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The Journal of Equipment Lease Financing™

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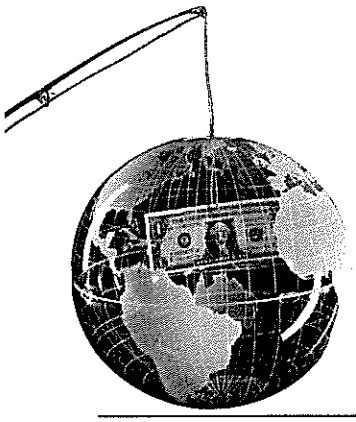
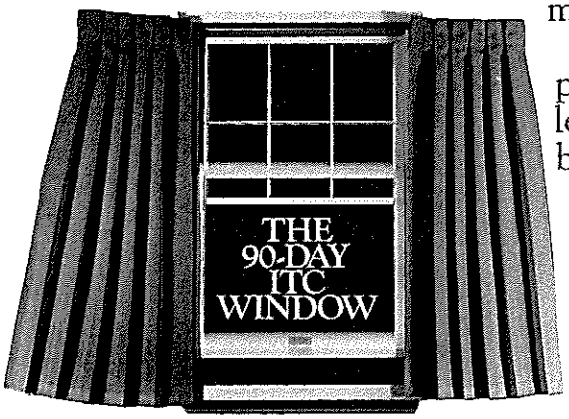


After providing a brief history of the development of the equipment leasing industry outside the U.S. and an analysis of the position of U.S. multinational leasing firms in that market, the author examines constraints upon the growth of the industry and recommends government action that will facilitate industry expansion and the accompanying increased export of U.S. goods and financial services.



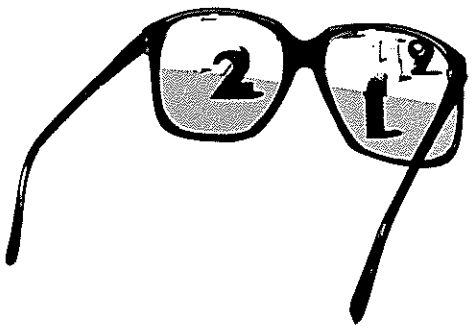
The Tax Equity and Fiscal Responsibility Act of 1982 amended section 48(b) of the Internal Revenue Code to postpone the "originally placed in service" date for Investment Tax Credit (ITC) purposes for up to three months. The language seems to permit sale-leasebacks and other lease structures to vest ITC for new section 38 property in the lessor, even after equipment is used by the lessee. In this article, the author examines the pitfalls and benefits of various structures utilizing this 90-day window, with particular emphasis on multiple-item transactions and the role of the leasing company. An addendum to the article is included based upon the revisions made in the 1984 tax bill.

The Journal of Equipment Lease Financing™

TOWARD A NEW UNDERSTANDING OF LEVERAGED LEASE PROFITABILITY

BY EDWARD P. BRENNAN

Existing leveraged lease analytical methods and structuring techniques are premised upon the concept that a leveraged lease is a "unitary" opportunity. This concept, in the author's opinion, has resulted in a twenty-year history of confusion in measuring the profitability of a leveraged lease. The article reviews the history, development and inadequacy of the existing major analytical methods and structuring techniques, and proposes a new, simple and "foolproof" approach, the Binary Lease Profitability Index, for evaluating the profitability of a leveraged lease. The new approach is based upon perceiving the leveraged lease as presenting the investor with two distinct opportunities (hence, binary), an investment opportunity and a financing opportunity, which need to be evaluated separately.

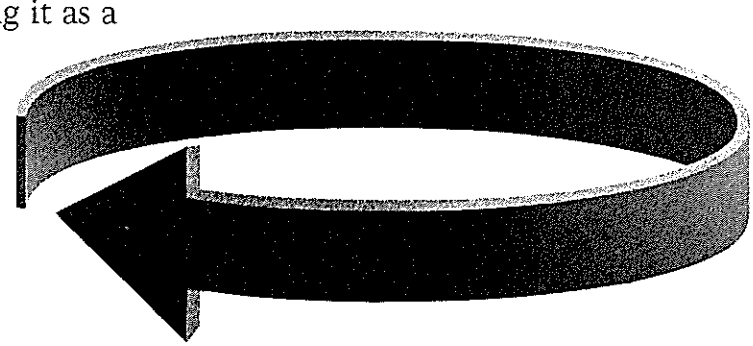


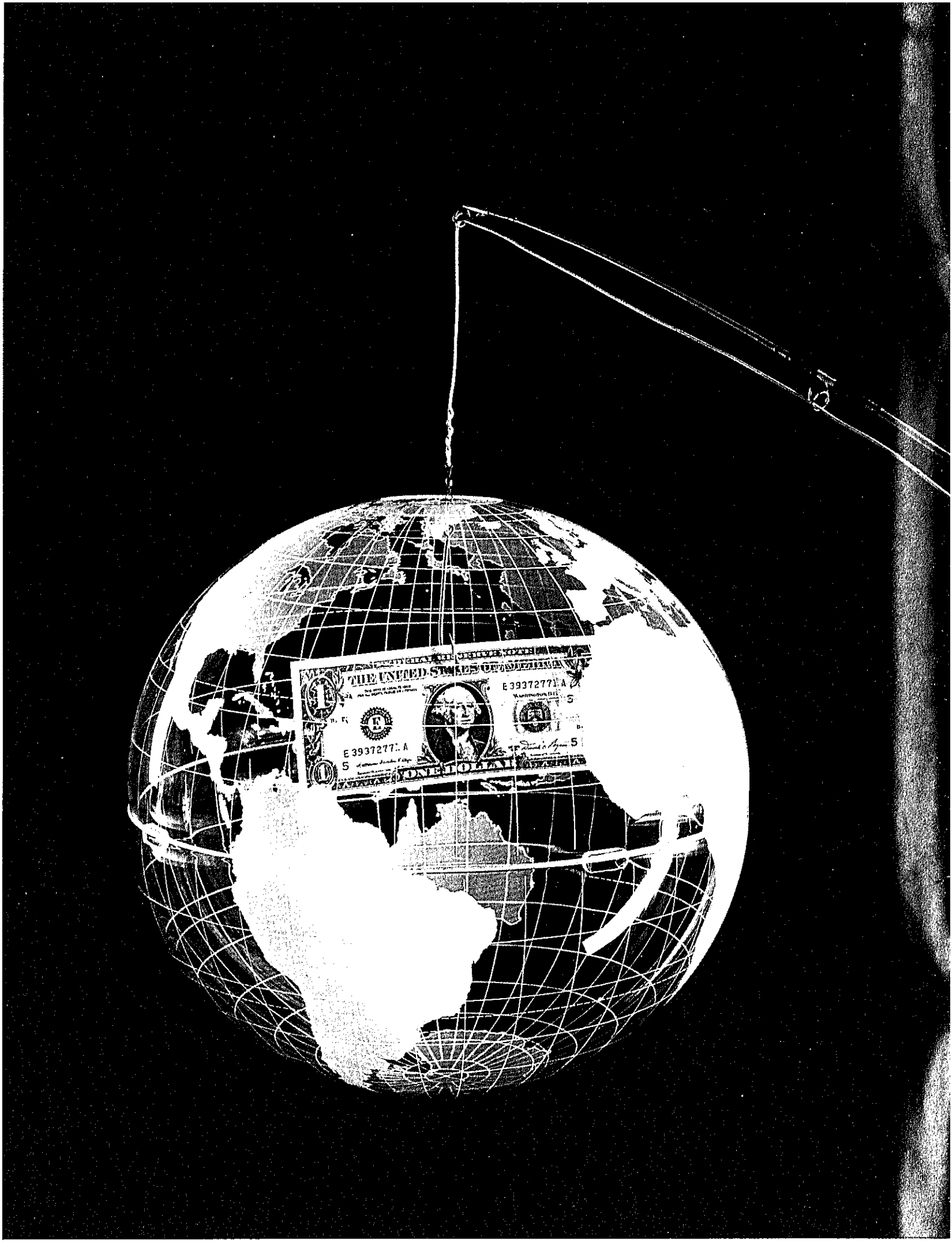
WRAP LEASES:

STRUCTURAL AND TAX CONSIDERATIONS

BY ALLEN P. PALLES, ESQ.

The article discusses the fundamental economic, structural and tax aspects of the wrap lease, identifying it as a structural variation of the leveraged lease.

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INTERNATIONAL LEASING: A Dynamic Industry under Constraint

by Lawrence M. Taylor, Jr., Esq.

Equipment leasing is undergoing unprecedented growth around the world. Most U.S.-based lessors participating in the growth of the industry abroad have been the large multinational financial institutions, who have aggressively pursued opportunities to expand into developed and developing foreign leasing markets. Whether this international expansion continues apace depends in large part on whether U.S.-based international lessors can maintain and improve their competitive position abroad.

This article provides a brief history of the development of the leasing industry outside the U.S. and an analysis of the position of the U.S. multinational leasing institutions in that industry today. In addition, it examines the constraints imposed by both U.S. and foreign governments which impede further growth of the industry. It concludes with a series of recommendations which would streamline U.S. government programs facilitating international leasing and provides U.S. officials with a working list of trade barriers in foreign markets affecting the "exportability" of the U.S. leasing business. The implementation of these recommendations will allow U.S.-based lessors to compete with renewed vigor in foreign markets.

The author is chairman of the AAEL International Leasing Industry Panel and a vice president in the international leasing division of Manufacturers Hanover Leasing Corporation in New York. He earned his undergraduate degree at Brown University and a law degree at Boston University School of Law.

The Growth of Leasing Worldwide

To the world leasing community, "leasing" generally connotes "financial leasing," wherein the lessor provides a financial service by purchasing equipment selected by the lessee for its use over a period normally less than the useful depreciable life of the asset.

Total rental payments during this initial and noncancellable lease term amortize the full capital outlay and interest cost of the lessor and provide some profit. The lessee bears the risk of obsolescence during the lease period as well as the risk of equipment loss or damage, takes care of all maintenance and pays all insurance and taxes. At the end of the lease, the lessee may have one or more options (depending on the legal, tax and accounting treatment accorded the leasing transaction in the lessee's country): To purchase the asset, at a set or determinable price or at the fair market value of the asset at the end of the term; to return the asset to the lessor; or to extend the term of the lease.

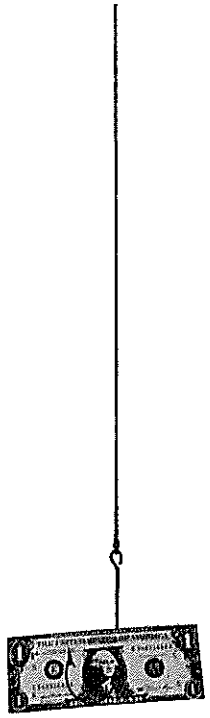
The term "international leasing" as used by the leasing community encompasses two broad and distinctly different kinds of transactions: (1) *Cross-border leasing*, where the lessor is located outside the country of the lessee; and (2) *foreign leasing*, where the lessor is an entity domestic to the lessee's country, but is wholly or partially owned by an entity located outside the lessee's country.

The variety of financial products and techniques falling within these two broad categories of financial services have been utilized by the worldwide financial community for export purposes to provide new sources of profit and diversification and meet competitive pressures abroad generated by the rapid growth of the leasing business in many countries. The fundamental concept of separation of use and ownership of a capital asset and the consequences which logically flow from that concept have provided a sustained

impetus for the rapid expansion of the worldwide leasing industry. Recognition by innovative financial institutions that *use* rather than *ownership* of capital equipment generates profits, and the gradual acceptance of this fundamental departure from more conventional methods of obtaining medium-term credit by both government and private industry worldwide has resulted in a service industry growing in most markets at a rate well ahead of the rate of general inflation.

The parallel development of a wide variety of tax and fiscal incentives offered by many countries to investors in capital equipment, and the use of the leasing device to allocate these incentives between the lessor/owner and the lessee/end user have been the principal factors fueling the growth of the industry. In addition, leasing has been aggressively marketed by lessors as a financial service, with emphasis on rapid response and a financial proposal tailored to the needs of the customer, and as a result has been increasingly perceived by industry as a viable alternative method of capital equipment financing, especially in times or places of limited capital availability.

Leasing traces its roots back to the early 1950s in the United States. Its use spread rapidly throughout the U.S. and the industrialized countries of Europe in subsequent years, led at first by independent nonbanking leasing corporations and followed by the large U.S. and United Kingdom multinational banks and financial institutions and their affiliates. In the 1970s, the leasing industry reached maturity in most developed countries. By the end of that decade, Organization for Economic Cooperation and Development (OECD) countries in the aggregate expended in excess of U.S. $50.0 billion on leased equipment, and investments in leased equipment as a percentage of total investment in capital equipment in OECD countries ranged from approximately 1.5% to 15%.[1] In the U.S., the domestic leasing business has enjoyed a twenty-year period of rapid growth. It is estimated that in 1983, U.S. lessors financed approximately U.S. $61.0 billion in new capital equipment representing approximately 17% of all such new investment.[2]



The "internationalization" of the leasing industry was slower to develop, but in recent years has become what has been termed an international phenomenon.[3] Many of the larger U.S. institutions were first attracted to the international leasing business by the availability of investment tax credit (ITC) and accelerated depreciation to U.S. owners of certain transportation and related assets (e.g., aircraft, rolling stock, vessels, drilling rigs, and containers) located and used primarily outside of the U.S. By structuring a transaction as a U.S. cross-border leveraged lease, where title to such assets resides with a U.S. taxpayer despite its use overseas by a foreign non-U.S.-taxpaying entity, a U.S. lessor is able to significantly reduce the financing cost to the foreign lessee of these types of assets, many of which are manufactured in the U.S. In dollar volume and in the number of international leasing transactions receiving publicity, this type of "tax-oriented" international leasing transaction is best known to the worldwide financial community, if only because of its full utilization of the leasing technique to maximize available incentives. Indeed, the U.S. is the world leader in cross-border leveraged leasing of these narrow categories of capital assets solely because of the impact of such U.S. tax incentives in the financing cost.

However, even though cross-border leveraged leasing has in past years generated a huge dollar volume of exports falling within these groups of capital equipment, its use today is relatively flat. This is due to a number of related factors:

- The strong U.S. dollar and worldwide recession has drastically reduced demand for such big-ticket items.

- Although the equipment falling within these categories represents a large dollar volume of export, the categories are very narrow when compared to the other categories of exported equipment to which such tax benefits are largely inapplicable. These other

equipment types will be much more likely to be the subject of a domestic U.S. lease, where full tax benefits are available, rather than a cross-border lease in which the risk, being foreign, is most likely higher, but the overall yield to the lessor is lower. The U.S. tax structure has resulted therefore, albeit unintentionally, in placing the vast majority of big-ticket equipment at a comparative and very significant financing cost disadvantage to that falling within transportation-related categories.

- The complexity of legal, tax and accounting problems associated with cross-border transactions, the requisite ability to assess international credit and political risk, and the innovative but complicated use of export credit devices and cover for foreign exchange risks, have required a good deal of financial and legal sophistication and resulting high cost. This has further restricted the use of cross-border leasing to the financing of big-ticket items, where the benefits significantly exceed the cost of implementation, and to the larger and more sophisticated lessors.

- Because of the way in which tax benefits applicable to these types of transactions are calculated and used, a U.S.-based international lessor with both substantial domestic U.S. leasing business as well as substantial other foreign activity is severely constrained as to the amount of such leasing transactions in which it can profitably engage.

- Last, but certainly not least, the "chilling effect" on the cross-border leveraged leasing market created by the Pickle/Dole legislation[4] now pending before Congress, has created an aura of uncertainty in the business and an unwillingness by lessors and lessees alike to enter into such transactions.

The leasing community, particularly in Europe, has developed the leaseclub system in an effort to foster international leasing. Essentially, the leaseclubs are loose associations of member leasing companies, one to a country, who refer leasing business to each other. Originally designed to reduce the difficulties involved with cross-border leasing and to improve access to foreign markets, the leaseclubs have been particularly useful in the development of vendor programs. In the programs, a manufacturer or lessor looking for lease financing in another country would be referred to a leaseclub member in the desired country. There are now five leaseclubs in existence with approximately 130 members.[5]

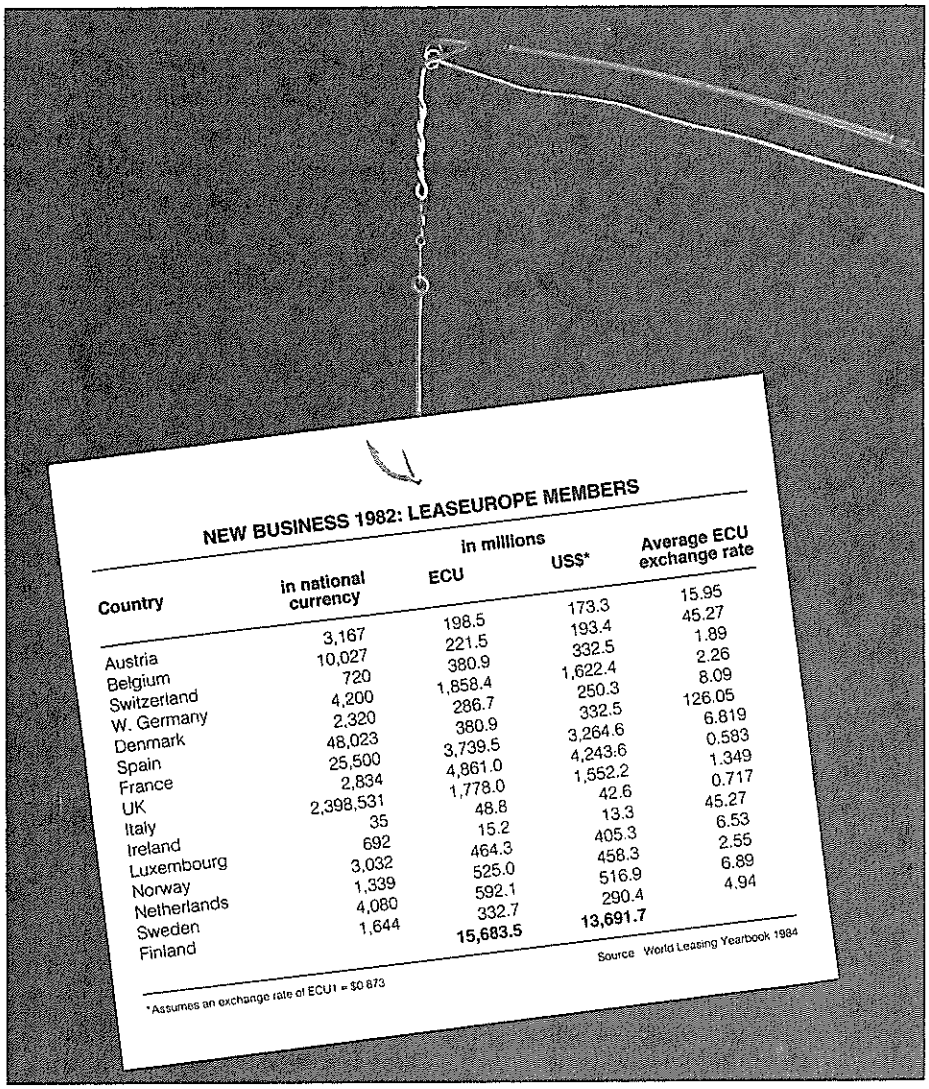
Compared to cross-border leasing, the penetration of foreign markets by U.S.-based and other foreign leasing companies has been slower and later to develop, but is rapidly accelerating. It is also undoubtedly of far greater long-term importance to the leasing industry. This method of reaching foreign acquirers of capital equipment has many advantages over cross-border leasing: The ability to handle small transactions on a purely local basis; access to the local financial markets and the resulting reduction of currency risk; direct access to and knowledge of the local leasing market and other competitive forces. However, its disadvantages are formidable: Primarily the long lead time and substantial expense of setting up and managing each such foreign company; complying with local rules of foreign investment in the financial sector; and the foreign exchange risk arising from an equity investment in a leasing subsidiary.

The larger U.S.-based lessors, particularly those affiliated with large U.S. multinational banks, have accelerated expansion of their overseas leasing presence. This has been partly in response to competitive pressures at home from other financial institutions as well as from their domestic exporting customers. There is also the competitive necessity of offering leasing to their foreign customers in countries where leasing increasingly is perceived as a viable financial alternative by both foreign financial institutions and their own customers. A recent informal survey by the American Association of Equipment Lessors (AAEL) of its members indicates that in 1983 alone approximately 10% of its members generated between $8.0 to $10.0 billion in new capital equipment leasing volume for equipment used overseas.[6] All of these institutions have made a substantial commitment of resources to the development of international leasing. While it is difficult to generalize, it is clear that of the aggregate lease receivables of each of these institutions, a significant amount (ranging as high as 30%) are due from foreign lessees.

The widespread expansion of U.S. lessors into foreign markets is more easily perceived by examining the *World Leasing Yearbook*, which provides brief summaries of the leasing industry in 41 countries, together with classified lists of over 4000 leasing companies operating around the world. A close analysis reveals the substantial commitment of the larger multinational financial institutions of U.S., Europe and Asia to international leasing. One or more of these institutions almost always is found as the whole or partial owner of the major leasing companies operating in each foreign environment.

Largely because of the involvement of these institutions, as well as the entry of local financial institutions into many of the newer foreign leasing markets, plus the growing maturity of most of the established markets, there has been a marked increase in recent years in the level of new international leasing business. The European Federation of Equipment Leasing Associations (Leaseurope), representing approximately 400 leasing companies from 16 countries, published its first annual report in September, 1981. It stated in part: "All fifteen member countries of Leaseurope had a successful year in 1980. Total new business amounted to BF 506 billion, compared to BF 398 billion in 1979 and BF 290 billion in 1978.

"The average rate of growth in 1980 was 27%, but several countries continued to enjoy exceptionally high rates, most notably Finland with a 101% increase and Italy with 69%. With the exceptions of Denmark and Ireland, all countries experienced a rate of growth above the general rate of inflation. Seven countries have



NEW BUSINESS 1982: LEASEUROPE MEMBERS

Country	in national currency	in millions ECU	in millions US$*	Average ECU exchange rate
Austria	3,167	198.5	173.3	15.95
Belgium	10,027	221.5	193.4	45.27
Switzerland	720	380.9	332.5	1.89
W. Germany	4,200	1,858.4	1,622.4	2.26
Denmark	2,320	286.7	250.3	8.09
Spain	48,023	380.9	332.5	126.05
France	25,500	3,739.5	3,264.6	6.819
UK	2,834	4,861.0	4,243.6	0.583
Italy	2,398,531	1,778.0	1,552.2	1.349
Ireland	35	48.8	42.6	0.717
Luxembourg	692	15.2	13.3	45.27
Norway	3,032	464.3	405.3	6.53
Netherlands	1,339	525.0	458.3	2.55
Sweden	4,080	592.1	516.9	6.89
Finland	1,644	332.7	290.4	4.94
		15,683.5	**13,691.7**	

Source World Leasing Yearbook 1984

*Assumes an exchange rate of ECU1 = $0.873

more than doubled their business of the last two years.

"As in the previous year, some 35% of the total expenditure on leased assets in 1980 related to industrial plant and machinery and a further 35% to commercial vehicles and cars. 20% consisted of computers and office equipment and the remaining 10% covered ships, aircraft, railway-rolling stock and other items.

"The net book value of the leased equipment owned by leasing companies in the fifteen member countries at 31st December 1980, amounted to BF 921 billion, compared to BF 640 billion at the end of 1979.

"In most cases national associations represent between 75% and 100% of the total equipment leasing business carried on in their countries, so that the combined statistics give a fair indication of the overall level of business carried on in Europe."

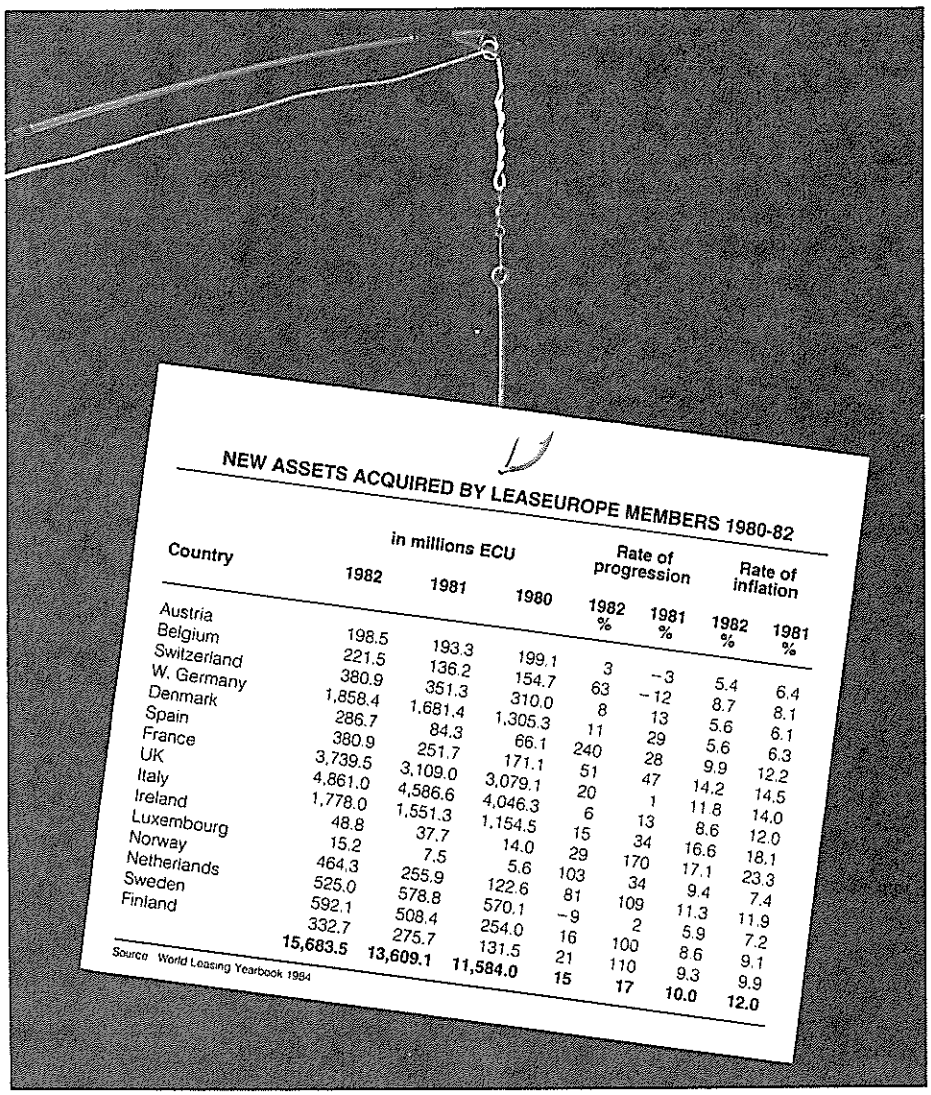
The 1982 statistics collated by the Leaseurope Statistics Committee showed a 15% overall increase in business, reflecting new equipment leased in Europe during calendar 1982 valued at U.S. $13.69 billion and an aggregate net book value of leased equipment owned by members at December 31, 1982 equal to U.S. $28.2 billion. See tables for details.

In the U.K., the Equipment Leasing Association (ELA) reported 572 million pounds sterling of international leasing business written in 1981 by U.K. leasing companies compared with 133 million pounds sterling in the previous year. The international business represented 21% of the new plant and equipment leased by member companies of the ELA in 1981. However, because of certain changes in the U.K. tax law, 1981's spectacular performance will not be repeated in the near future; and 1982 business was sharply lower at 94 million pounds sterling.

In the Latin American markets, growth in past years has been nothing short of astounding, although general economic conditions in that area have resulted in a sharp downturn in growth in the last year or so. In Mexico, new leasing business grew from 367 million pesos in 1970 to almost 8.0 billion pesos by 1980. Approximately a dozen major leasing companies provided the financing, all but three of whom have U.S. or European shareholders.[7] This growth has, of course, been sharply curtailed with the recent collapse of the Mexican economy; but Mexican leasing companies will undoubtedly be able to rebuild in future years due to their preeminent position as service-oriented companies supplying a substantial portion of Mexican industry's capital equipment financing needs. In Venezuela, there are over 35 leasing companies, the majority of which are owned in whole or in part by large Venezuelan or foreign banks. Figures available from the Venezuelan leasing association show that at the end of 1979 these leasing companies had total lease receivables of nearly U.S. $350 million. In fact, total lease contracts outstanding more than tripled from the end of 1977 to 1982, reaching 2.6 billion bolivares by the end of 1982.[8] This growth will also be checked as Venezuela seeks to get its financial house in order following the financial crisis of 1983. In Brazil, from its inception in 1969, the leasing industry had grown to 54 companies by December, 1980. Collectively, these companies have invested in excess of U.S. $1.3 billion in leasing transactions, accounting for almost 4% of total capital investment.[9] This growth continued through the end of 1982 when net book value of leasing transactions was approximately U.S. $2.6 billion.[10]

The leasing industry in Asia and the Pacific Basin also has seen substantial growth in recent years. It has its roots in the early 1960s in the Philip-

pines and Japan, and spread to other Asian countries in the early 1970s, led by Japanese and U.S. multinational financial institutions. In Japan, for the year through March 31, 1983, new leasing contract receivables totalled 1,933 billion yen (U.S. $8.4 billion), a 25% increase over the previous year and representing nearly 5% of total capital investment.[11] New leasing contracts in Japan are expected to run at an annual level in excess of 2.5 trillion yen (U.S. $10.7 billion) by 1985 and 4.0 trillion yen (U.S. $17.0 billion) by 1990, with some respected estimates reflecting even higher growth.[12] The Japanese have also developed the so-called "shogun lease," a yen-dominated lease for a foreign lessee which enables such a lessee to obtain yen funding from the domestic Japanese capital markets at lower spreads and long-term fixed rates and pay off the lease with yen revenues if available from the lessee's own operations. Shogun volume is around U.S. $1.0 billion per year, and to date most shogun leases have been done with airlines, especially the regional Asian carriers with yen revenue.[13] However, the market for shogun leases is expected to grow rapidly, especially in respect to foreign lessees seeking to diversify their financing.



NEW ASSETS ACQUIRED BY LEASEUROPE MEMBERS 1980-82

Country	in millions ECU			Rate of progression		Rate of inflation	
	1982	1981	1980	1982 %	1981 %	1982 %	1981 %
Austria	198.5	193.3	199.1	3	−3	5.4	6.4
Belgium	221.5	136.2	154.7	63	−12	8.7	8.1
Switzerland	380.9	351.3	310.0	8	13	5.6	6.1
W. Germany	1,858.4	1,681.4	1,305.3	11	29	5.6	6.3
Denmark	286.7	84.3	66.1	240	28	9.9	12.2
Spain	380.9	251.7	171.1	51	47	14.2	14.5
France	3,739.5	3,109.0	3,079.1	20	1	11.8	14.0
UK	4,861.0	4,586.6	4,046.3	6	13	8.6	12.0
Italy	1,778.0	1,551.3	1,154.5	15	34	16.6	18.1
Ireland	48.8	37.7	14.0	29	170	17.1	23.3
Luxembourg	15.2	7.5	5.6	103	34	9.4	7.4
Norway	464.3	255.9	122.6	81	109	11.3	11.9
Netherlands	525.0	578.8	570.1	−9	2	5.9	7.2
Sweden	592.1	508.4	254.0	16	100	8.6	9.1
Finland	332.7	275.7	131.5	21	110	9.3	9.9
	15,683.5	**13,609.1**	**11,584.0**	**15**	**17**	**10.0**	**12.0**

Source: World Leasing Yearbook 1984

In Singapore, the Leasing Association of Singapore at the end of 1982 represented 32 lessors, including 17 foreign-affiliated companies.[14] In Malaysia, the Equipment Leasing Association of Malaysia now has 107 members whose total leasing volume in 1982 amounted to approximately M$750 million (U.S. $330 million).[15] In Korea, there are at present three leasing companies and six merchant banks operating in the field with leased equipment cost reaching WON 202 billion (U.S. $290 million).[16] Development in Indonesia has been slow but the demand for lease financing has been strong, with more than 30 companies already engaged in leasing or planning entry into the market.[17] Hong Kong serves as a regional financial center, not only for leasing but for most other financial services, and many of the lessors located there primarily concentrate on big-ticket cross-border leasing to Asian lessees located elsewhere.[18] In the Philippines, there are approximately 40 leasing and finance entities, with an estimated total portfolio at the end of 1981 of 1.0 billion pesos (U.K. $115 million), and an historical annual growth rate of 10%.[19]

As a final note to this brief history, the efforts of the International Finance Corporation (IFC) should be cited. This private sector arm of the World Bank has introduced leasing as an alternative source of equipment finance for industrial, agricultural and commercial enterprises, has helped support the domestic capital markets of many countries and has stimulated economic development primarily in less developed countries. Since 1977, IFC has established and become an equity investor in leasing companies in fourteen countries: Colombia, Jordan, Korea, the Philippines, Sri Lanka, Thailand, Uruguay, Peru, Ecuador, Brazil, Portugal, India, the Dominican Republic, and Indonesia.[20] In addition, in some cases it has lent its own funds to the venture to insure an initial source of funds. IFC is currently investigating the possibility of future leasing ventures in Asia and Africa, and plays an active role as adviser to authorities in less developed countries in connection with the development and implementation of an appropriate regulatory framework for leasing.

A number of trends and potential growth areas relevant to the U.S. leasing community may be deduced from both the extent and nature of this world-wide expansion of the leasing business and the limitations facing the

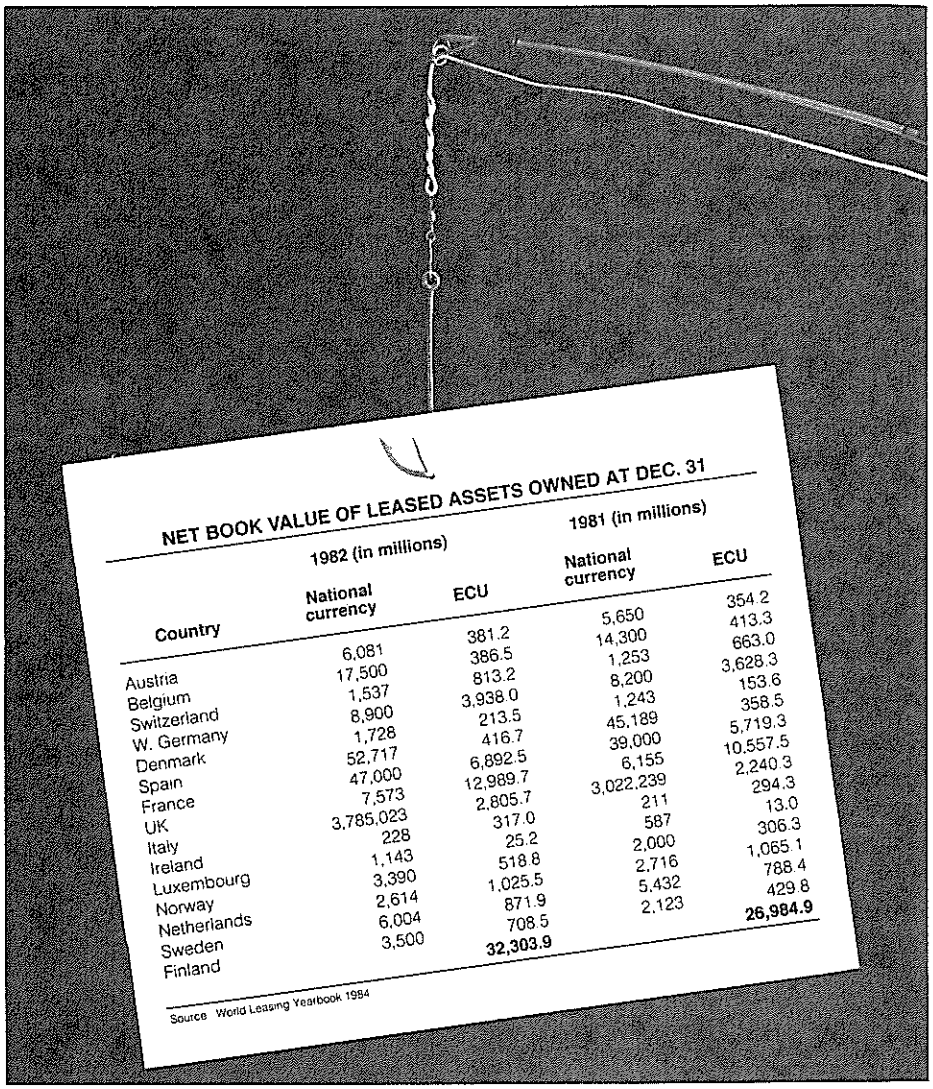
growth of leasing in the U.S.:

(1) The penetration of less-developed leasing markets around the world by U.S., European and Japanese financial institutions, either by themselves or with local partners, has accelerated, resulting in increased and more sophisticated competition for both cross-border and foreign leasing business.

(2) In many Anglo-Saxon countries, including the U.S., leasing has derived its growth from tax incentives. In contrast, the vast majority of countries where leasing has taken hold treat leasing as an efficient and readily available supply of medium-term funds for the acquisition of capital equipment, with tax incentives taking a secondary but not unimportant position. Changes in the tax law affecting future years in the U.S., coupled with the general shortage of a tax base among financial institutions in the U.S. and elsewhere, will undoubtedly cause U.S. lessors engaged in international leasing to become less tax-oriented and more willing to explore nontax-driven markets.

(3) The need to maintain the competitive trade position of the U.S. in world markets, especially in light of the strong U.S. dollar, a 1983 foreign trade deficit of U.S. $69.4 billion (62% higher than 1982), and a 1984 trade deficit expected to exceed U.S. $100 billion, will require increased concentration on exports of capital equipment and related financing. Leasing companies will be increasingly asked by vendors/customers for lease financing for a foreign acquirer of its product. Indeed, many captive leasing companies may find a similar reason to offer leasing as a financing alternative. The recent development of "export trading companies" in the U.S. is also likely to foster the development of international leasing.

(4) The acceleration of technology, especially in the electronic area, coupled with the rise in energy and labor costs, can be expected to result in an ever more rapid replacement of obsolete equipment.



NET BOOK VALUE OF LEASED ASSETS OWNED AT DEC. 31

Country	1982 (in millions) National currency	1982 (in millions) ECU	1981 (in millions) National currency	1981 (in millions) ECU
Austria	6,081	381.2	5,650	354.2
Belgium	17,500	386.5	14,300	413.3
Switzerland	1,537	813.2	1,253	663.0
W. Germany	8,900	3,938.0	8,200	3,628.3
Denmark	1,728	213.5	1,243	153.6
Spain	52,717	416.7	45,189	358.5
France	47,000	6,892.5	39,000	5,719.3
UK	7,573	12,989.7	6,155	10,557.5
Italy	3,785,023	2,805.7	3,022,239	2,240.3
Ireland	228	317.0	211	294.3
Luxembourg	1,143	25.2	587	13.0
Norway	3,390	518.8	2,000	306.3
Netherlands	2,614	1,025.5	2,716	1,065.1
Sweden	6,004	871.9	5,432	788.4
Finland	3,500	708.5	2,123	429.8
		32,303.9		**26,984.9**

Source: World Leasing Yearbook 1984

(5) The developing economies of the world, especially in Asia and Latin America, will continue to have a stronger appetite than more mature economies for new capital equipment. The advantages of leasing over other traditional methods of financing should result in the continued rapid growth of leasing.

(6) Small and medium-sized companies around the world have become more aware of the availability and attractions of leasing and can be expected to rely increasingly on leasing to fulfill their capital equipment needs.

These trends taken together illustrate the urgent need of the U.S.-based international leasing business to improve its competitive position abroad. It must facilitate its international growth by providing, in partnership with the U.S. government, an increased level of support consistent with these goals. The analysis which follows is intended to demonstrate that such increased support can be provided.

The Future: Needs and Opportunities

The classical advantages of leasing are even more attractive in less-developed economies where capital is in short supply.

(1) Leasing increases cash flow, con-

serves working capital and preserves existing bank lines.

(2) Lease financing can be more closely matched to the useful economic life of the asset than traditional term financing.

(3) Leasing usually permits financing of 100% of the cost of the asset, so there is little or no capital outlay.

(4) Lease financing is still treated in many countries as "off balance sheet" financing, although this is of diminishing importance as methods of accounting for leases gain in sophistication around the world.

(5) Leasing offers the opportunity for lessor and lessee alike to make maximum use of tax benefits and other fiscal incentives encouraging new investment in capital equipment.

(6) Leasing may enable an expanding company to circumvent spending limits or other restrictive loan covenants in its existing financing arrangements.

In the international market, leasing takes on several additional advantages for the prospective lessee which can often mean the difference between acquiring or not acquiring new capital equipment. Capital may not only be in short supply or exceedingly expensive, it may be simply unavailable through traditional means of financing. Easier access to the international capital markets through the leasing device is proving of vital importance in many less-developed countries. In fact, in many markets, leasing has grown to be the primary source of medium-term capital equipment financing, often with rates and terms far more attractive than those available on local markets. In addition, because of the traditionally competitive leasing environment and the characterization of leasing as a financial service, leasing companies are viewed as more responsive than local banks and other sources of capital to the needs of their customers and more flexible in developing financial packages.

Other less tangible advantages are also important. The separation of use from ownership can be important in high-risk environments. The employment of a lease rather than a loan in less-developed countries may avoid the appearance of a high debt to the West. A lease can be structured to give the lessee a choice or mixture of currencies for repayment, thus providing better management of currency risk and better asset/liability matching.

The vendor/exporter who can offer leasing to overseas customers, in addition to other financing alternatives, clearly will gain a competitive edge in a world market increasingly conscious of the high cost of financing. An increase in export sales is a likely result. In addition, the development of a working relationship with a leasing company willing to finance the vendor's product in one or more overseas markets under a classic "vendor program" will help accelerate the credit analysis and decision-making process with respect to such foreign customers and will enable the vendor to insure an adequate supply of funds at a cost known in advance. The vendor can even realize a better control over the after-market in used equipment, through remarketing or repurchase arrangements with the leasing company. In an era of flat or falling domestic productivity, the availability of the leasing device can be of critical importance to the manufacturer seeking to increase its sales overseas.

Lastly, a lessor offering leasing as an international financial service can realize a significant new source of profits, greatly expand its existing customer base and provide increased service to its exporting vendor/customers. Creative transaction structuring, making maximum use of available export funding and tax and other fiscal incentives, often can result in significantly higher yields on funds employed than in the domestic market. In addition, having title to an asset rather than a mere lien or security interest will often give the lessor a higher degree of security in the event of a default by a lessee. In many cases, this will make the transaction easier and less expensive to document. The development of both public and private credit risk and/or political risk insurance programs geared to the leasing device also offers the international lessor additional protection against the increased risk inherent in medium-term financing overseas.

However, it is just as clear that there are a number of problems which must be addressed by both the public and private sector if the U.S. leasing industry and U.S. manufacturers are to remain competitive in the current world trade environment and realize the growth opportunities presented. These problems are in large part interrelated and essentially revolve around the twin issues of *yield* and *risk*. "Yield" is the total after-tax return to the lessor in any given transaction. "Risk" is the quantification and analysis of all those factors inherent in any given transaction which affect the lessor's perception of lessee ability to repay and, if repayment does not occur, the existence of other remedies and the ease and rapidity with which they can be exercised. In a free market, yield and risk are directly proportional; the higher the perceived risk, the higher the yield, and vice versa. If a contemplated activity does not meet yield requirements at least as high as other domestic or international financial activities, or if the risk perceived is greater than the anticipated reward for engaging in such financial activity, then there is little or no incentive from a purely financial point of view to engage in that activity. It is no different in the leasing business.

Following is a brief summary of the major impediments to the expansion of the international leasing business which affect these two basic factors and which are found within our own U.S. institutions and regulatory framework.

RISK

In general, neither U.S. financial institutions nor U.S. manufacturers of capital equipment, except for the very largest and most sophisticated of each,

have ever had attractive incentives to export their products and services. The U.S. domestic market for each is so large, foreign markets are so fraught with peril and uncertainty, and the complexity of issues facing an exporter or a financier without considerable expertise are so overwhelming that many make a deliberate choice to forego export markets. Lessors examining potential overseas markets see unquantifiable or, at best, increased risks including an inability to assess political and credit risk, an inability to protect against these risks should they materialize and, more generally, uncertainties in any given foreign market which may affect the viability of the transaction itself.

Failure of our government to address these risks include:

(1) *The lack of a well-publicized, simplified and flexible export credit insurance program covering export financing through leases*—It is crucial to the U.S.-based lessor's ability to extend activities to foreign markets that the U.S. government develop an export credit and political risk insurance program which encompasses lease transactions of exported equipment. Although the U.S. Export-Import Bank (ExImBank) and the Foreign Credit Insurance Association (FCIA) have a lease program in place, neither organization has a staff familiar with leasing, and neither has given the program any support or publicity. The program itself has been little used, largely because of its lack of flexibility and its failure to permit international lessors to offer leasing customers many of the traditional advantages of leasing (e.g., 100% financing).[21] ExImBank and FCIA have periodically undertaken a review of the existing program, but such past reviews, despite support at the highest levels of ExImBank, amount to little more than lip service to the leasing industry. Any substantive changes are anticipated to be slow in coming, if at all. ExImBank has currently initiated another review of the program in coordination with leasing industry representatives, and it is hoped that a new leasing program can be devised and implemented which will meet the needs of the leasing industry.

There are signs that other developed exporting countries and their respective counterparts to ExImBank and FCIA are also feeling considerable pressure to revise the internationally agreed-upon framework for export-related credit insurance and subsidies. ExImBank/FCIA have traditionally rested their long-standing resistance to unilaterally developing an effective export credit insurance for leasing on this framework.[22] The Organization for Economic Cooperation and Development (OECD), of which the U.S. and most other industrialized countries are members, has undertaken in early 1984 an extensive review of the role of OECD-based financial institutions in financing the development process through leasing. While the results of this review will not be available to member countries until mid to late 1984, it is hoped that the results will evidence both the important role leasing can play in the development of capital markets in less-developed countries (LDCs) and the urgent need for each OECD country to develop effective and usable lease credit insurance programs.

Another positive note in this area has been the development of an insurance program by the Overseas Private Investment Corporation (OPIC), a self-sustaining U.S. government agency whose purpose is to promote economic growth in LDCs by assisting the U.S. private sector there. Coverage under a comprehensive political risk insurance program providing coverage to international lessors engaging in cross-border leasing is now available. However, the program is one of relative low visibility, offering coverage of only certain well-defined political risks, and does not, for statutory reasons, cover any credit risks. In addition, because of its focus on LDCs, OPIC has been unable to attract U.S. lessors who have their focus on larger and more economically viable markets.

(2) *A lack of a centralized source of information and expertise covering international leasing*—There is a general absence within the various departments and agencies of the U.S. government of any sources of information covering issues which are likely to arise in a contemplated foreign lease transaction. Although much of the information can be provided by foreign counsel knowledgeable in the leasing business, there is a good deal of general threshold information which could be provided by ExImBank and/or the Commerce Department.

Information on a variety of areas, all related to the particular foreign market in question, is necessary and generally falls into the following categories:

- "Doing business" issues such as the right of a foreign company to engage in the lease of personal property, registration, continuing regulatory aspects and limitation of activities;

- Monetary issues such as exchange controls, restrictions on foreign investments, and currency parity if other than a local currency is used as a base for lease payments (e.g., restrictions on remittances, convertability limitations, necessity to register lease transactions to insure ability to repatriate funds, and potential effects of a devaluation of the local currency);

- Tax issues peculiar to the foreign market under consideration, such as the availability of allowances on the capital cost of the equipment and who can claim them, permissible methods of depreciation, tax treatment of rental income to the lessor and of rental payments by the lessee, tax treatment of equipment disposal proceeds and the use of renewal or purchase options;

- Import restrictions and other customs problems relating to the import of foreign equipment and the duties assessed thereon;

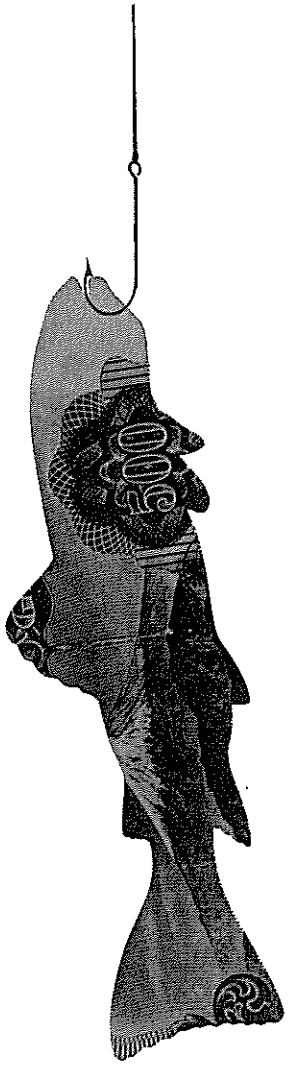
- Problems relating to the protection afforded an equipment lessor's interest in leased assets, both at the outset and upon and after a default by a lessee (i.e. creditors rights generally, the existence of a well-defined leasing law, rights of lessor in the event of claims by third parties or of bankruptcy of the lessee, ability of a lessor to

repossess and/or repatriate the leased equipment);

• Permitted provisions of a lease contract (e.g., "hell or high water" clauses, applicability of laws in respect to the sale of goods and any warranties attaching thereto, and civil liability problems).

YIELD

The nature of the leasing business worldwide as an innovative and adaptive financial service utilizing a variety of new techniques by which companies may more expeditiously fulfill their capital equipment requirements is the very reason why an extension of credit through leasing usually commands a higher yield to the lessor than a more traditional loan transaction. The usually greater assumption of credit and collateral value risks by a lessor, coupled with the ability to identify and quantify all of the various profit factors, including tax benefits, and to allocate these most efficiently through creative structuring, clearly justifies an increase in overall yield to a lessor. It is an undeniable fact that the U.S. leasing business is largely dependent for its growth and profit on its ability to use U.S. tax benefits which flow from the ownership of capital equipment. Given the finite resources of leasing companies and the current domestic U.S. market permitting relatively high yields in leasing transactions, the majority of U.S. lessors have found that, except for the big-ticket leveraged leases of transportation-related equipment, most international leasing transactions are not as attractive as domestic transactions. Pricing cannot both offer a profit in excess of the yield resulting from a comparable domestic U.S. transaction, and still remain competitive to the foreign lessee. Even if the lessor can price attractively a cross-border leveraged lease in which U.S. tax incentives make up a significant component of its after-tax yield to the lessor, such tax benefits may be unusable on its U.S. consolidated tax return.



These yield-related problems may be capsulized as follows:

• *The lack of a competitive program of export funding relative to leasing*—Despite the need for U.S. exporters of capital equipment to offer financing packages for their products which are competitive with those offered by other exporting industrialized countries, the ExImBank has reserved its limited funding resources for a small group of big-ticket traditional transactions. ExImBank has been unable or unwilling to devote the human resources necessary to develop and promote programs, among them a leasing program, available to a broader range of U.S. financial institutions and exporters. The Bank has traditionally pleaded lack of financial resources in this area, with some justification given its constant battle for funding appropriations and, indeed, for its very existence.

• *Lack of U.S. tax incentives available for equipment leased overseas*—Generally, a U.S. lessor of capital equipment leased to a U.S. lessee under a so-called "guideline lease" is treated as the owner of the equipment for tax purposes. The lessor is therefore entitled to receive U.S. tax incentives, principally investment tax credit and depreciation. As for the availability of ITC to equipment leased by a U.S. lessor but used outside the U.S., the general rule is that this property is not eligible for ITC.[23] The exception to the general rule lists certain categories of mobile and transportation-related equipment which are eligible for ITC regardless of predominant use.[24]

With respect to depreciation allowable on leased equipment, the rules in existence prior to 1981 depended on the nature of the asset and its expected useful life, and did not set up any serious inequities based on where the equipment was used. However, in an effort to stimulate U.S. productivity, the passage of the Economic Recovery Tax Act of 1981 (ERTA) dramatically changed the rules with the introduction of the acceler-

ated cost recovery system (ACRS). ACRS established four categories for depreciation—three, five, ten and 15-year property—with most capital equipment depreciated over five years. However, a separate set of less favorable recovery rules applies to assets used predominantly outside the U.S. The "recovery period" for non-U.S. personal property is the asset depreciation range (ADR) midpoint in effect on January, 1981 (12 years if the asset has no ADR class). The recovery percentage allowable is based on the 200% declining balance method with a switch to straight line at the optimum point.

The foregoing tax structure has essentially restricted the cross-border leasing business to that limited group of assets qualifying for ITC and accelerated depreciation under ACRS. However, even these well-defined exceptions are now under attack by several pieces of legislation now pending in Congress, the Pickle-Dole legislation cited earlier. The Pickle-Dole bills would extend the denial of investment tax credit and accelerated depreciation to any property used by any foreign person when income from the property is not subject to U.S. tax. Should these proposals be enacted, U.S. lessors engaged in this kind of leasing would be placed at a severe disadvantage with foreign lessors. More important, U.S. exporters would find that the cost of their products will significantly increase abroad and that many prospective foreign customers will fill their equipment needs with foreign manufacturers who can offer more attractive financing.

• *Inability of U.S. corporations to use available tax incentives*—Generally, all U.S. corporations are subject to U.S. income tax on their worldwide income, including "foreign source income." If foreign source income is also subject to a foreign income tax, the IRS allows such tax as a credit against the U.S. entity's tax liability. However, under Section 904 of the Internal Revenue Code, the amount of foreign tax creditable in any one tax year is limited according to the following formula:

$$\frac{\text{foreign taxable income}}{\text{total taxable income}} \times \text{U.S. tax (on taxable income)}$$

Because of the availability of some form of depreciation and ITC in selective cases of equipment used outside the U.S., it is probable that "foreign source losses," rather than foreign source income, may be produced in a leasing transaction where the leased property is used outside the U.S. This can have a significant adverse effect on the tax position of a U.S. lessor already paying substantial creditable foreign taxes. It reduces both the numerator and denominator of the above-mentioned fraction, thereby reducing the amount of U.S. tax liability against which foreign tax credits may be applied. In such a situation, a leasing company contemplating an international leasing transaction may be effectively precluded from entering into it. Moreover, since the calculations required by the IRS in computing foreign source income/loss occur prior to the utilization on a U.S. tax return of any domestic U.S. tax benefits, principally ITC and depreciation, a leasing company conducting a substantial tax-oriented domestic business may find itself in an even worse position by being unable to fully utilize domestic tax incentives on which the profitability of U.S. tax-oriented leasing largely depends.

Another tax disincentive to engage in international leasing is found in a section of the Internal Revenue Code known as "Subpart F." While a detailed treatment of Subpart F is beyond the scope of this brief summary, its provisions generally apply to foreign corporations controlled 50% or more by U.S. shareholders (controlled foreign corporations) which can be made liable under certain circumstances for U.S. income tax on certain undistributed income (Subpart F income). Under certain circumstances, lease rental income and interest income earned by a leasing company organized under the laws of a foreign country but classified as a controlled

foreign corporation could be subject to current U.S. income tax, even if income is not distributed to the owners.

In addition to these problems found within our own institutional structure, there is also a wide variety of problems faced by U.S. lessors in otherwise attractive foreign markets. These problems have deterred all but the largest and most sophisticated of U.S. lessors from committing the resources necessary to develop a meaningful and continuing international leasing program. These large U.S. lessors, along with their European and Asian counterparts, have demonstrated admirable innovation and adaptability in their aggressive pursuit of foreign market share, and as a result have largely prospered from their hard work.

Impediments

The following section is intended to graphically illustrate those restrictions and impediments which prevent U.S. lessors from competing fairly and effectively in many foreign markets. Certainly, many of these complaints are also true for nonfinancial sectors of U.S. business seeking to compete in foreign markets. This should give our government a greater incentive to work toward a resolution of common problems.

In addition, many of the constraints simply have arisen because foreign governments have failed to legislate as quickly as required the changes necessary to adapt their respective legal and tax systems to the needs of the international leasing industry. Leasing's rapid growth has simply outstripped the ability of such governments to evaluate the benefits of this new financial tool to their own economies against other competing national policies. Governments have not kept pace with multinational leasing companies who see financial gaps to be filled and market opportunities to be pursued. But those foreign governments which have actively encouraged technical assistance from foreign lessors in promulgating new leasing legislation and in fostering the growth of a domestic leasing business through adaptation of their capital markets are expected to reap economic benefits throughout their economies.[25]

The following discussion also is intended as a working agenda for the U.S. government when dealing with foreign governments on issues affecting the export of U.S. service industries in general, and the export of U.S. capital and expertise in the leasing business in particular.

CROSS-BORDER LEASING

• *Restrictive effects of withholding taxes*—Most countries, including the U.S., levy a "withholding tax" on a variety of remittances to entities located outside its taxing jurisdiction as a means of taxing income earned within its borders but not otherwise taxable. It is called a withholding tax because it is withheld at the source by the obligor remitting to the foreign entity. Most countries, whether by an across-the-board ruling or by specific tax treaties between itself and other powers, include *inter alia* a category for interest remitted abroad. However, remittances to be made to a foreign lessor often may be accorded treatment inconsistent with the financial characteristics of the transaction, either because the existing rules simply did not contemplate financial leasing when agreed upon or because no rules exist at all. This can have the anomalous effect of taxing lease payments at a much higher rate than interest income, or of taxing the entire lease payment without any attempt to allocate between the principal and interest components of a given payment. This is a complicated subject because of the ingenuity of lessors in structuring a wide variety of leases with varying payment structures; however, the intent in all cases should be to place a financial lease on an equal tax basis with a comparable loan.

• *Restrictions on terms of financing*—In deciding whether to enter into a cross-border lease, a U.S. lessor first must examine the powers it may exercise and the restrictions applicable to it as a foreign entity. Its powers and rights may be limited when compared to a domestic entity, and it even may be excluded from whole segments of the economy or from owning certain assets otherwise financable through a loan. It may find in any given transaction that the transaction itself may face lengthy and expensive qualification and registration procedures at the central bank, finance ministry or the like, whose approval may be purely discretionary and often designed to restrict or exclude certain transactions. Such approval procedures may also require transactions to conform to a variety of transactional parameters, perhaps even against the desires of both the lessor and lessee. These may include a maximum effective interest rate, a minimum or maximum lease term, and even required grace or amortization periods. A lessor may find that certain government subsidies (e.g., tax holidays, grants, tax forgiveness, or equivalents to the U.S. investment tax credit) which are available if the proposed lessee had acquired title to the asset, are often not usable by either a financial lessor or the acquirer of the equipment, thus putting the proposed lease on an uncompetitive footing when compared to a loan of similar terms. Once the lease is consummated, remittances to be made by the lessee may face further problems of an exchange control nature, such as restrictions on remittance to the lessor or convertability limitations if the lease payment is denominated in a currency foreign to the lessee.

• *Limitations on importation of capital equipment*—Many countries limit or exclude imports of certain kinds or origin of capital equipment, usually for balance of payments reasons or to protect fledgling or even mature national industries. A *de facto* exclusion also

may arise when the procedures to obtain import permits or licenses are exceedingly lengthy or costly or if customs duties are so high as to make import of such equipment too expensive when compared with a local or favored third-country alternative.

Such practices are well documented by a wide variety of U.S. manufacturers and need no elaboration here. Suffice it to say that U.S. export financing in general and the U.S. cross-border leasing business in particular suffer extensively from such limitations on free trade. The U.S. government should exert considerable pressure against offending governments to eliminate or at least minimize such practices.

As a side issue, it should be noted that such restrictions can be turned to the advantage of the U.S. cross-border lessor. By definition, a cross-border lessor holds title to leased equipment outside the lessee's country. In many cases, the foreign government can be persuaded in its own interest to permit the import of such equipment under cross-border lease financing, since it may not be counted in balance of payment or external debt calculations if the transaction is properly structured. The prospective lessee also may find that, because title to the equipment is held outside the country, it may be able to defer or even eliminate customs duties, which may be substantial.

• *Failure to accept ExImBank/FCIA/OPIC programs*—Assuming that ExImBank and/or the Foreign Credit Insurance Association (FCIA) eventually can develop a variety of lease programs which focus on broad parameters affecting their respective risks, foreign governments should and probably could be persuaded to accept the broad terms of such a program, as they have accepted similar loan financing, so long as the transaction accords with local law.

With respect to the Overseas Private Investment Corporation (OPIC), it should attempt to accelerate its negotiation and implementation of bilateral agreements between itself as an agency of the U.S. government and the various LDCs which it has targeted for assistance, inasmuch as the benefits of its lease program are unavailable in countries with which it has not concluded such as agreement. Also, U.S. lessors engaged in cross-border leasing may find such LDCs too small or otherwise too risky to warrant the investment of considerable funds in an occasional transaction. OPIC should seek appropriate changes in its enabling statutes permitting it to make lower cost funds available to such lessors than are otherwise attainable in usual capital markets. This would be accomplished either through its own resources or by subsidizing and/or issuing guarantees to the supplier of such funds, while at the same time allowing or perhaps guaranteeing the lessor that such transactions will return to it a better-than-average yield despite the reduced risks.

SUBSIDIARY OPERATIONS

• *Restrictive tax policies*—U.S. multinational leasing companies often want to make an intercompany loan to a foreign leasing subsidiary in order to insure adequate financial support for its present or projected level of local activity. They often may find that repayment of such loans, considered the *de facto* equivalent of an additional equity investment, will be subject to local withholding tax, thus indirectly making the local company's cost of funds higher. As a result, the U.S. multinational is less able to compete effectively with locally financed entities and the cost of equipment financing for local lessees is ultimately increased.

The leasing company may also find that it faces excessive taxation on foreign exchange operations or on remittances of normal dividends to its parent, thus reducing the value of the investment to the parent and inhibiting its future growth.

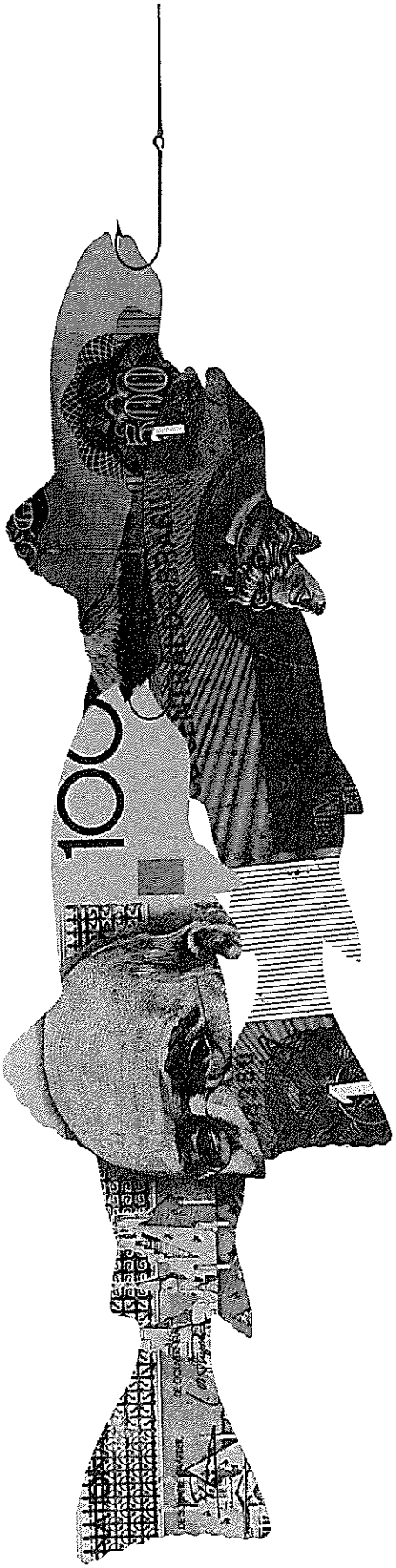
• *Restrictions on right of establishment and operations*—U.S. based leasing companies often may find that they may be excluded effectively from establishing a leasing subsidiary in a particular foreign market. Licenses to establish and operate a leasing subsidiary are often granted in an openly discriminatory or arbitrary process, or the process to obtain such a license may involve as much as several years of expense and waiting. In some countries the criteria for obtaining such a license, whether articulated officially or not, may be so narrow that they exclude all but a handful of persistent lessors.

The licensing process may also require that the prospective foreign investor be limited to a certain minority ownership position, reserving the balance of equity for local investors. While the existence of a local co-investor may be desirable under some circumstances, it can drastically slow down the development of the venture as a market force while the local partner educates its people, and can reduce considerably the value of the investment to the U.S. lessor by forcing it to share profits disproportionate to its considerable investment in funds and management. The U.S. lessor also may find itself with practical management and control problems. Local personnel supplied by the partner owe their ultimate allegiance elsewhere and may have management goals and investment objectives in mind which differ considerably from the U.S. investors. These conditions make it difficult, as well as inefficient, to effectively manage the company.

Such ownership restrictions generally are found in less-developed countries, especially in Latin America and more particularly in the Andean Pact countries. The restrictions usually have the avowed purposes of restricting control of the financial sector by foreign entities, forcing such entities to finance more than their respective share of the financial requirements of the entity through further injections of loan funds, and insuring the transfer of leasing expertise to a local financial entity. As a practical matter, such efforts usually seem to be counterproductive, as leasing expertise is freely available and local entrepreneurs

usually have been able to set up and obtain funding for their own local entities. In any event, it is a restrictive practice which the U.S. government can and should work to eliminate.

Once the U.S.-owned leasing company is established locally, it may find that as a foreign company, it is restricted from financing certain industries or equipment reserved for local companies. It even may find itself limited in leasing activities involving the financing of capital equipment requirements for local subsidiaries of U.S. multinationals.



• *Financial restrictions*—Prior to commencement of local operations, the U.S. leasing company/investor may discover that local law mandates a debt/equity ratio either less advantageous than that permitted for local companies or simply inappropriate in light of the world-class nature of the U.S. investor and the financial strength it brings to the venture. It also may find when it seeks to satisfy its working capital needs that the terms of intercompany loans the parent may desire to make, or even the terms of loans to be made by third-party foreign financial institutions, may be the subject of inappropriate or restrictive legislation.

If a U.S.-owned leasing company does manage to arrange intercompany or third-party loans, usually in U.S. dollars, it may be severely restricted in its hedging activities, so necessary to protect from shifts in the value of the local currency. Such activities quite often are limited to hedging of the leasing company's registered capital only, leaving remaining hedging to be done outside the country, usually at considerable extra cost. If it seeks funding on the local market, it may find itself restricted as to the amount or nature of such borrowings, and quite frequently will find also that locally owned entities may be able to access preferential government-sponsored long-term low-rate funding from which it is excluded. If it turns to the public capital markets, it often will be severely restricted in its issuance of stock, debentures or other local debt instruments, while local companies may be freer to engage in these activities.

Once its sources of funds are in place, it may find that there exist severe restrictions on its power to declare and remit dividends to its parent. These may take the form of an explicit formula related to a percentage of its capital or yearly profits, or an implicit restriction through the use of a lengthy and required permit process. Even an outright prohibition against remittances of any such funds can occur if exchange controls are imposed.

If a prospective lessee is foreign-owned, there also may exist restrictions on a lessee's access to local currency financing. This sometimes is reserved for local companies, forcing the foreign-owned lessee to import its capital at a sometimes-higher expense and in a foreign currency.

All of these restrictions may place the foreign-owned leasing company in an extremely uncompetitive position vis-a-vis its local counterparts, undoubtedly slowing its growth as a vigorous source of local capital, and usually resulting in increased costs to the local lessee.

• *Limitations on import of capital equipment*—As in the cross-border area, local leasing companies may be unable to offer financing for imported equipment. If they can, they may find that import procedures are so cumbersome and lengthy and import duties so expensive, that they effectively are restricted from that market.

Recommendations

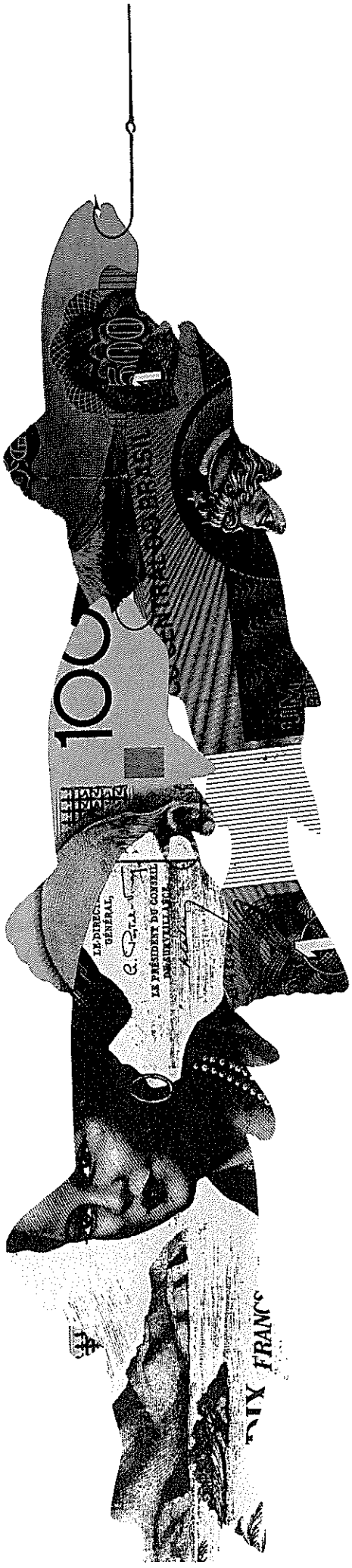
While there are no easy solutions to all these problems, the recommendations which follow can serve as the basis for a dialogue between the U.S. leasing industry and U.S. and foreign governments. Over time, such dialogue should improve the competitive position of the U.S. lessor abroad, maximize its attractiveness as an exportable service industry, and ultimately

increase U.S. export of capital equipment.

(1) ExImBank, in cooperation with the U.S. leasing community, must develop and implement a simplified and flexible export credit and political risk insurance program for U.S.-manufactured capital goods leased to a foreign entity. Once developed, the program's terms and conditions, availability and premium cost should be published formally and made available to all U.S. vendors of capital equipment and U.S.-based lessors, their subsidiaries and affiliates. While a detailed analysis of such a program is beyond the scope of this presentation, the terms of such a policy issued thereunder should include as a minimum:

- A definition of the insured party to include foreign-incorporated lessors that are wholly or partly owned by a U.S. parent;
- Provisions permitting payments under a lease to be made in any currency, at any place designated by the lessor under the lease, and, as a corollary, perhaps offering or requiring currency risk coverage;
- Provisions permitting financing of 100% of the cost of the equipment;
- Provisions permitting a lessor and lessee to structure and negotiate a lease transaction which fits each of their respective needs and/or the requirements of local law, specifying only broad parameters (e.g., maximum and minimum lease term, minimum frequency of payments, nature of permitted end of lease options);
- Provisions providing for the use of such policy for both a one-time transaction as well as in a "master lease" situation (i.e., where a series of leases are covered under one master line of credit).

Such a program should be designed with a premium structure which is cost effective, so that the program pays for itself. Application and approval procedures should permit the use of the program in a timely fashion, at the point of sale if possible. Small transactions (e.g., under U.S. $100,000) would be approved automatically if certain credit and transactional criteria were met, whereas transactions of a larger size could be subject to graded levels of credit approval according to size. The most important administrative feature of such a program would be responsiveness: If a transaction takes more than thirty days to obtain coverage, the program would be useless. The lessee often will see financing as an integral part of its decision to acquire equipment and often can be expected to fulfill its equipment needs elsewhere if it cannot obtain rapidly a financing commitment.



(2) ExImBank must initiate a program permitting easier and more expeditious access to its resources by U.S. lessors involved in smaller-ticket cross-border leasing transactions. ExImBank traditionally has believed it to be more cost-effective to allocate its limited resources to fewer transactions involving big-ticket items such as aircraft. While the need for support of this kind of transaction is unquestioned, the much larger community of smaller-ticket capital equipment exporters virtually has been excluded from access to Bank funding. The Bank's policies in this area should be given careful scrutiny and possibly revised to allocate some of its resources to other significant portions of the export market.

It also seems clear that ExImBank's power to guarantee leasing transactions is largely unexplored, and the establishment of a program of various types of guarantees would serve to attract lower cost funds from the private sector to cross-border leasing transactions without draining ExImBank's available and severely limited cash resources. For example, ExImBank could issue guarantees covering the timely remittance of lease payments, cover debt associated with a leveraged lease, or even cover a minimum market or resale value of the equipment at the end of the original lease term (i.e., residual value guarantees). Each of these guarantees would have

the immediate effect of making the ultimate cost of U.S. equipment less costly for lessees, would attract private-sector capital new to the leasing business, and would make possible a wider variety of lease transactions. Again, the program could be structured so that fees charged to the lessors would pay for the cost of the program itself and any losses incurred thereunder.

(3) A model tax treaty provision clearly spelling out the treatment to be accorded both cross-border financial leasing transactions and investments by U.S. multinational leasing companies in foreign leasing companies should be developed and implemented as soon as possible. The OECD recently has issued a report recommending the removal of withholding taxes on cross-border leasing transactions.[26] While the report is only a recommendation and covers only one aspect of the various tax matters affecting international leasing, it should serve as a point of departure when tax treaties are renegotiated among OECD countries. However, any such tax treaties, as well as others involving LDCs, should clarify *all* taxes and other payments applicable to cross-border leasing transactions, payments to be made thereunder and/or the equipment leased thereunder (e.g., withholding taxes, sales/value-added taxes, customs and import duties applicable to equipment leased under a cross-border lease, who is responsible for paying them and when, and in general, the tax treatment of all lease payments remitted from the lessee to the foreign lessor). In addition, the ability to remit dividends resulting from such foreign investments and the treatment of interest on intercompany loans made by a parent to such a venture also must be delineated clearly.

(4) The provisions of the Pickle bill and related legislation now pending before Congress, and likely to become law by the time this article appears, should be modified to permit U.S. lessors to again claim ITC and depreciation previously permitted under a lease of capital equipment, wherever manufactured, to a "foreign person," even though the income from the property is not subject to U.S. tax. As a fallback position, such an amendment could permit the use of U.S. tax incentives on cross-border leases of U.S.-manufactured equipment only. Either position would allow U.S. lessors to continue to lease transportation-related equipment, most of which is made in the U.S.

(5) The use of federal tax policy to motivate American business is only one of many tools available to the federal government and any changes must balance carefully the need for revenue against the anticipated benefits in the areas of domestic productivity and balance of payments. It may be debatable whether the policies our government seeks to further are appropriately accomplished through tax laws. However, given the fact that the U.S. domestic leasing business finds its strength and dynamic growth rooted in federal tax law, efforts should be made to find an acceptable package of tax incentives applicable to U.S.-made equipment leased abroad by U.S.-based lessors, which puts such transactions more nearly on a par with domestic leasing transactions vis-a-vis yield for the lessor.

The following are suggested, although by no means all-inclusive, proposals for change in federal law. The implementation of one or more of these would go far to encourage U.S. lessors to increase their current volume of international leasing business, increase U.S. exports and add to a more favorable balance of payments.

- *Alter present policy to make new U.S.-manufactured equipment, owned by a U.S. leasing company but leased abroad, eligible for all or some portion of tax incentives available inside the U.S.* Such a change in policy could be tailored to reach other objectives if desired (e.g., to encourage export sales of certain categories of industrial equipment). It also could be made applicable to certain large transactions lending themselves to cross-border leasing.
- *Pass legislation permitting U.S. leasing companies, owning all or part of a foreign leasing company, to take a credit against its overall U.S. tax liability or a deduction from its worldwide income of some percentage of the acquisition cost of all U.S.-manufactured capital equipment purchased by such foreign leasing company and leased to foreign lessees.*
- *Revise the existing tax law to permit "foreign source losses" generated by cross-border leasing transactions to be excluded from the calculation required by Section 904 of the IRC.* This would eliminate the effect of "foreign source losses" on the amount of foreign credits applied against U.S. tax liability.

(6) ExImBank should establish a division staffed with personnel knowledgeable in the leasing business. They should have overall responsibility for the development and implementation of export leasing programs, as well as the structuring and facilitation of transactions involving U.S. equipment exports and lease financing. Such a division also could serve as the repository of a centralized pool of information covering issues which are likely to arise in a contemplated foreign lease transaction, as well as a resource bank through which U.S. exporters could reach U.S.-based lessors operating in the foreign market to which equipment is being exported.

(7) The U.S. Commerce Department should undertake a country-by-country review of practices restricting entry to and fair competition in foreign leasing markets by U.S.-based lessors. The restrictions detailed herein are by no means all inclusive or even typical of any one country. An effort should be made to identify restrictions where they exist and persuade the government in question to modify, reduce or eliminate such restrictions.

The Future of International Leasing

The U.S.-based community of international lessors will be presented with numerous opportunities to extend

operations and investment to a wide variety of foreign markets in the 1980s and beyond. The feasibility and attractiveness of such opportunities will depend in large part on an active and consistent policy of U.S. government support for U.S.-based international lessors, together with appropriate programs to facilitate the continued expansion of the industry.

Foreign governments must be persuaded to reduce or eliminate the constraints inhibiting the growth of leasing. The consequences of U.S. government support of the equipment leasing industry undoubtedly will be a more rapid expansion of existing activities, the entry of new U.S. lessors into more receptive foreign markets, a more favorable balance of payments and an increase in U.S. capital equipment exports.

Footnotes

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23. U.S. Internal Revenue Code (IRC) Sec. 48(a)(2)(A).

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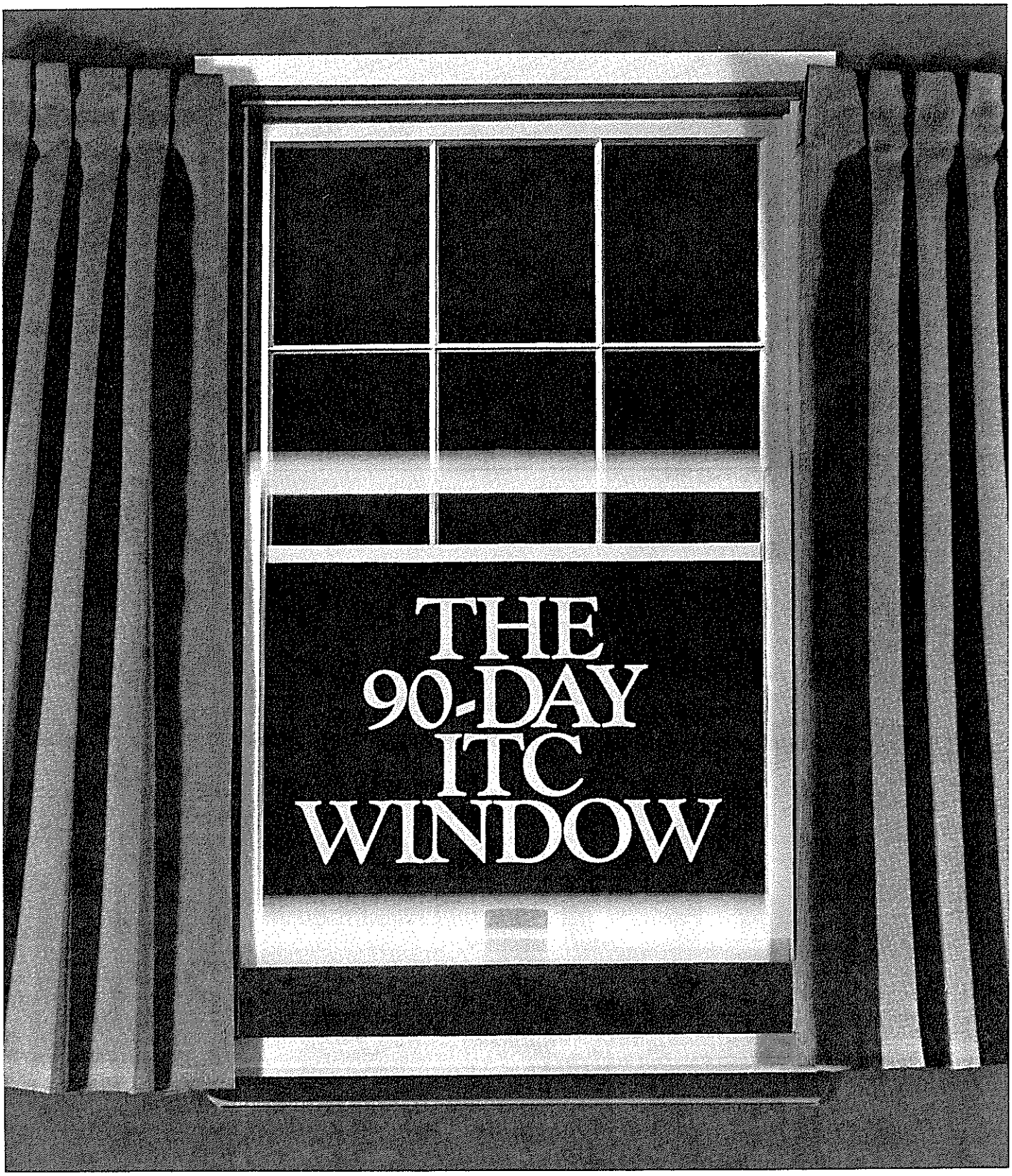

Tailoring the Emperor's New Clause

by Barry S. Marks, Esq.

Editor's note: The following article was initially prepared before passage of the Tax Reform Act of 1984. An addendum discussing the important changes made by the Joint Conference Committee has been included by the author.

Amid the furor over the demise of safe harbor leasing and the tortuous birth of TEFRA's "finance lease," congressional amendment of section 48(b) of the Internal Revenue Code went virtually unnoticed.[1] Effective for equipment placed in service after December 31, 1983, this liberalized definition of "new section 38 property" may prove one of the most useful of the recent amendments to the Code to those able to avail themselves of its benefits. However, it may serve as a trap for the unwary and stifle many creative lease structures.

A Panacea for "First Use" Problems?

The amendment discussed herein consists of a single, seemingly clear sentence added to the end of section 48(b): "For purposes of determining whether section 38 property subject to a lease is new section 38 property, such property shall be treated as originally placed in service not earlier than the date such property is used under the lease but only if such property is leased within three months after such property is placed in service." section 48(b), as amended.

On its face, this language would seem a panacea for some of the difficulties encountered in nonsafe harbor leasing. Prior to the amendment, the language of section 48(b)(2) (which has not itself been altered by TEFRA) stood as an unmitigated requirement that the equipment lessor own the relevant property at the very instant of its first use: "...the term 'new section 38 property' means section 38 property...(2) acquired after December 31, 1961, if the original use of such property commences with the taxpayer..." section 48(b).

Indeed, the regulations under section 48 distinguish "new" and "used" section 38 property without attempting to ameliorate the rigid language of the Code section: "The term 'original use' means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer." Regulation § 1.48-2(b)(7).

Thus, it was left to the Internal Revenue Service (IRS) and the courts to soften this rigidity through rulings and cases which would recognize the difficulties inherent in such a formalistic pronouncement. Some adjustment was forthcoming, such as liberalized rules permitting equipment testing and clarifying that the first use date was the date installation was completed.[2] Additional liberalization was created by various industry practices, usually with the equipment vendor's assistance, ensuring that the delivery and acceptance date on which "original use" occurred matched the lessee/lessor acceptance date. For many lessors, the existence of a purchase order assignment and invoices naming the lessor, was deemed sufficient evidence to stare down even an aggressive IRS auditor.

One principal difficulty remained: A lessee desiring to lease/finance an entire portfolio of equipment could do so only by designating the equipment with some degree of specificity at the time the lease was executed. This would serve as the basis for a master lease which could be executed in advance. Lessee flexibility was obviously restricted. At the same time, a lessor was left with an outstanding commitment, with both parties exposed to fluctuating market rates, unforeseen increases or shortfalls in the lessee's equipment needs, delivery delays or accelerations, and other contingencies.

With the advent of safe harbor

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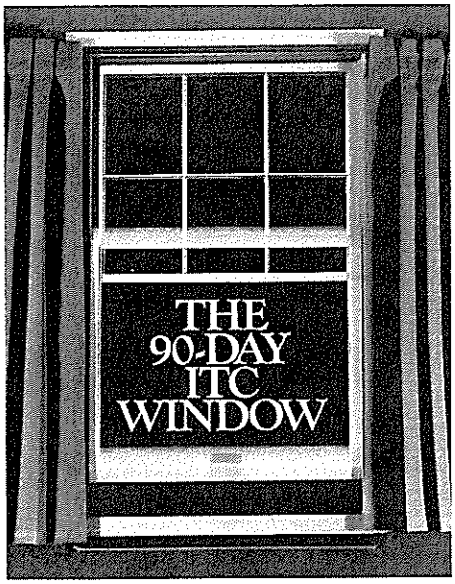


leasing under the Economic Recovery Tax Act of 1981, much of this problem was solved. Section 168(f)(8)(D) permitted the safe harbor leasing of "qualified lease property." Such qualified property included both: "(i) New section 38 property (as defined in section 48(b)) *of the lessor* which is leased within three months after such property was placed in service and which, if acquired by the lessee, would have been new section 38 property of the lessee, [or] (ii) property - (I) which was new section 38 property *of the lessee*, (II) with respect to which the adjusted basis of the lessor does not exceed the adjusted basis of the lessee at the time of the lease...." section 168(f)(8)(D)(emphasis added).

The bifurcated nature of the section permitted *two* types of 90-day windows for "new section 38" benefits: First, property, used by the lessee for up to three months before acquisition by the lessor, but originally titled in the lessor; and second, property owned and used for up to three months by the lessee prior to being subjected to a sale to and leaseback from the lessor. Thus, the formalism of the old rules was discarded: Regardless of who took title or at what moment the equipment was placed in service, the lessor could take investment credit for new property.

This was particularly important for sale-leaseback transactions, as the prior cases, rulings and regulations made it clear that the lessee's prior use prevented any investment credit (for new or used property) being taken by the lessor.[3]

When Congress did away with safe harbor leasing under the Tax Equity and Fiscal Responsibility Act, it was apparently decided to retain this favorable 90-day window. In describing legislation, the Senate report characterized the usefulness of the provision as follows: "[T]he 90-day window in the safe-harbor rules encourages businesses to use the safe harbor because they need not finalize their lease by an exact date on which the property is put in service. Under prior law, if a sale and leaseback was entered into after the property was placed in service, the property could be characterized as used property and subjected to the limits on investment credit for used property."[4]

The House conference report added the following: "Under the conference agreement, leases that qualify under *nonsafe harbor* rules are allowed *the same* 90-day window presently allowed for safe harbor leases. Thus, property subject to a nonsafe harbor lease will be considered new property if it is leased within 90 days after the property is placed in service. *In addition*, the conference agreement establishes a new category of leases referred to as finance leases."[5]

The intent of Congress was clearly stated: The *same* 90-day window as existed under the defunct section 168(f)(8)(D) was to be available to *any* nonsafe harbor lease. (The new 90-day window was added to section 48(b), not to the finance lease rules in new section 168(f)(8). Some commentators originally characterized the 90-day window as only available in TEFRA finance leases, which is in error.)

Nowhere will this intent be more important than where a lessee needs to finance an entire portfolio of equipment by accumulating numerous items to be leased in a single transaction. This "warehousing" potential of amended Code section 48(b) is probably its most important feature. It is submitted that Congress intended to facilitate these useful structures. Unfortunately, the new sentence leaves much of the leasing community exposed to uncertainty and potential disaster.

Old Problems, New Problems

Sale-Leasebacks

With its heart apparently in the right place, Congress thus continued its peripatetic overhaul of the leasing-related provisions of the Code. Unfortunately, it has been left to the leasing community and state jurists and legislatures to fall into step without federal guidance. Moreover, it remains up to the Internal Revenue Service to apply the new section 48(b) language to the very valuable warehousing leases.

In general, many problems applicable to transactions seeking to utilize the 90-day window indicate a different result in leases where the lessor takes title initially and in sale-leasebacks. Most are inherent in sale-leasebacks of all types. As evidenced by the confusion in the state revenue departments and legislatures over treatment of safe harbor leases documented on a sale-leaseback basis, it may well be some time before these differences are resolved.

Many states treat sale-leasebacks to a "double whammy" in state sales and use taxation. Arguably there are *three* potentially taxable transactions: The purchase by the user, the sale to the lessor (both potentially taxable), and the leaseback to the user. One would expect that, except in highly unusual circumstances, the sale to the lessor would not be taxed as it would constitute a private, isolated transaction. However, many states insist on collecting both the sales tax on the initial purchase by the user and a use or rental tax on lease rentals. In some instances, this may be a mechanical problem: The equipment vendor must collect the tax on delivery to the user unless the purchaser has a sales tax

exemption. Where the sale-leaseback transaction follows, the new lease is, in the absence of a statute or regulation to the contrary, automatically subject to tax.[6]

Despite the apparent intent of Congress to avoid formalism where investment credit is concerned, the formality of who takes title initially may therefore be an important factor.

Yet another problem in the sale-leaseback structure may be found in the lessee's own lending arrangements. Many traditional debt financings prohibit or restrict sale-leasebacks, while permitting traditional leases. Although such provisions should be designed to preserve the lessee's net worth as calculated at the time of the initial loan, broad drafting may cover later-acquired property as well. Sale-leasebacks may also adversely affect financial ratios under lending documents.

While these and other familiar sale-leaseback concerns would dictate a preference for the lessor to take title directly, other problems arise unless the lessee takes title and pays on delivery. For instance, will a vendor permit the lessee to hold equipment for up to 90 days without payment? If the vendor retains title, will a claim against the vendor result in a lien on the equipment which could survive the sale-leaseback? How can the vendor and lessee protect such equipment from creditor claims against the lessee?

A vendor may structure the delivery as a conditional sale transaction. The vendor could then file a Uniform Commercial Code financing statement against the lessee covering the equipment and agree to terminate such statement upon payment by the lessor. Many lessors prefer to avoid this situation, however, due to the potential for claims against the vendor surviving the lease inception date and such a structure might be unattractive to all parties for equipment, particularly where the lease is to be part of a warehousing transaction. The most difficult problems in structuring warehousing leases, however, may lie in the confused wording of the new last sentence of Code section 48(b).

THE NEW SENTENCE

The language of the new sentence must be re-examined with its application to a warehousing lease in mind: "...such property shall be treated as originally placed in service not earlier than the date such property is *first used under the lease* but only if such property is leased within three months *after such property is placed in service.*"

This language retains the terminology previously used under section 48 of the Code. Until new regulations are promulgated, we must assume the continued application of the existing rules regarding "original (or first) use" and "placed in service." Under these rules, one point should be clear: The first productive or business use of the equipment will trigger the running of the three-month period, regardless of whether such use occurs when the equipment is titled in the vendor, lessee or lessor.

What is left unclear, however, is *whose* first use under *what* lease is intended by the new sentence. As will be discussed below, a crucial issue to be considered will be whether use under an interim financing of the equipment, placed when the equipment is delivered and then cancelled or incorporated into a lease transaction closed within the 90-day period following equipment delivery, might be considered to be the first use under "the lease." In other words, if the lessee uses the equipment within a 90-day period, how can we avoid having this use deemed the first use under the lease for purposes of section 48(b) of the Code?

The Interim Financing Question

MAJOR CONCERNS

The major concern with which we are left may be stated as follows: During the 90-day window period, what structure should the lessee use to finance the equipment?

In this regard, the following concerns, some of which have been discussed, must be noted:

- Potential sales taxes and existing prohibitions under financial arrangements argue against the lessee taking title and doing a sale-leaseback.
- The lessee may want to avoid taking title to avoid creditor claims attaching to the equipment. Also, the spectre of a fraudulent conveyance claim may be raised by the lessee's sale-leaseback.
- The lessee will want some assurance that favorable financing will be available before taking title, and must have cash available to pay the vendor on delivery or when trade terms expire.
- The vendor will want payment or at least an unconditional commitment from a solvent party upon delivery.
- Particularly in the case of a warehousing situation, the lessee may not be in a position to specify all equipment to be leased until the end of the 90-day period.
- In a brokered, ITC-retained transaction where the third-party broker or leasing company (hereinafter, a "broker") has entered into the lease with the lessee and/or has acquired ownership of the equipment, or has committed to acquire the same, the broker will want to transfer the lease and such ownership or obligation.

SUGGESTED STRUCTURES

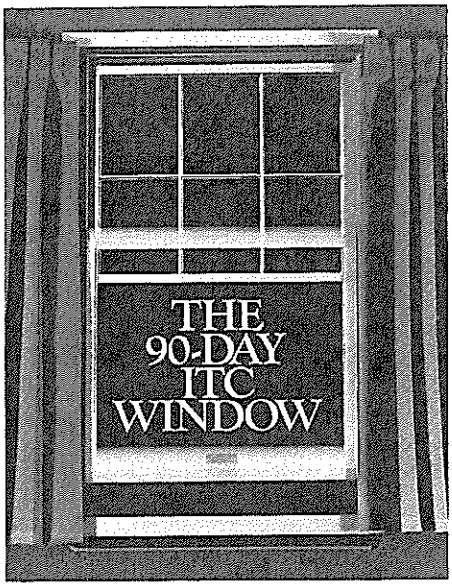
The available options, which are not intended as an exclusive list, line up as follows:

Structure 1

The lessee may take title, pay for the equipment or enter into a financing arrangement with the vendor, and consummate a sale-leaseback with the lessor.

Structure 2

The vendor may retain title and agree to sell the equipment to either the



lessee or a third party not later than three months after delivery and acceptance.

Structure 3

A broker may purchase, or commit to pay for, the equipment and subsequently (e.g. within the original 90-day period) place a lease between lessor and lessee, stepping out entirely. The broker might initially either (A) enter into a conditional sale or chattel mortgage with the lessee and within the original 90-day period arrange a sale-leaseback by the lessee with a third-party lessor, or (B) take title and lease equipment to the lessee, selling the equipment and assigning the lease to a third-party lessor. As discussed below, there is a serious question whether the interim lease described in clause (B) will satisfy Code section 48(b).

Structure 4

A broker may purchase the equipment and simultaneously place it with the lessee under a true lease. Within the original 90-day period, the broker may sell the equipment to a lessor and lease it back subject to the underlying user lease. Thus, the broker would remain in the transaction as a lessee/sublessor in a two-tiered lease (a wrap lease).[7]

The balance of this article will focus on the last two of these structures, which will be most useful in warehousing situations. The key to the viability and also the inherent dangers in these options lies in the language of the new sentence, coupled with a working understanding of prior law.

As noted above, the parties must establish that use under "the lease" does not occur when the lessee begins to use the equipment. This might be done in several ways. First, if it owns the equipment during the 90-day window, the broker might argue that it is simply acting as the lessee's agent in arranging a sale-leaseback and the initial relationship should be disregarded for tax purposes. Second, the broker could structure the initial relationship between the broker and the lessee as a financing arrangement which is not a "lease," making it clear that the first use under the lease occurs when the real lease is closed during the 90-day period. Third, the parties might seek to establish that, during the 90-day window, the equipment is being "used" by the broker in its own business; the argument here is that the broker, as user of the equipment, has 90 days to place the equipment under lease.

MERE AGENCY AND THE INTERIM LEASE

The first argument is best suited to clause (B) of Structure #3, where the broker leases equipment to the lessee, sells the equipment and leaves the transaction entirely within the original 90-day period. The chief flaw in this argument lies in the formalism exhibited by the courts and the IRS in the past when examining placed-in-service questions; one doubts that the broker's brief ownership of the equipment would be disregarded.

A likely scenario for a Structure #3 (B) transaction is as follows: The broker accepts an assignment of the lessee's purchase order for equipment and signs an equipment lease with the lessee. When the equipment is delivered, the broker pays for the equipment (or makes an unconditional promise to pay the vendor). The equipment is accepted by the lessee under the lease and is titled in the broker. Within the original 90-day period, but subsequent to delivery and acceptance by the lessee,[8] the broker sells the equipment, subject to the lease, to a third-party lessor. This sale might be either by original design or due to the lessor's unwillingness to enter into a two-tiered lease with the broker and the lessee.

As title never passes to the lessee under this structure, the sale to a third party cannot be viewed as a true sale-leaseback. It therefore falls outside the ambit of the old safe harbor rules which were the basis for new Code section 48(b).

Also, it would appear that recently-introduced legislation, discussed below, would amend section 48(b) to eliminate the possibility of using Structure #3 (B) altogether. It is submitted that this type of transaction will not be viewed favorably by the IRS or the courts whether or not the amendment passes.

INITIAL FINANCING AGREEMENT FOLLOWED BY A LEASE

The second argument, that an initial broker-lessor relationship can be structured as a financing which is not a "lease," may be used in Structure #3 (A).[9] In this case, the broker would never own the equipment for tax purposes, but would enter into a chattel mortgage or conditional sale with the lessee simultaneous to delivery of the equipment by the vendor. The broker's role would be much like that in placing a traditional lease, except that the broker would provide some interim financing or commitment. The broker would arrange a sale-leaseback between lessee and lessor, with the broker relinquishing its security interest in the equipment or assigning such interest to the lessor.

One problem with using an interim conditional sale or chattel mortgage is that the use of an interim financing other than a true lease is subject to

many of the problems inherent in a simple sale-leaseback by the lessee. For instance, if state law treats the lessee as the owner of the equipment prior to transfer of title to the lessor, liens against the lessee and a potential fradulent conveyance claim could cause problems. Still, avoiding the use of an interim lease between broker and lessee would seem to avoid the argument that the interim financing is "the lease" under which the property is first used for section 48(b) purposes.

It should also be noted that great care must be taken in drafting the interim financing arrangement. For the argument that only one lease existed to be successful, the broker-lessee relationship must be clearly a financing arrangement and not a true lease. However, the lessee will want some assurance that the lease with the lessor will be on favorable terms, including those found in well-negotiated leases. This would seem to require that the interim financing be structured as a "flawed" lease, including tax indemnities, sublease rights and other provisions not normally found in sales or mortgage agreements, but also including bargain purchase options or other language fatal to a determination that an agreement is a true lease for tax purposes.[10] Such an agreement could provide that the broker may assign its position to a lessor, deleting the purchase options or other financing provisions, if the final lease is on a rate and terms acceptable to the lessee. It is suggested that to protect the broker, these terms should be negotiated in advance and specified in writing.

USE IN THE BROKER'S BUSINESS

This argument is chiefly useful if Structure #4 is to be used and the interim financing is to be a lease between broker and lessor. It may be argued that Congress intended to allow a *user* a 90-day grace period to place a lease for its property. For the broker to argue that it, not the lessee, is the user, the broker would seem required to establish that it is in the business of owning and leasing equipment. This would not be the case under clause (B) of Structure #3, as the broker's leaving the transaction entirely would seem to contradict an argument that the broker is using the equipment in its own business.

The argument that the broker, not the lessee, is the original user of equipment is based on turning the successful IRS position against itself. In several cases, most notably G.R. *Haddock*, 70 T.C. 511, Dec. 34, 242, the IRS successfully argued that the *lessor*, not the lessee, was the original user of equipment which is originally titled in the lessor and used by the lessee under a lease.[11] The same principle may now support the position argued by the broker as to its use of equipment.

Special Concerns in Two-Tiered Leases

Several observations apply to Structure #4 leases. First, the broker should provide something more than mere packaging and placement. In order to give some economic substance to the transaction, and to ensure that it is deemed to be using the equipment in its business, the broker should perform some continuing function, such as remaining liable for lessee failure to maintain the equipment, certifying that proper insurance is maintained or collecting and remitting rentals. In this regard, it would seem a major concern to all parties that the broker have economic viability.

Second, the documentation must be prepared carefully by the broker and lessee. The broker will need a lease that is worded broadly enough to sufficiently ensure marketability to the lessor. The lessee will be concerned chiefly with quiet enjoyment (ensuring its rights despite broker bankruptcy or breach of the lease between lessor and broker) and assurance that tax contest rights and other lessee benefits are available despite the superior lease.

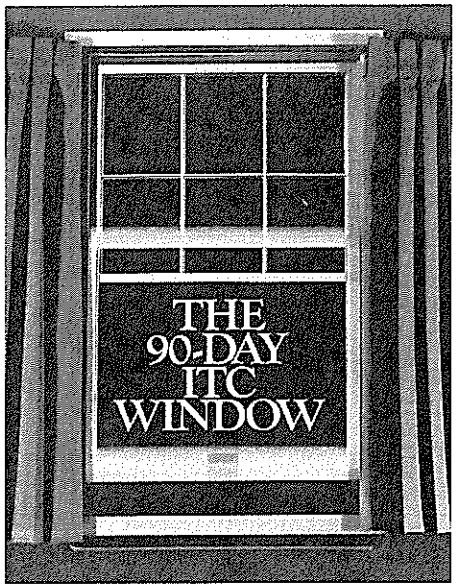
Third, as the broker will be engaged in some form of sale-leaseback if the interim financing is a lease rather than a financing arrangement, the potential sales tax concerns discussed above must be considered. Through careful planning, however, these problems may be minimized. A broker may be able to obtain a sales tax exemption certificate for property to be resold to a third party, or rely on a general state law exemption for intermediate purchasers. Also, state laws and rulings arising in response to safe harbor leasing should be examined for possible application.

Finally, vendor cooperation must be assured. In any two-tiered structure, warranties and product support must be assignable to the lessor, preferably through an assignment by the broker.

Additional Concerns

In addition to the foregoing, there are certain aspects of the new sentence in Code section 48(b) which remain unclear or potentially troublesome. It should be remembered that the 90-day window is effective for determining whether equipment is "new section 38 property" only.

The interrelationship between section 48(b), as amended, and the recapture provisions of section 47 of the Code need to be considered. When calculating stipulated loss value (casualty value) tables, it must be remembered that section 47 computes the recapture percentage for recovery property on the basis of the number of full years following such property being "placed in service." There appears to be no basis for viewing the date placed in service under section 47 to be changed due to the amendment to section 48(b) of the Code. For this reason, calculations based on the lease term and rental periods may not be accurate. Also, no change has been made to the "shelf partnership rules" under Reg. § 1.167(a)-11(c) and section 168(f)(5) of the Code, or to the requirement that a lessor own equipment prior to the end of its fiscal year if it desires to take tax benefits for such year.



Recent Developments

As this article went to press, Congress passed a further amendment to section 48(b). The amendment, modifying language proposed by Senator Robert Dole on April 11, 1984, reads as follows: "SEC. 114. DEFINITION OF SECTION 38 PROPERTY IN SALE-LEASEBACK TRANSACTIONS. (a) IN GENERAL. Subsection (b) of section 48 (defining new section 38 property is amended to read as follows: '(b) NEW SECTION 38 PROPERTY. For purposes of this subpart (1) IN GENERAL. The term "new section 38 property" means section 38 property the original use of which commences with the taxpayer. (2) SPECIAL RULE FOR SALE-LEASEBACKS. For purposes of paragraph (1), in the case of any section 38 property which (A) is originally placed in service by a person, and (B) is sold and leased back by such person, or is leased to such person, within three months of the date such property was originally placed in service, such property shall be treated as originally placed in service not earlier than the date on which such property is used under the lease. (3) SPECIAL RULE FOR ENERGY PROPERTY. The principles of paragraph (2) shall be applicable in determining whether the original use of property commences with the taxpayer for purposes of section 48(1)(2)(B)(ii).' (b) EFFECTIVE DATE. The amendment made by this section shall apply to property originally placed in service after April 11, 1984 determined without regard to such amendment."

Unfortunately, the Joint Committee did not include an extensive discussion of the proposed amendment. In introducing his version, Senator Dole made the following observations: "Mr. President, while we are on the topic of the 90-day window, I understand that present law is not working properly. I thought the 90-day rule was intended to permit a taxpayer who places property in service to sell it and lease it back within three months without the property failing to qualify for full investment credit in the hands of the buyer/lessor. However, the words of the statute appear to permit more. For example, suppose a person places an item of property in service and within three months he sells it to a second party who leases it to a third party. The statute appears to allow full credit to the second party as if he were the first user, even though the real first user is out of the picture. My substitute amendment would tighten the rule to make it clear that it applies only when the person who originally placed the property in service sells the entire property and leases it back within a three-month period."

It is crucial to note that Senator Dole's proposal did not include the words "or is leased to such person" into section (2)(B). This phrase, added by the Joint Committee, may change substantially the effect of section 48(b).

Read literally, this language indicates that many structures under which a user places equipment in service and accepts such equipment under lease within three months will preserve new section 38 status.

Returning to the structures discussed above, it seems that a Structure #4 transaction (a lease followed by a sale-leaseback as part of a two-tiered lease structure) would not be affected by the proposed amendment, as there is no requirement that the person who "originally placed in service" the property must be the physical user. A Structure #3(A) transaction (a financing converted to a lease) would appear to be far safer than under the present law, as the interim financing would no longer need to be followed by a sale-leaseback.

Structure #3(B) transactions remain subject to attack as the proposed amendment continues to focus on the "date on which such property is used under *the lease*." Where the broker leaves the transaction entirely, it might be argued that the broker cannot be deemed to be using the property in its own business. It is therefore likely that the initial broker-lessee lease would be deemed to cut off the running of the three-month period.

As noted above, the proposed amendment no longer requires an actual sale-leaseback. Accordingly, many programs in which a vendor or other party keeps title to equipment and allows the lessee to place it in service (other than through a lease) may be facilitated.

The foregoing concerns, and the many which will arise in the coming months, indicate that there is more work to be done before congressional intent is effected. Section 48(b) of the Code and the further amendment now before Congress serve as examples of how difficult it can be to draft a simple statutory provision. One wonders how aggressive the IRS will be in challenging those structuring leases which rely on congressionally expressed intention to permit a lessee a period of 90 days after physical in-service date to consummate a lease financing. However, until clarification is established through regulations, rulings, cases or further amendment to the Code, it will be left to the leasing community to determine how best to bear the risk of relying on good intentions, poorly expressed.

Footnotes

1. Section 209(c), P.L. 97-248, adopted 9-3-82.

2. *E.g., Madison News Papers, Inc.*, 47 T.C. 630; Rev. Rul. 78-433, 1978-2 C.B. 121; PLR 8323018; *but see Indian Creek Lumber Co. v. C.I.R.*, 43 T.C.M. 841. See also, Rev. Rul. 69-272, 1969-1 C.B. 23. The effect of these and other rulings was to create a limited and somewhat unreliable exception for demonstration and pre-certification testing by a vendor.

3. *See G.R. Haddock*, 70 T.C. 511, Dec. 35,242; Reg. § 1.48-3(a). Note, however, that investment credit is not recaptured from a sale-leaseback lessee. Reg. § 47-3(g).

4. 128 Cong. Record, p. 137. *But see* Reg. § 1.48-3(a) (above).

5. 128 Cong. Record, p. 489 (emphasis added).

6. Statutory or administrative override of these provisions was necessitated by the advent of safe harbor leasing. See, e.g., letter, Arizona Department of Revenue, June 9, 1982.

7. Structure #4 contemplates that the broker will take title and lease the equipment to the lessee on the same date as the equipment is first used. A tempting variation on this would be to allow the lessee to use the equipment for up to 90 days before doing a sale-leaseback to the broker, with the broker consummating a second sale-leaseback within an additional 90 days and arguing that it is this second transaction which is contemplated by Code section 48(b). Those wishing to attempt such a structure should be cautioned by Reg. § 1.48-2(b)(7), which indicates that "original use" is not limited to the original use by the particular taxpayer in question, and by the recently proposed further amendment to Code section 48(b), discussed below.

8. An interesting question may be whether a sale on the date equipment is placed in service will qualify under section 48(b). It would seem that such a transfer of title would qualify for "new section 38" treatment even under prior law, as the lessor would take title on the date equipment is first placed in service. However, the effect of the recently proposed amendment, discussed below, must be considered.

9. It also may be possible to use a conditional sale or chattel mortgage as the interim financing vehicle in a Structure #4 transaction. After the equipment is placed in service by the lessee, the lessee would sell the equipment to the lessor, who would lease it to the broker. The broker would then convert the interim financing into a sublease to the lessee. The broker would never "use" the equipment before title passes to the lessor, and there would be no interim "lease." However, one may question whether the transaction would qualify as a true sale-leaseback, with particular reference to the recently proposed amendment discussed below.

10. If the "flaw" does not cause the lease to be deemed a mere financing under the state law, the concerns of the preceding paragraph might be avoided.

11. In *Haddock*, the lessee purchased the equipment from the lessor during the lease term and sought to receive investment credits. *See also*, PLR #8411008 (12/8/83).

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Toward a New Understanding of Leveraged Lease Profitability

by Edward P. Brennan

Measuring the profitability of a leveraged lease is one of the most difficult and frustrating tasks confronting the manager of a leveraged leasing investment operation.

The confusion surrounding leveraged leasing in general, and measuring its profitability in particular are attributable to the unitary perception of a leveraged lease which is embodied in all of its analytical and structuring methodologies. This article (1) reviews the history and development of the major analytical techniques which are commonly used to measure lease profitability; (2) identifies their limitations; and (3) proposes a new conceptual approach for measuring the profitability of a leveraged lease and an accompanying comparative profitability measurement technique. I have called this technique the Binary Lease Profitability Index, which derives from perceiving a leveraged lease as presenting the investor with two opportunities. It is opposed to the concept of a "unitary" opportunity which is implicit in all existing analytical techniques.

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Historical Review

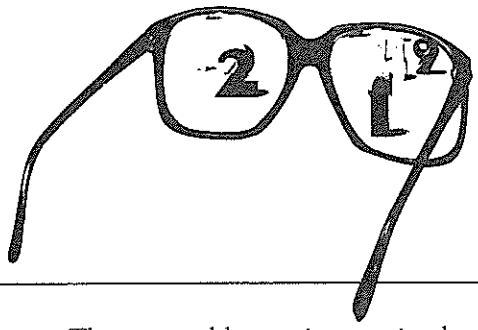
Measuring the profitability of a leveraged lease has been confused by two factors: First, there is no standard definition of profitability; second, there are a large number of analytical techniques in use, all purporting to measure profitability in some sense. The multiple and conflicting array of profitability methodologies confronting the decisionmaker is further confused by a complex overlay of leveraged lease structuring techniques. As will be shown in this review, both the profitability methodologies and the structuring techniques are inextricably linked to the concept of a leveraged lease as a "unitary" investment opportunity.

In the early 1970s, leveraged lease analytical and structuring techniques were relatively simple. Nearly everyone used the sinking fund method of yield analysis. Debt structuring as known today was not in the lexicon; instead, the debt/equity relationship would be tested at several combinations, always using level debt service, until a "satisfactory" yield was achieved. And, since no accounting standard existed, accounting was pretty much "as you like it." Aggressive investors were making residual value assumptions in the then unheard of range of 7.5–10.0%, and the chief subjects of debate were the assumed sinking fund rate, sinking fund earnings, and the sinking fund itself.

Sinking Fund Rates

One article published in that period argued that cash flows generated by a leveraged lease investment should be divided into "hard dollars" and "soft dollars."[1] "Hard dollars" were those attributable to rentals, residual value and tax benefits, while "soft dollars" were the product of sinking fund earnings. (Not surprisingly, some "soft dollar" earnings have in fact proved to be harder than certain "hard dollar" lessee rental obligations.) The authors of the article went on to propose that "soft dollars" were so intangible that a lease yield (for a lease using a mortgage-type debt structure) should be calculated using a *zero* sinking fund rate and that the resultant "hard dollar" yield should be reasonably good. It now seems difficult to believe, but a number of people in the industry agreed with their conclusion.

For those new to this investment area, it should be pointed out that the sinking fund debates centered upon the question of whether the assumed sinking fund rate should be an opportunity cost rate or an investment rate. An investment rate (especially a tax-exempt investment rate) invariably produced a higher yield and was therefore preferred and/or defended by many. That it is fallacious to attribute to the leveraged lease the excess of the investment return over a corporation's opportunity cost of funds (since the corporation could always borrow at its



opportunity cost of funds and make the same investment) is now generally accepted throughout the industry. But however obvious this view of the matter seems in retrospect, the debate continued for several years.

The Sinking Fund with Borrowing Method

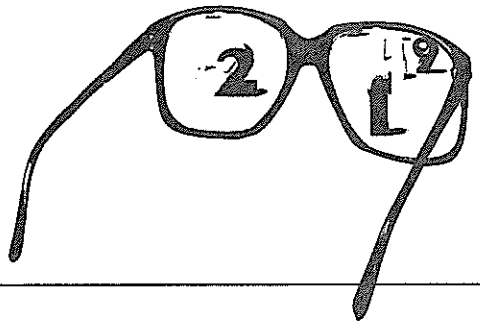
One of the greatest flimflam yield techniques—the sinking fund with borrowing method—which was introduced in 1972, was extensively promoted by a major, now defunct, lease broker. A major analytic and conceptual problem with residual value assumptions under the sinking fund method is that positive cash flows, which after a series of negative cash flows, such as those generated by residuals, are discounted for a number of years at a high yield rate. If a method of analysis were developed under which these end of lease (or terminal) cash flows could be discounted at a much lower rate (such as the sinking fund rate), the yield would increase dramatically. Thus emerged the concept of a sinking fund with borrowing method of analysis which had the investor assume a borrowing against the anticipated residual. In my opinion, it was no accident that the appearance of this method coincided with the general acceptance and use of lower sinking fund rate assumptions based upon the opportunity cost of funds thesis described above.

The assumed borrowing consisted of amounts equal to the negative cash flows which preceded the residual cash flow, and charged against the transaction. This yield method had two consequences: First, the resulting yield was much higher than the standard sinking fund yield (since fewer of the earlier positive cash flows were required to offset the remaining negative cash flows); and second, the investor had made (typically without being aware of it) a zero-profit secondary investment, since the imputed earnings rate on the borrowing was exactly equal to and therefore offset the investor's opportunity cost of funding the borrowing. A third anomalous result also sometimes occurred in the instance of leases with very significant residual value assumptions; this result was a higher yield at lower sinking fund rates.

Multiple Investment Sinking Fund Method

Early in 1973, I developed and introduced the multiple investment sinking fund technique into the leasing industry. The technique was adopted widely and has emerged as the industry's standard for evaluating the yield in a leveraged lease.[2] The multiple investment sinking fund method treats all cash flows equally; in this respect, it is opposed to the sinking fund yield method which arbitrarily differentiates between those positive cash flows which precede negative cash flows and those positive cash flows which succeed the negative cash flows. The multiple investment sinking fund method is based upon the simple assumption that an investor's position can either be an investment or a financing, but not—as the sinking fund method implicitly assumes—both an investment and financing simultaneously.

The multiple investment sinking fund method was formally validated as the industry standard when it was incorporated as the basis for recognizing income in a leveraged lease by the Financial Accounting Standards Board in November 1976 in its Statement of Accounting Standards No. 13, *Accounting for Leases*. However, while this method finally provided a consistent and accurate means to evaluate yield, the proper assessment of profitability continued to be an elusive target. Moreover, the multiple investment sinking fund method proved to be a Pandora's box for investors when an inherent weakness of the method was exploited by the more creative and imaginative minds in the leasing community. However, before dealing with this topic, a digression on the subjects of cash flow and "optimized" debt is needed at this time.



Cash Flow

While many investors as early as the late 1960s believed that yield by itself was an inadequate consideration for selecting investment opportunities, and that the net cash flow (hereafter cash flow) was also important, no one was able to explain how much cash flow was appropriate and why. Even now, cash flow continues to be measured in many different ways, but is not explained; and investors establish minimum standards in an *ad hoc* fashion.

The meaning and interpretation of cash flow has been seriously misunderstood by many who fail to realize the substitution effect inherent in most debt structuring manipulations. (The substitution effect is discussed in detail in a later section of this paper.) A second source of serious misunderstanding of cash flow is that most investors think in terms of nominal (undiscounted) cash flow as compared with present value cash flow. Nominal cash flow is capable of being grossly manipulated and exploited under the multiple investment sinking fund method; sometimes even the investor is unaware of the consequences of the debt structuring operations it is controlling. I believe the great difficulty many people have with evaluating cash flow and in measuring profitability is directly related to the unitary perception of a leveraged lease inherent in existing analytical techniques. Before discussing cash flow misperceptions, it is necessary to review the techniques of debt structuring.

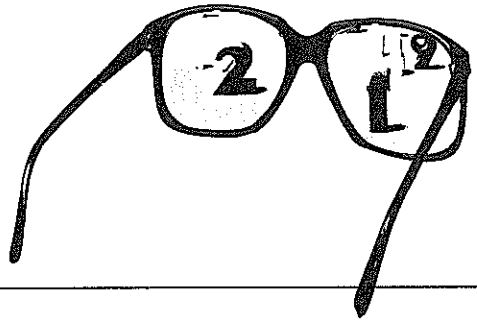
"Optimized" Debt

Debt structuring techniques can be classed under two broad categories. The first category includes those techniques which improve the actual economic return to the investor. The improvement in the economic return can be demonstrated by the higher net present value of the earnings the investor realizes when using these techniques. The second category includes those techniques which result only in the illusion of an improved return to the investor and either no improvement or a decrease in the present value of the earnings. Both debt stripping[3] techniques (introduced in 1971) which take advantage of the yield curve without increasing the cost of debt to the lessee, and debt "optimizing" techniques generally fall into the first category; all other techniques fall into the second category.

Debt "optimizing" techniques began to appear in 1974, and were developed by several people along two related yet divergent lines of thought. The term "optimized" debt has been questioned and challenged; however, it has become the term of art and, moreover, as I soon will show, it is both accurate and apt.

My discovery of "optimized" debt occurred as I was sketching rough graphic representations of the sources and uses of cash flows under a leveraged lease. Suddenly, a hallowed tenet of leveraged leasing crumbled before my eyes. This tenet (which had appeared in various published articles[4]) that the sinking fund in a leveraged lease was utterly false. These sketches revealed that the sinking fund is determined solely by the debt structure and amortization; it has nothing to do with taxes. Consider this—a direct lease (or nonleveraged lease) *never* creates a sinking fund. In addition, an important consequence becomes immediately clear: That creating a sinking fund is a huge mistake. This discovery presented an exciting opportunity.

Remember, the sinking fund was assumed to be earning a rate equal to the investor's opportunity cost of funds. This was usually deemed to be its short-to-intermediate cost of funds rate and was, in addition, established conservatively, since it represented a future, hence, unknown rate. On the other hand, the cost of the sinking fund which was created by the debt structure was equal to the interest rate on the long-term nonrecourse financing. The spread between these two rates was typically in the range of 4-6%. As unbelievable as it now seems, the investor was borrowing at a long-term interest rate to create the sinking fund on which a short-to-intermediate cost of funds rate was assumed to be earned. This incredible negative arbitrage had continued unrecognized and, therefore, unchallenged for over ten years. However, by eliminating the sinking fund through debt structuring, the investor could in effect assume the debt interest rate as its sinking fund rate (actually, the investor saved the interest expense associated with debt which had funded the sinking fund). Until debt "optimizing" techniques became more widely known, a handful of investors enjoyed a tremendous pricing advantage.



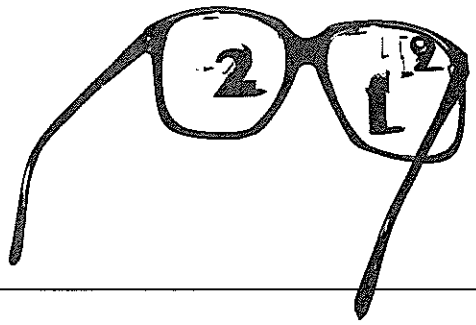
Debt Structure vs. Rental Structure Modification

The two approaches to debt "optimizing" referred to above were: (1) Rental structure modification and (2) debt structure modification. It is useful to remember that the debt structure typically encountered in leveraged leases from 1964 through 1974 was predominantly level debt service (mortgage-type amortization) which was derived from adapting aircraft and railroad equipment conditional sale agreement, equipment trust certificate and related financing structures to leveraged leasing. In these early transactions, the equity investor simply stepped into the shoes of the airline or railroad, invested its equity in place of the "downpayment," and adjusted the amount of debt (using level debt service) to solve for a competitive rental. The rental structure modification approach viewed level debt service as being an immutable given, and attempted to eliminate or minimize the sinking fund by increasing rentals in the later years of a lease to levels which provided sufficient cash flow to meet both debt service and tax liabilities. This approach was short-lived because it: (1) Exacerbated the tax liability problem it was attempting to solve by increasing rentals at a time when depreciation deductions were either very small or no longer available; and (2) added substantial additional credit risk by increasing rental payment obligations toward the end of the lease term when the value of the leased asset was expected to be decreasing.

The second approach, debt structure modification, which I and at least one other person developed nearly simultaneously, attacked the problem by assuming that debt could be serviced only from that cash flow which remained after the tax liability had been provided for. This assumption eliminated the sinking fund by eliminating negative cash flows. The debt structure modification approach suffered from neither of the drawbacks of the rental modification approach, and has become the standard approach used in debt "optimizing" structuring techniques. This basic type of "optimized" debt is also referred to as a "minimum pool" debt structure since the total elimination of a sinking fund (or a series of sinking funds) is "impossible" without incurring an economic penalty. It is "impossible," because in the real world there nearly always are significant timing differences between the tax payment dates (when tax-related cash flows are realized) and the rental and debt service payment dates. The sinking fund (or funds) can be totally eliminated by maintaining a continuous, relatively small investment position throughout the lease; however, such an approach is more costly (hence, the penalty) than is the cost of a series of mini-sinking funds created by the "minimum pool" debt structure. The firm responsible for the debt placement for the leveraged lease in which I first used "optimized" debt was initially reluctant to attempt the placement and then skeptical that it could be achieved. As it turned out, the debt lenders were delighted with the structure because it gave them much better asset-to-outstanding-loan-balance coverage than did the traditional mortgage-type debt structure.

Why Optimized Debt Is Optimum

With this by way of background, we can turn to a defense of the term "optimized" debt[5] and begin to unravel the misunderstandings concerning cash flow. Every leveraged lease has an inherently unique "optimized" debt structure which is a function of the rental, the debt interest rate(s), the depreciation (or cost recovery) deductions, the tax rate of the investor and the lease term. Tax credits affect the rental, which already is a determinant of debt structure; and residual value affects both rental and debt structure, since debt can be structured by including or excluding the residual value cash flow. In my opinion, either you believe in the residual value assumption or you don't. In either case, you should include what you believe in the analysis, and not segregate the availability of certain types of cash flow (i.e. residual) for debt structuring purposes. To do otherwise is to suboptimize the expected results. Excluding the residual from consideration in determining the "optimized" debt structure will result in an investment position for the full term of the lease, since all negative cash flows will be eliminated, leaving only several initial years of positive cash flows and the positive terminal residual cash flows.

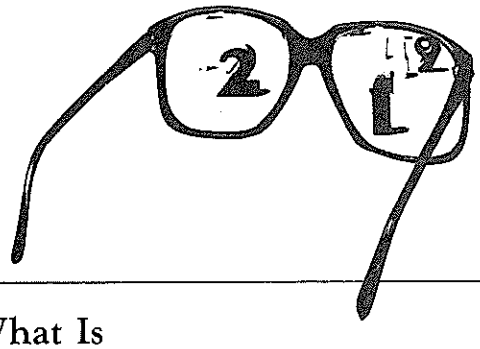


Solving for the "optimized" debt structure in a lease using the simple algorithm described above (first use cash flow to pay any tax liability, then use the balance to service debt) produces what I will argue is the *optimum* debt structure on the ground that no other debt structure can produce a higher combination of yield and cash flow. Either the yield or the cash flow can be made larger; but increasing one measure will always decrease the other. Altering this inherently unique debt structure will always result in a less efficient debt structure. To understand this concept, it is necessary to examine what happens at the margin when the "optimized" debt structure is altered.

Substitution Effect

If an investor replaces $1.00 or more of the debt contained in an "optimized" debt structure with $1.00 or more of equity in order to increase the cash flow when the yield is above its minimum requirement, but the cash flow is too low, all the investor has done is to make a marginal investment at the debt interest rate with the result that its yield must decrease. (The resulting yield has been averaged down.) However, an investment at the debt rate typically is not considered to be attractive by equity investors. Therefore, the above marginal investment (or substitution) at the debt interest rate should not represent an attractive investment opportunity. On the other hand, if it does, the investor should follow this substitution process to its logical conclusion by investing the full amount of the equipment cost and "unleverage" the lease. If the dollar amount required is too large, I would argue that it is better to locate other investors and structure the lease as a multi-investor direct lease than it is to inappropriately leverage the lease. By substituting equity for debt only at the margin in order to increase cash flow, the investor in effect becomes a loan participant for income purposes, but remains an equity investor for collateral value purposes (which improves the lender's position at the expense of the investor). If it were possible, it would be better to invest an amount equal to the incremental equity in a loan certificate, since the investor would then realize both the added income and the security interest position of the lender. However, once an investor understands the consequences of this type of substitution, I believe it will no longer be willing to increase the equity investment above the "optimized" debt structure level in order to improve its cash flow.

Substituting in the other direction (adding debt to the "optimized" debt structure) is equally erroneous. It typically occurs when the yield is too low, but the cash flow exceeds the investor's minimum requirements. This type of substitution is an even bigger mistake, since its immediate consequence is the creation of a sinking fund with its attendant negative arbitrage (which is precisely what the "optimized" debt structure was designed to eliminate in the first place). While the yield can be increased somewhat by increasing the amount of debt, the decrease in cash flow is always proportionately larger as negative arbitrage goes to work. In fact, at some point, an increase in the amount of debt will cause a decrease in both yield and cash flow. This occurs when the potential for an increase in yield, which results from a decrease in the equity investment base upon which the yield is calculated, is finally overwhelmed by the economic cost of the negative arbitrage.



Most of the debt structuring techniques which deviate from "optimized" debt continue to exist for two reasons: (1) Investors (and, often, even the structurers) have not recognized or been aware of the substitution effects; and (2) investors typically compare and evaluate cash flow in terms of nominal (or undiscounted) dollars. Thinking of cash flow in terms of nominal dollars places the investor in a very vulnerable position. If a dollar of cash flow generated in the fifteenth year of a lease is accorded the same meaning and value as is a dollar of cash flow generated in the second year of a lease, it is very easy to manipulate the debt structure to achieve both a higher yield and a higher cash flow. This is achieved by using debt structuring alternatives such as "rapid payback" and debt-shortening. Of course, there is no free lunch, and the investor actually realizes a lower present value aggregate cash flow.[6] To repeat: Any alteration from the "optimized" debt structure is a mistake; the apparent results may seem to be improved from the investor's perspective, but the actual economic results are less attractive.

The principle implicit in this statement is that the investor should not attempt to set or otherwise control cash flow. Yield, in the context of the "optimized" debt structure, is the variable the investor should target, and once the yield has been established, the cash flow resulting from the "optimized" debt structure is the best that can be achieved.

We can now return to the initial question: "How do we measure the profitability of a leveraged lease?"; but that question has been simplified, and reduced to: "What is an appropriate yield?" As noted above, the investor should not attempt to control cash flow by manipulating the debt structure.

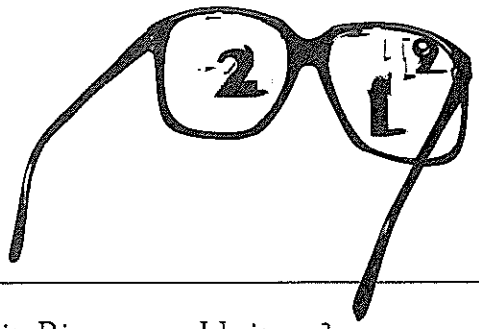
What Is an Appropriate Yield?

In the final analysis, the attainable yield will always be determined by market forces (which will of course always reflect certain investors misunderstandings of the investments they are making). However, a better understanding of the nature of the leveraged lease investment also will operate as a market force to establish minimum levels of profitability below which no informed and rational investor will invest. Perceiving the leveraged lease as a binary opportunity and the Binary Lease Profitability Index (BLPI) will permit investors to establish more easily this minimum level and provide for quick and simple comparisons of competing investment opportunities. However, before describing the concept and the rationale for the BLPI (which is a yield-oriented technique based upon pretax yield), let's put to rest a piece of nonsense that continues to plague leveraged leases: I.e. the distinction between "nominal" and "effective" yield.

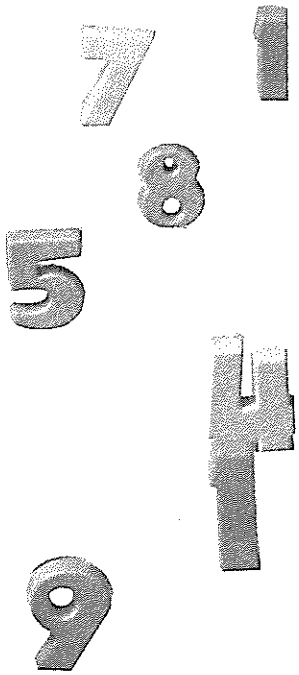
The concept of "effective" yield is pure chicanery in the context of leasing in general and leveraged leasing in particular. "Effective" yield has no meaning, for example, in the case of a zero coupon bond which by its nature provides a reinvestment opportunity at a known rate, however there is no reinvestment opportunity afforded to the investor by the leveraged lease investment to give meaning to an "effective" yield. A leveraged lease is not a zero coupon bond. "Effective" yield should be stricken from every lease analysis program; if you find it mentioned by anyone attempting to sell you an investment, ask the proposer to explain its merit—beyond that of fallaciously inflating the yield.

One problem which at first will seem to result from the statement that an investor only needs to determine an appropriate yield, is that for a given yield the cash flow associated with a lease closing in December will be significantly lower than the cash flow associated with a lease which closes in January. (For illustrative purpose, it is assumed that the lessor is a calendar year taxpayer.) The solution for this seeming problem is simple. A lease closing in December should have a higher yield and a lower cash flow than a lease closing in January. The questions this solution raises are "Why?" and "How are appropriate yields determined?"

To answer "Why?," it is necessary to understand that the yield on a leveraged lease is integrally related to cash flow through the average life of the equity investment. The present value of the tax benefits for a lease closing in December are higher than they are for a January lease. This is reflected in the lower rental pricing for December leases and the consequently higher equity investment (since lower rentals can service less debt, and the higher value of the tax benefits is paid by the investor through a larger equity investment). Although the initial equity investment amount is adjusted automatically when a leveraged lease analysis program is given the instruction to solve for a rental to achieve a targeted yield, the adjustment process is imperfect in the larger context of profitability. While the resulting yield is the same, the adjustment process makes no allowance for the shorter average life of the equity investment which occurs in year-end closings, and the cash flow decreases significantly.



The reason this imperfection exists is that the yield on a leveraged lease is measured with respect to the outstanding balance of the equity investment only, which has a very short and highly variable average life as compared with the average life of the total funding sources (debt and equity), and therefore, measures only the rate of profitability, but not profitability itself. The average life shortens because the increase in the initial equity amount is not large enough to compensate for the much earlier availability of the tax benefit cash flows in a year-end lease. In order for a December lease investment to be as attractive an investment as a January lease, the investor should realize a higher yield on a December closing to be compensated for its lower cash flow and shorter average life.



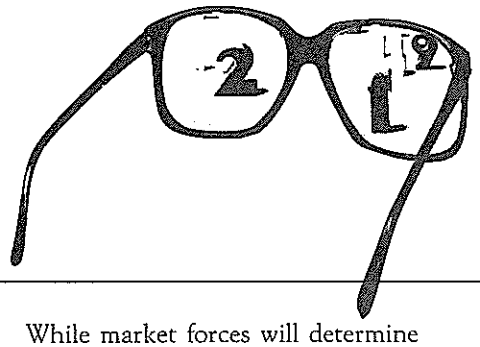
Is it Binary or Unitary?

The question "How is an appropriate yield determined?" is answered by the binary concept underlying the BLPI. A leveraged lease has been regarded as a unitary opportunity; this assumption is reflected not only in the analytical tools used to evaluate it, but also provides the basis for the existing accounting treatment. However, I believe that such a lease is more accurately regarded as a binary opportunity offering the investor two distinct choices. *First*, the investor is being offered an investment opportunity to acquire and lease an asset and to receive rental payments, tax benefits and a residual value interest; this investment opportunity is commonly known as a single investor or direct lease (and it will be shown that the yield on this opportunity determines the "appropriate yield"). *Second*, the investor is being offered a financing opportunity (which may be declined, since the lessee typically is indifferent to the investor's use or nonuse of this opportunity). In fact, it is highly questionable whether or not the specific financing opportunity, which accompanies a leveraged lease, can be differentiated sufficiently from the general financing opportunity, which is available to the direct lease investor (which is, to borrow nonrecourse debt by pledging the rentals and the equipment on either an after-the-fact or contemporaneous basis), for the distinction between a leveraged lease and a direct lease to exist.

Since the lessor has complete freedom of choice (within very broad limits) to select whether or not to use debt, the amount of debt, its maturity and its amortization pattern, it can be argued that a unitary analytical approach is both misleading and erroneous. The financing opportunity exists independently of the investment opportunity; why, then, should they be integrated in the analysis? The only benefit to a unitary concept of a leveraged lease is the unique (and I believe also erroneous) income accounting treatment which it has been afforded under FASB #13.[7] The unitary concept, when applied to the analytical techniques, has resulted in a twenty-year history of confusion in measuring the profitability of a leveraged lease.

The Binary Lease Profitability Index

If instead, the leveraged lease is regarded as a binary opportunity, the investor will evaluate each of the opportunities (the investment opportunity and the financing opportunity) separately, and then will be able to readily compare alternative leveraged lease proposals by measuring the relative attractiveness of each of the opportunities through the construction of a simple index. This index, the Binary Lease Profitability Index, is simply the yield on the investment opportunity (which is the direct lease pretax equivalent yield) divided by the cost of the financing opportunity (which is the debt rate). As simple as it is, the BLPI is a very powerful tool to measure the relative profitability of a leveraged lease and offers three principal benefits to the investor.



The *first benefit* the investor will realize when using the BLPI technique is a distortion free picture of the investment opportunity. By separating the investment opportunity from the financing opportunity, all of the fiendishly clever and misleading leveraged leasing structuring gimmicks (for example, deferred or "bridged" equity investments) are eliminated. What you see is what you get. Some investors may not want to see what they have gotten because the investment opportunity yield of the leveraged leases in their portfolios may not even be equal to the interest rate on the leveraging debt. This will produce a BLPI value of less than 1.0 which is a reject signal.

The *second benefit* will be a meaningful way to evaluate and quantify the yield. The investment opportunity yield always should be significantly greater than the related debt rate since:

- The lessor assumes four risks a lender typically does not, namely: (1) either 100% financing of the cost of the asset or a subordinated (or "equity") position if the lease is leveraged; (2) tax risk; (3) residual value risk; (4) ownership liability risk; and
- The lessor is using a valuable resource, namely tax liability, which has alternative tax-advantaged investment uses (and therefore, an opportunity cost), in order to make the lease investment.

While market forces will determine the attainable relationship between the investment yield and cost of the financing opportunity, the BLPI always should have a value greater than 1.0. Based upon the added risks stated above, I believe that at a minimum, the BLPI value should be a value no lower than the value obtained by dividing: (1) The yield on the lessee corporation's subordinated debt by (2) the yield on its senior debt for comparable maturity issues. This belief is not given as an absolute, but as a guide. The cost of the financing opportunity used in calculating the BLPI always should be the debt rate which would be incurred by the lessee corporation for debt which is coterminous with the lease, since this provides the lessor with a market-determined starting point.

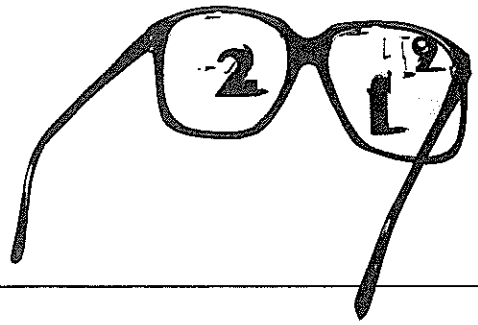
The use of an index enables the investor to evaluate the relative attractiveness of competing investment alternatives among lessees having significantly different debt rates.

The *third benefit* of the BLPI technique is that yield on the investment opportunity is measured with respect to an average life which closely approximates the average life of the total funding sources in a leveraged lease. This longer average life is highly insensitive to the effect of closing dates as compared with the much greater sensitivity exhibited by the average life of the equity investment alone. The investment opportunity yield, determined on the basis of this longer average life, has meaning with respect to the concept of profitability.

We are finally in a position to answer "*How* does the investor determine appropriate leveraged lease yields?" The answer, remarkably, is that the investor does not. The investor does not and should not target either a yield or a cash flow in order to structure or measure the profitability of a leveraged lease. Rather, both the yield and the cash flow for the leveraged lease should be determined by the investment opportunity yield which produces a satisfactory BLPI. The investment opportunity yield (or direct lease yield) should be used to establish the rental payment stream. Inputting this rental into a leveraged lease analysis program, which has been instructed to solve for a yield using an "optimized" debt structure, automatically will determine the yield and cash flow for the leveraged lease; and the values for yield and cash flow will conform to the pattern set forth earlier—a December leveraged lease will have a higher yield and a lower cash flow than a January leveraged lease when the investment opportunity (or direct lease) yield is constant. (Note: Market forces, such as the year-end rush for tax shelters, can be expected to result in slightly different market-determined investment opportunity yields over the course of the year.)

Conclusion

Although the concept of evaluating the profitability of a leveraged lease by using the yield on its investment opportunity component and the use of an index may seem at first to be a radical idea, its fundamental simplicity and soundness should be readily appreciated by investors after the initial shock wears off. The Binary Lease Profitability Index technique is a more



foolproof and more readily intelligible method to measure leveraged lease profitability than any other of which I am aware. Moreover, it uses the more easily understood measure of yield to evaluate relative profitability, instead of present value, which despite its analytical superiority, continues to be a much less widely used (and comprehended) measure of profitability.

The BLPI technique should enable investors to make investment decisions with greater confidence, while preserving their ability to subsequently structure the leveraged lease to achieve whatever yield, cash flow and FASB #13 accounting results they have determined to be in their best interest. If the BLPI of a leveraged lease opportunity is at or above an investor's minimum target, the investment decision can be made with confidence in the basic economic attractiveness of the leveraged lease's investment opportunity. However, the investor will not attempt any structuring of the leveraged lease debt, except to use the "optimized" debt structure if it understands "optimized" debt and the substitution effect.

Footnotes

1. See C. Rogers Childs, Jr., and William G. Gridley, Jr., "Leveraged Leasing and the Reinvestment Rate Fallacy," *The Bankers Magazine*, Winter, 1973.

2. See Edward P. Brennan, "Will the Real Yield Please Stand Up," *The M.A. Monitor*, July, 1974, for a full description and comparison of this and other yield methods.

3. Debt stripping involves the placement of leveraged debt in a serial form which takes advantage of lower interest rates associated with a normal yield curve.

4. See Louis A. Zehner, Jr., "Investor Leasing Programs," *Leasing World*, May/June, 1970, p. 29, for an example.

5. The optimized debt structure referred to in this article is a pure form of optimized debt which may not satisfy IRS cash flow tests.

6. See Edward P. Brennan, "Shortened Debt: A Spurious Structuring Technique," *The M.A. Monitor*, September, 1977, for a detailed analysis of this subject.

7. See Edward P. Brennan, "Leveraged Leasing May Be Hazardous to your Financial Health," *The M.A. Monitor*, February, 1980, for a discussion of a proposed method of income recognition for leveraged leases which more accurately reflects both lessor risk and the balance sheet presentation of a leveraged lease.

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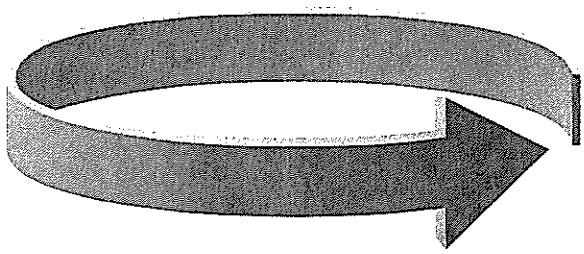
WRAP LEASES:

Structural and Tax Considerations

by Allen P. Palles, Esq.



One of the more controversial structures used by the equipment leasing industry is the sale/leaseback wrap-around transaction (the "wrap"). It has been characterized by some as primarily tax-motivated. While virtually all leasing is associated with tax attributes, when the wrap is properly structured and analyzed it becomes clear that it is merely a structural variation of the leveraged lease. This article, while not an exhaustive exploration of the subject, is intended to discuss the fundamental economic, structural and tax aspects of the wrap.

ECONOMICS

The equipment leasing industry historically has provided capital to users of equipment in the form of sale/leasebacks. While this mechanism has been more predominant in the real estate industry, equipment lessors have engaged in sale/leaseback arrangements so as to provide an additional source of capital to their clients which, secondarily, result in transference of tax attributes. The wrap is fundamentally a sale/leaseback and is a mechanism for providing an alternate capital source *to equipment lessors.* It is used in the same way and for the same purpose that lessors use sale/leasebacks for their customers and clients.

The wrap has come into more frequent use as the equipment leasing industry's need for capital has increased and its ability to take on additional risk and to make effective current use of tax attributes has decreased. The relative balances of the sharing of economic benefits and burdens in the wrap has shifted as these economic requirements have shifted.

While computers—mainframes and peripherals—have been the primary type of equipment used in wraps, in the late 1970s lessors began using the wrap in conjunction with operating leases of transportation equipment (railcars, aircraft, semitrailers). Its use has now been expanded to virtually all equipment types.

The most obvious effect of use of the wrap on the equipment leasing industry has been increased cash flow, more effective pricing for lessees, and transference of risk. These results have a beneficial impact on capital formation in general, and the leasing industry in particular. Why, then, does so much controversy surround the wrap?

Essentially, the viability and credibility of lessors is in many ways associated with the "economic substance" of the structure of the business in which they engage. This writer, for one, believes that "economic substance" should not be *totally* dependent on the tax attributes of an equipment lease nor should it be *totally* separated from tax attributes. It is in this regard that most critics of the wrap have expressed concern. They argue, with some possible degree of validity, that the structure may have, at times, been *misused* as a mechanism for transferring tax attributes in situations that have no other economic motives or substance, thus resulting in an adverse impact on equipment lessors.[1]

Critics further argue that investors in wraps (who have been primarily individuals and corporations who do not normally engage in leasing) are not sufficiently sophisticated to be able to properly evaluate the "economic substance" of an equipment lease transaction.[2]

Recent experience dictates to the contrary. Investors in wrap transactions have become a significant source of capital to the leasing industry. Wraps are believed to have accounted for at least $2 billion of volume in 1983. When coupled with other types of "syndicated" equipment lease transactions, one must conclude that nontraditional lessors have become a significant source of capital to the leasing industry.

As use of the wrap expanded, diligence on the part of investors has expanded dramatically. Virtually all investors are now requiring extensive support of the economic viability of the transaction. Further, involvement of major investment banking firms has led to intensified diligence.[3]

In short, the wrap is nothing more than a device for providing capital to the leasing industry in a form that it has been continuously using when it provides capital to its customers. If a lessor transfers a meaningful portion of

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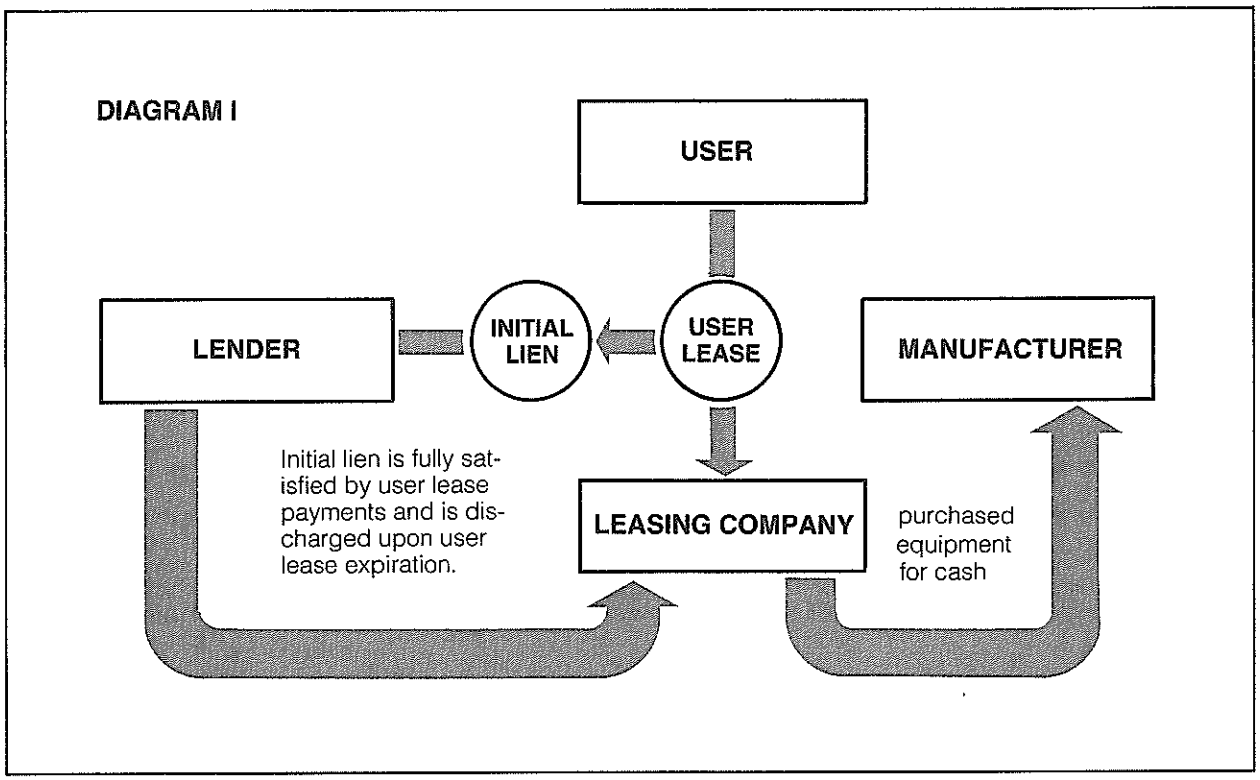
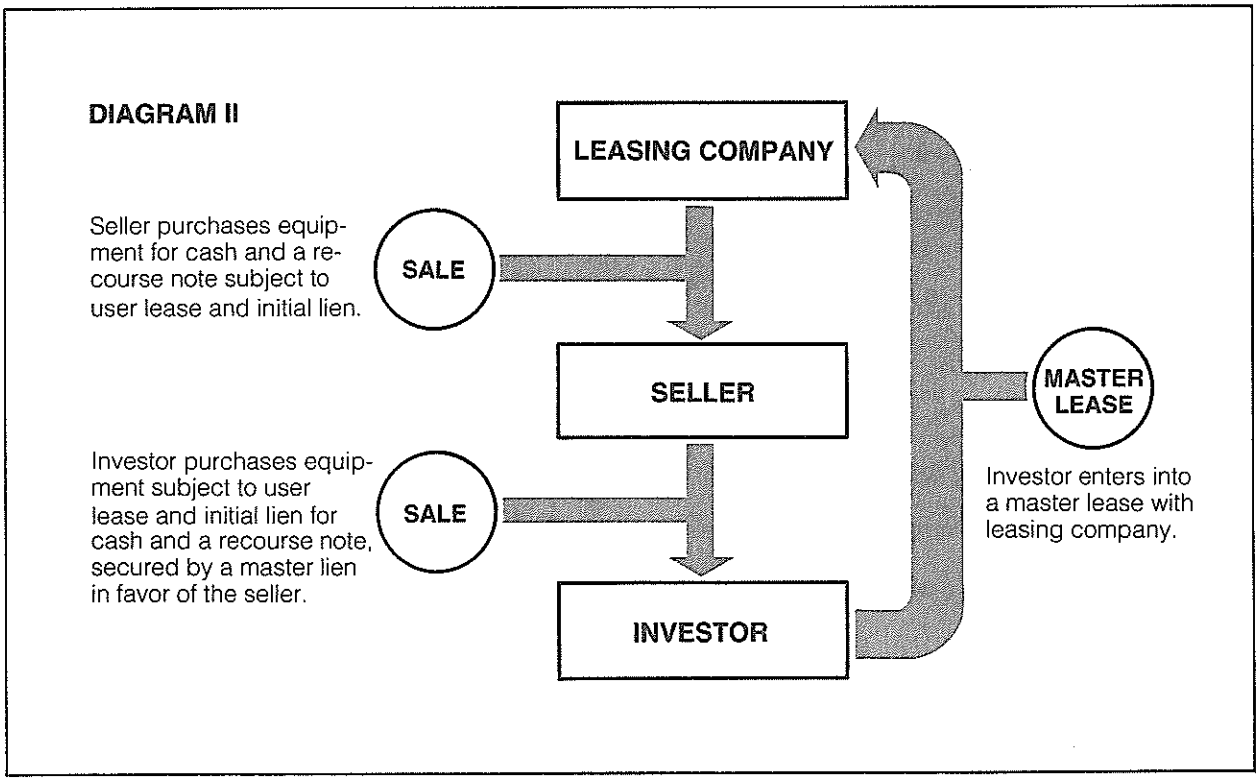
The author is Vice President of Lease Investment Corporation, of Chicago.

TABLE 1

WRAP LEASE

These diagrams illustrate the events described in the typical transaction.





the economic benefits of a transaction (exclusive of tax attributes) to an investor in a wrap, the "economic substance" maxim should be established. Whether or not benefits (and burdens) have been transferred can only be analyzed on a case by case basis. A clear understanding of the wrap structure is essential to such an analysis.

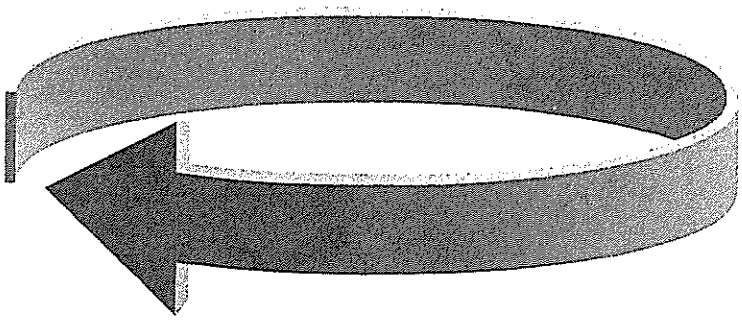


Table 2

ANALYSIS OF CASH FLOW

CASH TO ABC LEASING COMPANY WITHOUT A WRAP LEASE

Equipment cost	$(1,000,000)
Bank financing	900,000
Net investment	(100,000)
Rent received from user in excess of debt service to bank—months 1-60 ($200/mo.)*	12,000
Rent months 61 thru 84	120,000
Residual	150,000
PROFIT TO LEASING COMPANY	$ 182,000

*60 months of rent at $20,000 per month, less 60 months of debt service at $19,800 per month.

STRUCTURE

There are as many structural variations to the wrap as there are companies using it. The structure that is illustrated in Table 1 is typical. I am sure however that other structures are mere variations on a theme.

The first step in any wrap is the arrangement by the leasing company of an initial lease for the equipment involved (the initial user lease).[4]

This step can involve purchase of new equipment from a manufacturer, as is illustrated, or a sale/leaseback of used equipment with the initial lessee.

Following completion of the initial user lease, the leasing company will normally finance its acquisition of the equipment on a nonrecourse basis by assignment of the initial user lease to a financial institution (the underlying financing). In some cases underlying financing is not completed until after the equipment is sold to an investor, as discussed below. However, in syndications, the transaction is virtually impossible to complete in this way.

After arrangement of underlying financing, typically, the equipment is sold for its fair market value to a packager or financial intermediary. The packager may be an affiliate of the leasing company, but in most cases is unrelated.

The consideration paid by the packager normally takes the form of cash and an installment note or notes (the packager installment note). In some cases the cash portion may be staged in over a period of time.

The packager installment note always amortizes over a term exceeding the term of the initial user lease. Depending on the economic and tax requirements of the transaction, the packager installment note may be recourse, secured or unsecured. Some authorities believe that the packager installment note should not be secured by the equipment, and should be a recourse obligation of the packager in order to strictly comply with some interpretations of the "at risk" provisions of the Internal Revenue Code.

Following completion of sale of the equipment to the packager, it sells the equipment to a lessor/equity investor. This sale generally occurs immediately after the packager's acquisition of the equipment from the leasing company. The terms of sale to the investor are similar to the terms of sale by the leasing company to the packager—cash and an installment note (the investor installment note).

If the investor's equity is periodically staged, the deferred equity will be evidenced by a full recourse note and at times will be secured by a letter of credit and accompanied by an estoppel agreement (particularly where the transaction is part of a syndication). The investor's installment note is always secured by a lien on the equipment in favor of the packager. Depending on the circumstances, the investor installment note may or may not be recourse.[5]

The final step is the lease of the equipment by the investor to the leasing company (the wrap lease). The term of the wrap lease will exceed (or wrap around) the term of the initial user lease, but will be for a period that is less than the useful life of the equipment. The term of this lease will

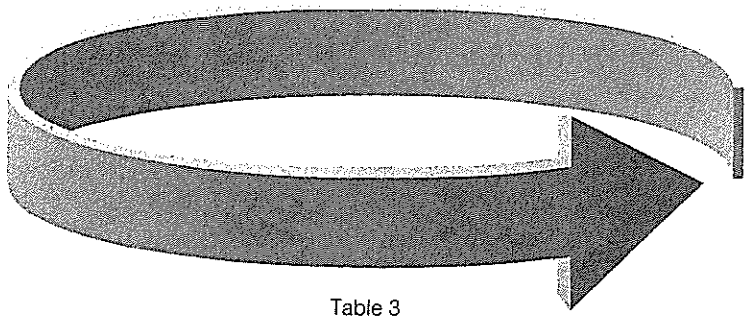


Table 3

ANALYSIS OF CASH FLOW

CASH TO ABC LEASING COMPANY USING A WRAP LEASE

Net investment (as in Table 2)	$(100,000)
Proceeds of sale to the lessor/equity investor	150,000
Net "profit" at closing	50,000
Rent received from user in excess of debt service, as in Table 2	12,000
Rents for months 61 thru 84	120,000
Excess of rent paid to lessor/equity investor over note payments from packager*	(33,600)
Additional rent paid to lessor/equity investor in months 61 thru 84**	(60,000)
PROFIT TO LEASING COMPANY	$ 88,400

*Rent of $14,900 per month for 84 months, less packager installment note payments of $14,500 per month for 84 months.

**50% of monthly rents from month 61 thru 84.

typically match the period over which the investor installment note amortizes. The fixed rents payable by the leasing company to the investor will be at least equal to the amortization of the investor installment note issued to the packager and the transaction will always be *at least* cash neutral during the term of the wrap lease. Depending on equipment residual expectations, the investor may insist that the fixed rent significantly exceed the note amortization. That is, the investor's economic profit potential will consist of cash flow during the lease term and residual ownership. The wrap lease normally requires that the leasing company pay contingent additional rent from all of, or a portion of, the net revenue derived by the leasing company after expiration of the initial user lease and before expiration of the wrap lease.

The structure can best be illustrated by the following simple example.

On January 1, ABC Leasing Company enters into a 60-month lease with XYZ User for $1 million in equipment recently purchased by ABC from a manufacturer (the initial user lease). The rent paid to ABC is $20,000 per month.

ABC finances the initial user lease with GRDE Bank on a nonrecourse basis for 60 months at approximately 12% per annum. Payments to the bank are $19,800 per month. Bank advances $900,000 leaving ABC with a $100,000 investment.

ABC sells the equipment for its fair market value of $1 million to SKNE Packager. The purchase price is payable by SKNE with $150,000 in cash at closing and by delivery of a packager installment note in the amount of $850,000 payable in 84 monthly installments of principal and interest of $14,500 per month.

SKNE sells the equipment to an investor for $1 million, payable $150,000 at closing and by delivery of a secured investor installment note in the amount of $850,000 payable in 84 monthly installments of principal and interest of $14,550 per month.

The investor enters into a wrap lease of the equipment with ABC Leasing Company for 84 months at a fixed monthly rental of $14,900. In addition, the investor will receive 50% of all net proceeds received by ABC from the releasing of the equipment to XYZ User or to a new user between the 61st and 84th month of the wrap lease.

The investor has the option of causing ABC to remarket the equipment at the end of the 84-month lease term for which ABC will receive a market rate fee.

The equipment has an economic useful life of ten years and an expected residual of 15% of original cost at the end of 84 months. The rental value of the equipment in months 61 through 84 is $5,000 per month.

Tables 2 through 4 illustrate the economic result (without consideration of tax attributes) to the leasing company and the investor. Assuming the facts occur as illustrated, ABC has transferred about half of its pretax cash profit opportunity of $182,000 to the investor and packager.

Table 5 illustrates the tax impact of the wrap on the leasing company and the investor. As can be seen, the wrap significantly affects the timing of taxable income and loss to the leasing company. This shift in timing is precisely equal to the timing of tax losses and income to the investor. A similar effect is obtained in every sale/leaseback transaction. Obviously, over the term of the transaction taxable income and loss of the parties is equal to "economic profit." Keep in mind that the analysis does not focus on internal rate of investment return, but on the flow of cash and tax attri-

butes between the parties.

There are a few critical components in the structure of the wrap that require further exploration before turning to tax issues.

• **Fair Market Value** In many cases, the price paid for the equipment by the investor exceeds the price paid by the leasing company on its initial purchase of the equipment. This occurs primarily where the leasing company has made a bulk purchase of equipment at a discount or where a wholesale purchase of new or used equipment has been made. The leasing company may support the selling price to the investor with appraisals or comparisons to list price.

• Because of over-valuation issues many packagers are refusing to permit a markup of equipment cost unless value is well supported by independent parties.

• **Relationship with Packager** In some circumstances, the packager has been an affiliate of the leasing company. In these cases, it is obviously difficult to establish the arm's length nature of the relationships between the parties. Many authorities feel that relationships with an independent packager are essential for supporting the arm's length nature of the transaction. In addition, many packagers have now developed an independent distribution expertise that truly adds value to the transaction.

• **Flow of Cash between Parties** is approached in two ways. In the simplest method, the only cash that actually flows to the investor is the excess of fixed rent and renewals under the wrap lease over the investor's debt service to the packager. The balance of all remaining payments are covered by standing acknowledgement letters between the parties. This method has been used for years in sale/leasebacks, but may raise issues with respect to the substance of the transaction. The most protective *and* substantive method for handling flow of cash between the parties results from use of irrevocable letters between the parties directing their banks to make the appropriate transfers at the appropriate time.

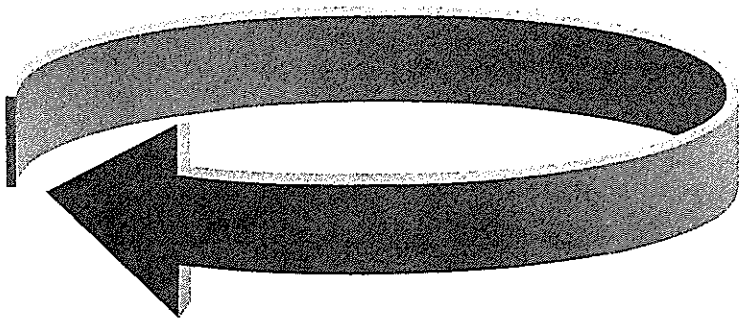


Table 4

ANALYSIS OF CASH FLOW
CASH TO LESSOR/EQUITY INVESTOR

Initial cash investment	$(150,000)
Rent received from leasing company in excess of debt service to packager*	29,400
Additional rent received from the leasing company in months 61 thru 84	60,000
Residual realized	150,000
PROFIT TO LESSOR/EQUITY INVESTOR	$ 89,400

*Rent of $14,900 per month for 84 months less debt service to packager of $14,550 per month for 84 months.

• **Soft Income** Like most sale/leasebacks, the wrap creates "soft" taxable income (that is, income without cash) in its early years and soft tax losses in later years. The soft income and losses are precisely equal to the tax attributes transferred to the investor. In the example, the leasing company will report $348,800 in taxable income in the first five years of the lease, using a wrap and $88,000 in tax losses if a wrap isn't used (a difference of $436,800 per $1 million in equipment). During the same period, the leasing company has generated only $150,000 in additional cash (the cash portion of the investor's purchase price). This obviously necessitates use of a wrap by a leasing company who has a surplus of tax losses or credits. This problem, if it is a problem, can be dissipated through the use of a number of techniques. In a technique similar to one used in leveraged buyouts, it is possible for the leasing company to joint venture with another entity capable of absorbing the soft income.

A number of structural variations have been developed that are of significance, the most important of which eliminates the use of a packager and the pledge of the initial user lease to a financial institution.

When a packager is eliminated, the equipment is sold directly to the investor by the leasing company. The investor then finances its purchase by assigning the *wrap lease* to a financial institution. This can be accomplished

only when the credit of the leasing company is well-established.

In another variation, the leasing company finances its acquisition of the equipment from internally generated funds and does not obtain secured nonrecourse financing by assignment of the initial user lease. This is done where the leasing company is a major "single investor" lessor and has sufficient unsecured borrowing capacity.

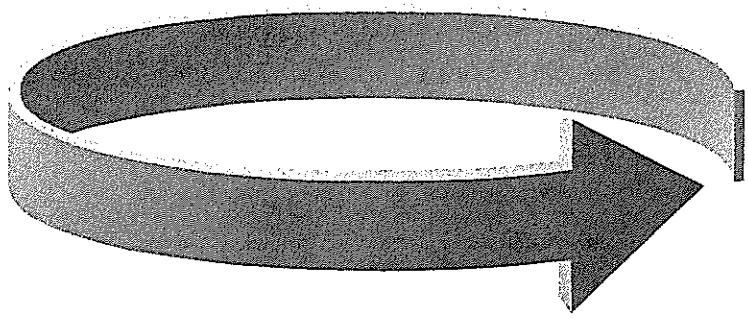


Table 5

TAXABLE INCOME OR LOSS TO THE PARTIES

Year	To ABC Leasing Company		To the Lessor/ Equity Investor
	No Wrap	Wrap	
1	$ (200)	$ 53,100	$(53,900)
2	(61,600)	59,900	(122,400)
3	(31,900)	68,300	(100,800)
4	(9,700)	78,100	(87,800)
5	15,400	89,400	(74,600)
6	60,000	(121,400)	180,800
7	210,000	(138,700)	348,100
	$182,000	$ 88,400*	$ 89,400*

*Difference between totals and total profit of $182,000 is the profit realized by the packager over the term of the transaction.

TAX CONSIDERATIONS

The tax requirements of the wrap structure are, in general, identical to those of any leveraged lease transaction. The tax controversies relating to the wrap center in three primary areas:

- The wrap generally meets some but not all of the ruling requirements set forth in Rev. Proc. 75-21, etc.[6] Thus, a wrap is automatically thrust into the realm of the uncertainty of private letter rulings, legal opinions and apparently inconsistent case law. It is clear however, in the ultimate sense, that the IRS and the courts do not rely on the objective requirements of Rev. Proc. 75-21, etc., but more rationally rely on the subjective tests of economic profit motive and shifting of benefits and burdens of ownership.

- There is little dispute that the structure of the wrap optimizes tax attributes. Case law is clear that a taxpayer is entitled to structure its affairs in a manner that minimizes its tax burden, so long as minimization of tax burden is not the sole purpose for the investment or structure of the transaction. It is thus possible for the *form* of the wrap lease to be disregarded and treated as a sale if the investor is deemed to hold insufficient ownership attributes.[7]

- The IRS and, most likely, the courts will disregard a transaction (irrespective of its form) where there is no profit motivation (exclusive of tax attributes) and business purpose. A number of early wraps involved circumstances where (1) the term of the wrap lease may have been extensively long in relation to equipment life, (2) fair market value may have been inadequately supported, (3) the leasing company retained a substantial share of residual and residual expectations were unrealistic or unsupported, and (4) the leasing company retained full authority with respect to refinancing of equipment and the investor appeared to assume no responsibilities of ownership. In these cases, transference of tax attributes appeared to be the sole purpose for the transaction and the IRS disregarded them in their entirety.[8]

When all of the above factors are combined (noncompliance with objective ruling standards, high tax motivation, and inadequate demonstration of economic substance) *any* lease transaction can become suspect. As private letter rulings and case law evolved and analytical sophistication increased, it is clear that greater emphasis was placed on economic substance in wraps.

While no objective rules exist, I think, at least with respect to the more obvious tax issues discussed above, that the investor or its advisors should apply the following standards when considering an investment in a wrap transaction (or any lease investment):

- The investor should be able to demonstrate that a nondiscounted cash-on-cash return is expected, exclusive of tax attributes, from cash flow during the term of the wrap lease and residual. Multiple (and reputable) appraisals of renewal rent opportunities and residual values should be obtained.[9]

• Reputable evaluations of fair market value and equipment life in relation to the term of the wrap lease also should be obtained. Obviously, if the equipment is sold to the investor at a price in excess of fair market value and leased back for excessive periods, the viability of the transaction can be questioned.[10]

• Compare the present value of the rents from the initial user lease plus residual value at the end of the user lease to the investor's purchase price. If there is a substantial disparity between the two, require an explanation of how market value was determined. If the equipment is new, compare the investor's purchase price to available list prices.

• Since the wrap lease is a net lease, there are few ministerial burdens of ownership (insurance, maintenance, taxes) assumed by the investor. Thus, if the investor also gives the leasing company absolute discretion in refinancing and remarketing, indicia of ownership have been stripped to a minimum. The investor should, as a rule of thumb, retain some authority over remarketing and refinancing which are the primary remaining risks of ownership in a net lease.[11]

• If the leasing company has the right to remarket the equipment at termination of the wrap lease, the remarketing arrangements should be at arm's length (that is, the remarketing fee should be comparable to industry standards). Time periods and objective remarketing standards should be established. In a number of recent transactions, the investor has been permitted to use other companies to remarket the equipment.

• There is no objective method for determining *how much* cash-on-cash return must be present to insure viability. It is also clear that every lessor includes tax attributes in measuring *rate* of *return*. While the IRS uses discounting as a test to determine if further inquiry is required on audit, the courts have not evidenced an inclination toward adopting use of a discounting method for purposes of determining economic viability. Thus, the requirement for cash-on-cash return may not be substantial and may vary in accordance with each investor's criteria, but the expectation of cash-on-cash return must be realistic and demonstrable when considering all facts and circumstances.[12]

• Tax deferral mechanisms such as step-up rents, cash/accrual differences, balloon payments, and the like, should be used only when the commercial reasonableness of those techniques is established.[13]

• It is most important to insure that the leasing company, packager and promoter of the transaction are experienced and reputable. Large capitalization isn't essential. There are many small, very reputable and experienced companies who sponsor wrap transactions.

If each of the above standards are considered by the leasing company and the investor, the viability of the wrap transaction is likely to be favorably compared to any lease transaction.

There are other more esoteric tax elements in the wrap that do not necessarily affect the treatment of the transaction as a true lease, but would limit or change the timing of deductions by the investor.

The primary esoteric risk relates to the "at-risk" limitations of IRC Section 465. The tax losses of individuals and certain closely held corporations who are investors would be subject to limitations to the extent that they are not "at-risk" in a wrap.

• Under IRC Section 465 (b)(3)(B) an investor who is required to be "at-risk" could not include the investor installment note in its "at-risk" amount if the amount is considered to be "borrowed from any person who has a capital interest (other than an interest as a creditor)" in the activity.

• Under proposed Treasury regulations, the investor installment note is not included in "at-risk" amounts if the packager is considered to have either a capital or net profits interest in the activity.[14] The mere fact that the packager holds a lien on the equipment and would receive foreclosure proceeds would not give the packager a capital interest in the activity. If however, the packager retains a *net profit* interest in the residual, it may have a net profits interest in the activity.

• The fact that the leasing company holds a residual remarketing interest based on *gross income* should be insufficient in and of itself to support the position that the leasing company has a net profit interest in the activity.[15] However, if the packager is treated as a mere conduit, with the result that the investor pays debt service on the investor installment note to the leasing company (through the packager), the investor installment note may be treated as borrowing from an entity (the leasing company) who has a net profits interest in the lease.

In order to avoid these pitfalls, it may be best to insure that the leasing company and packager are unrelated; the leasing company does not hold a lien on the equipment from the packager; the leasing company's residual or remarketing interest is based on gross revenue; and that the packager is itself a substantive entity and that its relationship with the parties is "commercially reasonable."

Keep in mind that Section 465 gives Treasury reasonably broad authority and no final Treasury regulations exist for Section 465. These issues should always be reviewed by competent tax counsel.

Other more complex tax issues have to be considered. For example, does the fact that the leasing company has a residual interest mean that a partnership has been created between the leasing company and investor? This issue was explored inconclusively in a recent case.

CONCLUSION

There is no question that the leasing industry, the IRS, courts and Congress are concerned justifiably about

use of tax shelters whose *sole purpose* is avoidance of tax. Appropriate steps are being taken to discourage such transactions.

As this article points out, the wrap is merely a form of leveraged lease. As with all leveraged leases, the issue of economic substance is not necessarily susceptible to objective numerical tests. The definition of economic substance is much like that of obscenity: "I can't define it; but I know it when I see it."

Clearly, if the economic viability of a wrap is properly supported and the tax issues are properly considered, it is a useful and appropriate investment tool consistent with the spirit and letter of tax policy.

When a leasing company is using the wrap vehicle, it is, in fact, using the investor's asset and is in some way acting in a fiduciary capacity. We should treat the asset and the transaction in that light.

FOOTNOTES

1. See, *Rice's Toyota World, Inc. v. Commissioner*, 81 T.C. No. 16 (August 29, 1983).

2. While a discussion of securities law aspects of wraps is not within the scope of this article, the Securities and Exchange Commission recently, in a refusal to issue a "no action" letter, concluded that a wrap was a security. *Meridian Leasing Corp.*, ("no action" letter available January 19, 1984).

3. Private transactions on a one-on-one basis have diminished while syndications have expanded dramatically.

4. The initial user lease is normally accounted for as an operating lease by the parties.

5. If the investor is required to be "at risk," the note will be at least partially recourse. In some situations the recourse obligation can be deferred in the event of a default.

6. Revenue Procedure 75-21, 1975 C.B. 715. However, the Revenue Procedure specifically states that its guidelines do not attempt to define, as a matter of substantive law, whether a transaction is a lease for tax purposes.

7. See National Office Technical Advice Memorandum, Ltr. 8418006, December 9, 1983. The IRS concluded, in a wrap structure similar to the example in this article that the lessor (investor) was not the owner of the equipment and that the wrap lease was not a true lease for tax purposes. Heavy emphasis was placed on the IRS view that there was an "inadequate" shifting of the benefits and burdens of ownership (see footnote 10).

8. Cf *Rice's Toyota World*, supra; *E.A. Brannen*, 78 T.C. 471 (1982). In *Rice*, the court held that a purchase and leaseback of computer equipment was a sham, on the ground that the taxpayer lacked a business purpose for entering into the transaction and there was no "realistic hope of profit." Based on the testimony of expert witnesses regarding residual values, the court concluded that the taxpayer would not even recover its initial investment. The taxpayer in *Rice* was to receive only 70% of any residual value and the purchase price in *Rice* exceeded the fair market value of the computer. The case emphasizes the importance of residual values and the necessity that investors conclude that there is a realistic hope of profit, apart from tax benefits. For an excellent discussion of the *Rice* case and the tax consequences of equipment sale/leasebacks, see Rubinstein and London, "Sales and Leasebacks: Some Valuation Problems," *The Tax Lawyer*, Vol. 37, No. 3, Spring, 1984.

9. In *Rice*, the Tax Court seemed to acknowledge that tax deferrals were the primary factors considered by the investor, but permitted appraisals that were attained only in conjunction with the litigation (and not at the time the transaction was closed) in support of the taxpayer's profit motive. Clearly, contemporaneous appraisals may have been more persuasive.

10. If the investor's purchase price exceeds fair market value by 200%, "gross overvaluation" penalties may be assessed under the Tax Equity and Fiscal Responsibility Act of 1982. In overvaluation situations, two arguments are made: (a) The investor's basis is overstated, particularly if the investor installment note is nonrecourse; and (b) the investor has no "equity" in the transaction and therefore no "profit motive."

11. After it is determined that the investor has entered into a real transaction with sufficient profit motive to support deductions under Code Sections 162 or 212, the next logical issue is whether the purchasers have made an equity investment or whether the transaction should be recharacterized as a financing in which the purchasers acquired no equity ownership interest in the property. Normally ownership of property is determined by examining which party to the transaction has the benefits and burdens of ownership. Although the Supreme Court's decision in *Frank Lyon Company* v. *United States*, 435 U.S. 461 (1978), is an uncertain precedent because of the many factors mentioned by the Court, I believe the case stands for the proposition that in a net lease transaction many of the benefits and burdens of the property may be shifted to the net lessee, and what is in question is whether the purported owner has the traditional attributes of a net lessor.

12. Some authorities believe that, as a result of accelerated cost recovery system depreciation and investment tax credit (when available) more accurate tests are (1) whether an investor obtains a reasonable after-tax return and (2) that this return can vary significantly as a result of changes in value of the property; *Frank Lyon Company* v. *U.S.*, *435* U.S. 461 (1978).

13. Section 74 of the Deficit Reduction Tax Bill of 1984 (adding Section 467 to the Internal Revenue Code) as passed by the Senate would virtually require a "commercial reasonableness" test. Provisions of H.R. 4170 (The Tax Reform Bill of 1984) would eliminate cash/accrual differences. Both of the bills were awaiting conference committee reconciliation at the time this article was written.

14. Proposed Treasury Regulation Section 1. 465-7(b)(1).

15. See Example 2 of Proposed Treasury Regulations Section 1.465-8(b)(4).

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