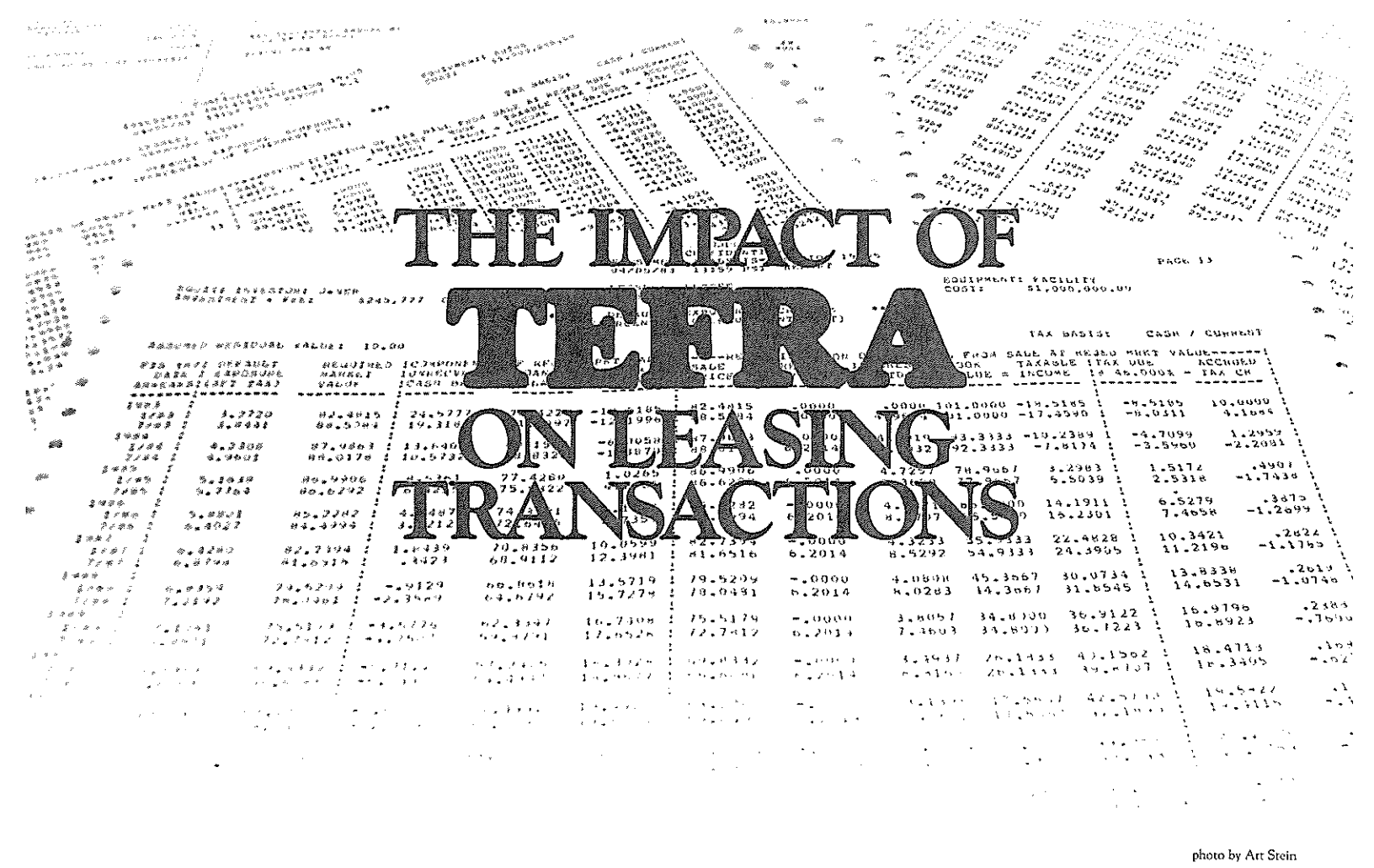

THE IMPACT OF TEFRA ON LEASING TRANSACTIONS

photo by Art Stein

by James M. Johnson, Ph.D.

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Introduction

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) reduced the tax benefits available to equipment owners relative to those which existed under the Economic Recovery Tax Act of 1981 (ERTA). As a consequence, it would be expected that leasing transactions governed by TEFRA would result in lower lessor yields, higher lessee rents, or both, than experienced under ERTA. The purpose of this article is to estimate the *magnitude* of TEFRA's adverse impact on leasing transactions. To accomplish this, the investment tax credit (ITC)/depreciation elections TEFRA permits is discussed and compared to the provisions which existed under ERTA. Since TEFRA permits two options, rules for optimum elections under TEFRA are constructed. This then permits estimates to be developed concerning the relative impact of TEFRA on lessee rents (with the assumption that lessors pass on this unilateral cost increase rather than suffer a reduction in yield). To develop these "TEFRA disadvantage estimates," numerous illustrative lease transactions are analyzed. By evaluating rent increases necessary for lessors to earn the same yield before and after TEFRA for transactions with differing terms, tax rates, in-service dates, residual values, and yield requirements, an understanding of the overall magnitude of TEFRA's impact upon the equipment leasing industry is shown. The final section of the paper presents a summary and conclusions.

ITC/Depreciation Elections under ERTA and TEFRA

ERTA introduced a new and highly simplified method of depreciation dubbed the Accelerated Cost Recovery System (ACRS). Under ACRS, assets subject to depreciation are classified as three, five, ten or 15-year property and depreciated over that respective number of years for tax purposes. As part of the simplification process, 100% of an asset's cost may be depreciated; the requirement to depreciate down to a "reasonable" salvage value was eliminated. Depreciation deductions for each year are also easily determined by multiplying the asset's cost by percentages set forth in the Act.

The rules governing ITC were also simplified under ERTA. Property qualifying for ITC earns a credit equal to 6% of asset cost in the case of three-year property, and a 10% credit for all other qualifying property. In addition, ERTA eliminated a taxpayer's ability to elect a longer depreciable life to earn more ITC (and conversely).[1] Under the new systems (ERTA and TEFRA), ITC is determined solely by the classification life of an asset—regardless of the tax depreciation life chosen.

Faced with an awesome deficit, Congress approved TEFRA and therein reduced the ACRS/ITC benefit package available to asset owners. Owners placing assets into service may continue to earn the same amounts of ITC available under ERTA, or may continue to depreciate 100% of an asset's cost, *but not both*. TEFRA forces asset owners to give up some ITC or some depreciation, whichever is preferred.

The options available under TEFRA are twofold, and vary for assets of different life classifications. Three-year property may continue to earn 6% ITC, but this requires the asset's depreciable basis to be reduced from 100% to 97% (define this as the 6/97 option). Alternatively, three-year property may earn 4% ITC and be 100% depreciated (the 4/100 option). Five-year or greater property may earn 10% ITC by reducing the depreciable basis to 95% (10/95 option), or earn 8% ITC and depreciate 100% (8/100 option).[2]

Clearly, TEFRA offers an inferior mix of ITC/ACRS depreciation to that available under ERTA. However, since TEFRA offers two options, the optimal election must be determined prior to making a legitimate TEFRA/ERTA comparison.

Optimal ITC/ACRS Elections under TEFRA

Three-Year Property

In the case of three-year property, determining the better election—6/97 or 4/100, is a simple matter. The top half of Table 1 indicates the ITC and ACRS tax benefits earned under each option for a $100,000 asset, assuming an owner in 46%, 50% and 54% tax brackets (50% and 54% represent illustrative composite rates for businesses subject to significant state and local taxes). For the 6/97 and 4/100 options, ITC would be $6,000 and $4,000, respectively. The tax cash value of all ACRS deductions under the 6/97 option is determined by multiplying the asset's cost by 97% times the tax rate. For example, a 46% taxpayer's ACRS value is $100,000 × .97 × .46 = $44,620; this is the tax bill reduction which the owner will realize over the depreciable life of the asset. All other ACRS values in Table 1 are computed in the same fashion.

When the total (ITC and ACRS) tax benefits of the two options for three-year property are compared, it is seen that the 6/97 option "wins" in the case of all three tax brackets shown (produces a larger total quantity of cash benefits, regardless of the owner's tax bracket). If an asset owner is a "current taxpayer," meaning tax benefits are used to reduce its tax bill as rapidly as they are earned, the ITC will be used during the first year the asset is in service. This means a current taxpayer will be cash ahead in year one by electing the 6/97 option (more ITC). But since total benefits are also greater under 6/97, the owner will be cash ahead[3] during the entire three-year tax benefit earning period: 6/97 provides more benefits up front and more benefits in total. Not surprisingly, the 6/97 option remains superior even if the owner is not a current taxpayer. Suppose, for example, that the business owner placing an asset into service is carrying tax operating losses forward, and estimates it will not exhaust these losses for three years. In such a case, all benefits under either option would be forecast to be utilized totally in year three. If this is the case, 6/97 still wins, since it will provide more total benefits at the time they can be used. In short, regardless of an asset owner's tax bracket or tax status (current or deferred), the 6/97 election will *always* be the better choice.

Table 1

TOTAL TAX BENEFITS RELATING TO THREE AND FIVE-YEAR PROPERTY

Property Class	TEFRA Election	Tax Benefit	Tax Bracket 46%	50%	54%
3-year	6/97	ITC	$ 6,000	$ 6,000	$ 6,000
		ACRS	44,620	48,500	52,380
		total	$50,620	$54,500	$58,380
3-year	4/100	ITC	$ 4,000	$ 4,000	$ 4,000
		ACRS	46,000	50,000	54,000
		total	$50,000	$54,000	$58,000
5-year	10/95	ITC	$10,000	$10,000	$10,000
		ACRS	43,700	47,500	51,300
		total	$53,700	$57,500	$61,300
5-year	8/100	ITC	$ 8,000	$ 8,000	$ 8,000
		ACRS	46,000	50,000	54,000
		total	$54,000	$58,000	$62,000

Five-Year Property

The optimal election relative to five-year property is not as clear. Inspection of the bottom half of Table 1 reveals

Table 2

TAX BENEFITS FOR FIVE-YEAR PROPERTY BY YEAR

Year	10/95 ELECTION ITC	10/95 ELECTION ACRS	10/95 ELECTION Total	8/100 ELECTION ITC	8/100 ELECTION ACRS	8/100 ELECTION Total	10/95 minus 8/100 Net
tax rate = 46%							
1	$10,000	$ 6,555	$16,555	$8,000	$ 6,900	$14,900	$1,655
2	0	9,614	9,614	0	10,120	10,120	(506)
3	0	9,177	9,177	0	9,660	9,660	(483)
4	0	9,177	9,177	0	9,660	9,660	(483)
5	0	9,177	9,177	0	9,660	9,660	(483)
tax rate = 50%							
1	$10,000	$ 7,125	$17,125	$8,000	$ 7,500	$15,550	$1,625
2	0	10,450	10,450	0	11,000	11,000	(550)
3	0	9,975	9,975	0	10,500	10,500	(525)
4	0	9,975	9,975	0	10,500	10,500	(525)
5	0	9,975	9,975	0	10,500	10,500	(525)
tax rate = 54%							
1	$10,000	$ 7,695	$17,695	$8,000	$ 8,100	$16,100	$1,595
2	0	11,286	11,286	0	11,880	11,880	(594)
3	0	10,773	10,773	0	11,340	11,340	(567)
4	0	10,773	10,773	0	11,340	11,340	(567)
5	0	10,773	10,773	0	11,340	11,340	(567)

that the 8/100 election will produce greater total benefits for each tax bracket shown. However, the 10/95 option will provide more cash early (in year one) due to greater ITC—provided the owner is a current taxpayer. Determination of the better option for five-year property will thus require a more refined analysis.

Conceptually, the better option would simply be that which produces the higher present value of benefits. The problem is that the present values will be influenced by the owner's tax rate, whether it is a current or deferred user of tax benefits, which quarter of the year the asset is placed in service, and the discount rate used. This last factor—the discount rate—should reflect the owner's required rate of return on investment or its opportunity cost of capital (the terms here will be used interchangeably), and may differ from owner to owner. To make the analysis manageable, then, indifference discount rates (IDR) will be developed. IDRs will indicate the required return a business must have which would cause it to be economically indifferent between the two options. A business may then maximize the present value of tax benefits by basing the election on whether its required return is greater or less than the IDR.

The following assumptions will be made in determining optimal elections for five-year property: (1) the asset will cost $100,000; (2) the asset owner makes quarterly tax payments; (3) the asset owner is a current-year tax estimator (makes quarterly tax payments based upon its projected tax bill for the current year; and (4) the asset will remain in service for at least five years.

The data in Table 2 defines the tax benefits derived from the $100,000 property by year, benefit type, tax bracket, and election option. The values in the top third of the table, for example, define the tax benefits for a 46% taxpayer. The year one ACRS value of $6,555 represents the cash value of first-year depreciation computed: $100,000 × .15 × .95 × .46. I.e., the asset's cost is multiplied by the first-year ACRS percentage of 15%, and then multiplied by 95% to reflect the required TEFRA adjustment for the 10/95 election. The product of these first three terms yields a year one depreciation tax deduction of $14,250; the deduction times the taxpayer's rate of 46% yields tax savings of $6,555. Other values in Table 2 are computed in similar fashion. The last column in the table shows the tax cash flow difference between the two options, with 8/100 benefits being deducted from 10/95 benefits.

The information in the last column of Table 2 provides the basis for computing IDRs between the two TEFRA options. Consider first a current 46% taxpayer which places the $100,000 asset in service at the beginning of the first quarter of a tax year (prior to its first quarterly tax filing for that year). In this instance, the net cash flow advantage or disadvantage of 10/95 relative to 8/100 for each quarter over the five-year tax life will be one-fourth of the annual values shown. Thus, 10/95 has a net tax cash flow advantage of $413.75 for quarters one through four ($1,655/4); a disadvantage of $126.50 for quarters five through eight ($506/4); and a disadvantage of $120.75 for quarters nine through twenty. If these tax cash flow differences are now discounted at a rate which causes them to collectively equal zero, their IDR will have been determined which will permit any business to then determine which option would be more profitable. The IDR for this example is 6.9%. This means that under the circumstances described, a taxpayer with a required after-tax return on investment in excess of 6.9% will derive a higher present value of benefits by electing the 10/95 option. Alternatively, if the owner's required return is less than 6.9% (unlikely) it will be more profitable to elect the 8/100 option.

Table 3 gives the IDRs for taxpayers in various tax brackets, for current taxpayers by the quarter in which the asset is placed in service, and for deferred taxpayers which expect to become current taxpayers in one or two years. In all cases, the IDRs shown are nominal annual rates, meaning that the quarterly indifference rate was calculated and then multiplied by four. Effective annual rates

may be computed by adding one to the decimal equivalent of the quarterly rate, raising the sum to the fourth power, and subtracting one from the result (the 6.9% nominal rate translates into an effective rate of 7.1%, for example).[4]

IDRs for the case of a current taxpayer placing the asset in service during the second, third, or fourth quarters were computed by dividing first-year cash flow values from Table 2 by three, two and one, respectively; cash flow differences for all subsequent periods were identical to the first quarter in-service case. (The assumption here is that if the asset is placed in service during quarters one, two, three or four, the first-year cash flow difference will be uniformly recognized in four, three, two and one quarterly tax payments respectively). The two sets of deferred taxpayer analyses indicate that tax benefits commence in quarter five or nine. The quarter five commencement means the taxpayer is presently carrying losses forward and does not expect to use tax benefits created by the new investment until next year. IDRs for this case were determined by adding together benefits for years one and two, and recognizing one-fourth of them during each of the four quarters in year two. IDRs for the ninth-quarter deferral were determined by adding cash flows for years one through three together and recognizing one-fourth of them during each of the quarters in year three.

The IDRs in Table 3 indicate that the 8/100 option becomes relatively more attractive (or less unattractive) as a business becomes less able to use tax benefits efficiently; e.g., a 46% taxpayer would generally find the 10/95 option more attractive if benefits are used as earned, but would find the 8/100 option more profitable if it was estimated that new benefits could not be used for two years. It may also be noted from Table 3 that the 8/100 option becomes relatively more attractive as the taxpayer's effective tax bracket increases. Suppose an owner has a required return of 15%. If the business is a 46% taxpayer, it should elect the 10/95 option if benefits are used as earned, or if it expects to be a current taxpayer within the next year. If the business faces a 50% composite rate, it should elect the 10/95 option only if it is a current taxpayer. If the effective tax rate is 54%, then the 8/100 option will be more profitable in all cases.

In sum, a singular rule for making optimum five-year property elections under TEFRA does not exist; the preferable choice will depend upon the taxpayer's required return on investment, the taxpayer's effective tax bracket, when the asset is placed in service during the year, and whether the business is a current or deferred user of newly created tax benefits.

Table 3

INDIFFERENCE DISCOUNT RATES (IDRs) FOR FIVE-YEAR PROPERTY*

Taxpayer Status	Tax Benefits Commence in Quarter	46%	50%	54%
current	1	6.9%	11.3%	15.5%
	2	7.3	11.9	16.5
	3	7.7	12.7	17.5
	4	8.2	13.5	18.8
deferred	5	12.0	20.2	28.8
	9	26.1	47.4	73.9

*Elect 10/95 if after-tax return on investment is above the appropriate IDR; otherwise elect 8/100

TEFRA's Impact upon Rent Requirements

It is difficult to make a categorical statement relative to the impact TEFRA should exhibit upon rents paid by lessees due to the tremendous diversity of leasing transactions; it would be impossible to present one definitive "plain vanilla" financing and make general inferences based upon that one finding. Accordingly, thirty-two simulated lease financings are presented in this section which should permit a feel for the range of impacts to be discerned. Examples will be provided for three and five-year property, two terms for each, first and fourth quarter commencements, 46% and 54% tax rates, residual values from 10% to 30% of equipment cost, and nominal annual pricing yields of 12% and 16%.

In all cases, the following will be assumed: (1) the owner/lessor is a current taxpayer; (2) the owner is a current-year tax estimator making quarterly tax payments; (3) the asset is placed in service either at the beginning of the first or fourth quarter of the year; (4) the residual value is realized at termination and taxes thereon paid immediately; (5) the lessor is either a 46% or 54% composite taxpayer; (6) all rents are received and taxes paid on a quarterly basis; and (7) the lessor prices to earn an internal rate of return of either 3% or 4% per quarter (12% or 16% nominal annual yield, respectively) on total capital invested.

To illustrate exactly how the values in Tables 4 and 5 were developed, consider the first lease shown in Table 4. Suppose the asset underlying this lease is three-year property; has a cost of $100,000; lease term is three years (twelve quarters); the lessor is a 46% taxpayer; the asset is placed in service at the beginning of the first quarter of the year; a residual value of $30,000 (30% of equipment cost) is expected to be realized at the end of quarter twelve; rents and

Table 4

TEFRA RENT INCREASES REQUIRED FOR THREE-YEAR PROPERTY

Yield	Tax Rate	Lease Term	In Service	Residual	TEFRA % Rent Increase under: 6/97	4/100
12%	46%	3	Q1	30%	2.5%	4.1%
			Q4		2.9	4.6
12	54	3	Q1	30	3.3	4.6
			Q4		3.9	5.3
16	46	3	Q1	30	2.2	3.7
			Q4		2.6	4.3
16	54	3	Q1	30	2.8	4.1
			Q4		3.2	4.6
12	46	5	Q1	20	2.2	3.7
			Q4		2.6	4.1
12	54	5	Q1	20	2.9	4.1
			Q4		3.4	4.7
16	46	5	Q1	20	1.9	3.3
			Q4		2.3	3.8
16	54	5	Q1	20	2.5	3.7
			Q4		2.9	4.2
Average increase of optimum method					**2.8%**	
Average increase of inferior method						**4.2%**

taxes will be paid quarterly; and the lessor prices the lease to earn a quarterly return of 3% (12% nominal annual yield) on total capital invested.

Under ERTA, the quarterly rent which must be charged in this example would be determined as follows: (1) Compute the present value of depreciation tax savings. Depreciation would be 25%, 38% and 37% of equipment cost in years one through three respectively, and thus $6,250, $9,500, and $9,250 on a quarterly basis during years one through three. Tax savings would be 46% of these amounts; thus, the cash value of depreciation deductions would be $2,875 in quarters one through four, $4,370 in quarters five through eight and $4,255 in quarters nine through 12. The present value of all depreciation tax savings, discounting at the quarterly rate of 3% would be $37,604.49. (2) Compute the present value of ITC. ITC will be used to reduce the lessor's tax bill during the first year. Since the asset is in service during the first part of quarter one, savings of $1,500 will be realized in quarters one through four (for a total of $6,000, or the allowable 6% of equipment cost). The present value of ITC, discounted at 3% per quarter is $5,575.65. (3) Compute the present value of the residual. It is assumed that a residual of $30,000 will be realized at the end of quarter 12; since the asset will be fully depreciated, the after-tax value of the residual at that time will be $16,200 ($30,000 × (1−.46)). The present value of the residual will be $11,362.35. (4) Determine the amount to be recovered through lease payments. The lessor invests $100,000 at the outset, but derives the benefits of ownership specified in parts (1)-(3) above. Thus, the present value of the rent stream must enable the lessor to recover his investment of $100,000 less the present value of benefits computed above. The present value of depreciation tax savings, ITC and residual represent total benefits of $54,542.49; accordingly, the rent stream required will have an after-tax present value of $45,457.51 ($100,000 − $54,542.49). (5) Determine the quarterly rent required. Rent will be received at the end of quarters one through 12, and will be reduced by tax payments thereon. The cash value of each rent payment is thus RENT × .54. Since rent payments will be level over the term, an annuity factor may be applied; the after-tax present value of the rent stream will be RENT × .54 × 9.954. Setting the value of rents equal the net costs to be recovered permits the quarterly rent to be computed: RENT = $45,457.51/.54 × 9.954; RENT = $8,456.96 per quarter.

Since the 6/97 election has been shown to be preferable for three-year property, the rent requirement with an optimal TEFRA election may now be determined. Under 6/97, ITC will be the same as under ERTA; however, the value of depreciation is reduced by 3%. The present value of depreciation tax savings determined under ERTA above was $37,604.49. Thus 3% of this total depreciation benefit is $1,128.13 and becomes an additional cost to recover, since it is lost under TEFRA. Adding this incremental cost to the net cost to recover value of $45,457.51 computed in (4) above yields a net cost to be recovered under TEFRA of $46,585.64. Rent under TEFRA for the same financing may now be determined: RENT = $46,585.64/.54 × 9.954; RENT = $8,666.84 per quarter, or 2.5% more than required under ERTA to achieve the same yield. All other values in Tables 4 and 5 are determined in the same manner.

Table 4 presents the rent increases required under each TEFRA election for 16 simulated lease financings for three-year property. Yield in Table 4 means nominal annual yield; all simulated financings were solved using either 3% or 4% quarterly values, which translate into 12% or 16% nominal annual yields. The tax rate column refers to the tax bracket of the lessor, and the lease term defines the number of years the lease will run (although all values are determined on a quarterly basis). The in-service column indicates whether the asset was placed in service at the beginning of the first (Q1) or fourth quarter (Q4). The residual column indicates the expected liquidation value of the asset at the end of the lease term, expressed as a percentage of the equipment's cost. The last two columns indicate the percentage rent increase necessary under each of the two TEFRA options for the lessor to maintain yield, and thus reflect the magnitude of TEFRA's adverse impact upon lessee rents. Table 5 presents the same type of information for 16 simulated lease financings involving five-year property.

The data in Tables 4 and 5 indicate that lessors making optimum ITC/ACRS elections under TEFRA will be required to raise their rents by an average of 2.8% and 3.6% for three and five-year property, respectively.

Table 5

TEFRA RENT INCREASES REQUIRED FOR FIVE-YEAR PROPERTY

Yield	Tax Rate	Lease Term	In Service	Residual	TEFRA % Rent Increase under: 10/95	8/100
12%	46%	5	Q1	20%	3.3%	3.6%
			Q4		3.8	4.1
12	54	5	Q1	20	4.3	4.0
			Q4		5.1	4.6
16	46	5	Q1	20	2.8	3.3
			Q4		3.3	3.7
16	54	5	Q1	20	3.6	3.6
			Q4		4.3	4.2
12	46	8	Q1	10	3.1	3.4
			Q4		3.5	3.8
12	54	8	Q1	10	4.0	3.8
			Q4		4.7	4.0
16	46	8	Q1	10	2.6	3.1
			Q4		3.1	3.5
16	54	8	Q1	10	3.4	3.4
			Q4		4.1	3.9
Average increase of optimum method						**3.6%**
Average increase of inferior method						**3.9%**

Summary and Conclusions

The purpose of this article has been to develop estimates of the adverse impact TEFRA should be expected to have on lessee rents. Care was exercised to make the analysis as realistic as possible, recognizing that it is extremely difficult to characterize a "typical" lease. In order to make the analysis as precise as possible, rules for making optimum elections under TEFRA were developed prior to making a comparison between ERTA and TEFRA.

It was shown that virtually any business will always be better served by electing the 6/97 option for three-year property. For five-year property, the important parameters were identified which should enable lessors to make optimum elections there as well.

Table 3 displays indifference discount rates for five-year property applicable to lessors which are current or deferred taxpayers, and are in the 46%, 50% or 54% composite tax bracket. To use the table, a lessor may identify his tax status and tax rate, and would more profitably elect the 10/95 option if his after-tax return on investment is greater than the IDR shown. If the lessor's return on capital is less than the applicable IDR, it will be more profitable to elect the 8/100 option.

The last section attempted to estimate the magnitude of TEFRA's injury to the leasing community. A review of the 32 simulated leasing transactions shown in Tables 4 and 5 suggests that TEFRA will cause lessees to suffer rent increases on equipment placed in service ranging from about 2.8% on three-year property to 3.6% on five-year property.

FOOTNOTES

1. For an analysis of how optimum tax life elections were made pre-ERTA, see references 2 and 3.

2. Technically, TEFRA states that election to retain maximum ITC requires the asset's depreciable basis to be reduced by 50 percent of the credit taken. Alternatively, an election to retain maximum (100 percent) depreciable basis allows ITC of 4% on three-year property and 8% on other qualifying property (expressed as a percent of asset cost) to be earned.

3. Cash ahead in the sense that the *cumulative* cash flow advantage of 6/97 over 4/100 persists for all periods.

4. Nominal rates do not reflect the reinvestment of funds within a given year. Effective rates, on the other hand, reflect an ability to reinvest cash as it is received.

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