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Tax-Based Leasing: Broader Public Policy Issues

By Lawrence B. Lindsey

Lawrence B. Lindsey is president and chief executive officer of The Lindsey Group, a global economic advisory firm based in Washington. He previously served as director of the National Economic Council under President George W. Bush.

Congress is considering reforms of tax rules regarding sales, leases, and sales contracts involving depreciable property. As in many areas of taxation, there is no question that some leasing transactions that are technically permissible go well beyond what Congress intended. In considering reforms in this area, Congress should be aware of some of the broader public policy issues that might be affected by reform.

The Economics of Leasing

Fundamentally, a leasing transaction involves a separation of the owner of a property from its effective user. An investor buys a property and then provides it to the user on a long-term basis for monthly or annual rent. For analytic purposes, the owner's cost of holding a property can be thought of as the sum of the rate at which the property wears out, or economic depreciation (d), and the interest foregone by holding the property rather than a financial instrument (r). In the absence of taxes, the owner of a property could be made whole by leasing the property at a rate that covers d+r.

In the absence of taxes, leasing typically makes sense because some business entities might have a lower cost of, or easier access to, capital than other entities. In the above analysis, "r" might be lower for one company than another. In that case, the company with the higher "r" might find it in its interest to lease its equipment from the company that can obtain capital at a lower rate. Large companies with easy access to credit, such as General Motors and General Electric, have divisions that specialize in leasing.

Taxes become an important component of the leasing transaction when the rate of allowable tax depreciation is different from the rate of decline in the residual value of an asset. To see this, consider the case in which tax depreciation corresponded to economic depreciation. The leasing company would be expected to receive a periodic rent that covered the economic depreciation and interest cost of owning the property (d + r) for the period. Depreciation equal to the economic depreciation (d) would be deducted for tax purposes, as would the interest paid on the capital borrowed to buy the property (r). The net effect of the leasing transaction would be a wash and no taxes would be due on the transaction.

The cases in which tax depreciation corresponds to economic depreciation are few as tax law necessarily groups assets into classes for depreciation purposes to ease compliance and enforcement. But two other issues make the straightforward case described above fairly uncommon. First, some firms may not be profitable and have no taxable income against which they can apply their depreciation deductions. In this case, the company that uses the asset will have a rate of tax depreciation far below actual depreciation, and therefore has a clear tax motivation for leasing the property from a profitable and taxable company. Second, Congress may choose to intentionally make tax depreciation rules more generous than actual depreciation in order to encourage investment. This makes taxes an inherent factor in any leasing transaction since the present value of the tax deduction for depreciation is higher than the economic depreciation for the property.

Profitability and Tax Leasing

Those issues were addressed directly by Congress two decades ago. In 1981 Congress passed the Economic Recovery Tax Act (ERTA). Before 1981, leasing explicitly for tax purposes was prohibited. Lease transactions were subject to a series of tests under tax law to establish whether or not they had nontax economic substance. Leasing could not be used for the sole purpose of transferring tax deductions. Leases that failed these tests were reclassified as conditional sales or as financing arrangements. In these cases, the lessee would lose the deduction for the rental payments made in the lease but retain the depreciation deductions and investment tax credit associated with the property.

The lessor would be taxed on any difference between the money received for the property and the tax basis. Needless to say, this created a substantial disincentive to undertake transactions that ran afoul of the economic substance rules.

ERTA explicitly established a set of rules to facilitate leasing exclusively for tax purposes. As the Joint Committee on Taxation noted, "These provisions were intended to be a means of transferring tax benefits rather than a means of determining which person is in substance the owner of the property."[1] The law therefore moved from explicitly prohibiting tax-based leasing

[1]Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982,* p. 45.

transactions to actively facilitating them. A look at congressional thinking underscores the rationale for this shift.

In explaining its reasons for this change of approach, the problem faced by unprofitable companies was important. Under "Reasons for Change," the Joint Committee said, "Under the prior law depreciation rules, many corporations were in a loss position and thus unable to utilize fully the tax benefits of depreciation deductions."[2]

The law moved from explicitly prohibiting tax-based leasing transactions to actively facilitating them.

If a company is not making a profit, the tax reduction that would result from depreciating a property the company bought for investment purposes could not be used in the year of the purchase. Instead, the depreciation deduction would result in an increase in the firm's net operating loss. Those losses could be carried forward seven years or back three. But this meant, in effect, the depreciation deduction would be deferred until the company turned profitable because the negative taxable income of the company would be carried over and applied against taxable income once the company returned to profitability. Due to the time value of money, the need to carry over the deduction meant that the firm had a higher after-tax cost of acquiring the asset than a profitable company.

The deferral of the depreciation deduction created an important reason for tax-based leasing. A company with profits from ordinary operations could buy a property and lease it to a nonprofitable company and receive the depreciation deduction immediately. This meant that a clear tax motive existed for leasing because the present value of the depreciation deduction occurred sooner and thus the after-tax cost of acquiring the property was lower in a leasing transaction than in a purchase for companies that were not currently profitable.

It is important to note that this was true even if tax-based depreciation schedules exactly corresponded to true economic depreciation. The effective deferral of the depreciation deduction for tax purposes for a company with insufficient taxable income to take the deduction meant tax depreciation was slower than actual depreciation. The leasing transaction made tax and true economic depreciation more similar by allowing the lessee to receive a portion of the benefits of the depreciation deductions used by the currently taxable lessor, and thus pay a lower rental cost for the property.

In retrospect, the advent of leasing provided an economic benefit that was not fully appreciated at the time. It leveled the playing field between profitable or taxable entities and nonprofitable or nontaxable entities with regard to the cost of acquiring an asset. The issue of neutrality of investment cost with respect to tax status is an important one that was widely debated at the time, and is quite applicable in the current debate.

When the provisions of ERTA were enacted, there was some concern that extending the benefits of depreciation deductions to nontaxable entities was both bad tax policy and inefficient economically. Entities that might never prove profitable would still, in effect, receive a depreciation deduction through a leasing transaction. From a tax perspective, this would mean that a depreciation deduction for an investment would be extended to the company but the flow of capital services that resulted from acquiring the asset would never be subject to tax. The economic effect of this would mean that firms that were not viable would stay in business longer since the profitability signal to encourage investment would be muted.

At the time this argument was being played out in an economy undergoing a very rapid transition. It could be reasoned that declining "rust belt" industries would stay in business longer as a result of having access to the tax benefits of depreciation through leasing. This might be viewed as inefficient since capital would exit from declining industries more slowly than it otherwise would, as their cost of acquiring capital would be reduced through leasing.

However, over time a consensus has emerged that this concern was more than outweighed by two other economic benefits. First, leveling the playing field from a cost-of-capital point of view probably creates a more dynamic and efficient economy on net. Key to this is that start-up businesses were also key beneficiaries of tax-based leasing. It is a rare business that becomes profitable in the first year of its existence. As a result of leasing, these start-up businesses could enjoy the benefits of a lower user cost of capital than they otherwise would.

It is also not clear that economic dynamism is reduced by limiting tax depreciation for mature enterprises. No one can tell with any certainty that a company or industry that is currently unprofitable is ultimately going to exit from the economy. Denying current tax depreciation to unprofitable companies targets cyclical industries, not necessarily dying industries. In fact, the wisest long-term time to invest in updated plant and equipment in a cyclical industry may well be in an economic downturn. This might be especially vital for the company and for the economy if the reason for the downturn is foreign competition. Cost-reducing investment might be key to the survival of this industry — an industry that might otherwise prove internationally competitive over the long run. Leveling the playing field with regard to the acquisition of assets by firms with differing tax statuses is therefore a key economic advantage of permitting tax-based leasing.

The second economic advantage of allowing tax-based leasing to make depreciation deductions more widespread is on the macro-economic level. Business fixed investment is usually the most cyclical component of the economy. It declines the fastest as the

[2]Joint Committee on Taxation, *General Explanation of the Economic Recovery Tax Act of 1981,* p. 103.

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economy deteriorates. It is usually the sector of the economy whose revival leads to a self-sustaining economic expansion. It is also certainly the case that as economic conditions deteriorate, more and more companies find themselves in a nonprofitable and non-tax-paying situation.

In the absence of tax-based leasing, the confluence of declining investment and non-tax-paying status exacerbates the business cycle by raising the effective cost of capital to many firms just when business fixed investment is most needed to sustain an economic revival. By smoothing out the cost of capital over the business cycle, tax-based leasing acts as a countercyclical force. Sometimes economists call this an "automatic stabilizer." In this case it is not quite accurate since tax-based leasing merely offsets one of the economically destabilizing features of the tax system, the loss by non-taxable entities of the economic benefits of depreciation deductions, rather than actually contributing to stability by itself.

> ***In sum, the economic benefits to tax-based leasing are now widely recognized, more so than they were when the practice first became widespread two decades ago.***

In sum, the economic benefits to tax-based leasing are now widely recognized, moreso than they were when the practice first became widespread two decades ago. Recently, some who are concerned with the abuses associated with leasing have argued that the standard for leasing should return to its pre-ERTA status, that there be economic benefit in the leasing transaction even in the absence of taxes. By that they mean that there should be demonstrable economic benefit to the contracting parties, not that there should be economic benefit to the economy as a whole. If adopted, that position would undermine both the dynamic and the economic stabilizing benefits to the economy of a tax-based leasing system.

Leasing and the Use of Tax Incentives

The extension of tax-based leasing provisions in ERTA also corresponded to a decision regarding the workability of deliberate policies enacted by Congress to encourage investment. By "deliberate" we mean that the effective rate of depreciation for tax purposes is consciously held below the actual expected decline in the residual value of the asset. This deliberate policy goes well beyond the "automatic stabilizer" described above. When ERTA was passed, the stated rationale was that "prior law rules for determining depreciation allowances and the investment tax credit needed to be replaced because they did not provide the investment stimulus that was felt essential for economic expansion."[3]

Nor was the case for faster depreciation deductions limited to the case of macroeconomic stimulus due to a downturn in the business cycle. Rather, investment incentives had a long-term purpose in stimulating the overall rate of economic growth and national competitiveness. "The congress agreed . . . that a substantial restructuring of depreciation deductions and the investment tax credit would be an effective way of stimulating capital formation, increasing productivity, and improving the nation's competitiveness in international trade."[4]

But leasing proved essential to the effective administration of these laws. Congress was explicit in this in its rationale for establishing leasing. "Since, in most instances, the deductions permitted under the Accelerated Cost Recovery System (ACRS) are more accelerated than those permitted under prior law depreciation rules, the net operating losses of companies previously in a loss position would be increased and companies that were marginally profitable for tax purposes could be thrown into a loss position." Hence, some way had to be found to make the deliberate policy of increased depreciation deductions workable, and leasing provided it.

This issue remains with us today. In 2001 and again in 2003, Congress approved a temporary "bonus" depreciation provision. This provision allowed investing companies to depreciate a portion of the cost of the investment in the year in which the investment was made and to depreciate the remainder according to the normal depreciation schedule. This clearly was intended to make tax depreciation greater than true depreciation to encourage firms to invest in new plants and equipment. To date, it appears to have been successful in that regard.

Should Congress choose to restrict leasing to cases where a clear nontax economic purpose is served for the contracting parties, it needs to consider carefully how the macroeconomic management it mandates through creation of investment incentives can be carried out. These investment incentives are a powerful tool in stabilizing economic policy and in contributing to the long-term growth and international competitiveness of American industry.

Leasing and the Public Sector

While the economic benefits to the private economy discussed above are now widely accepted, an increasing number of leasing transactions are occurring for purchases of investment goods that are used by public-sector entities — most notably states and municipalities. This is far more controversial and some of the arguments that apply in support of tax-based private-sector leasing do not apply as directly in the case of public-sector goods. Indeed, at a superficial level, it might seem that all leasing transactions to the public sector would constitute an abuse.

The key element of this argument is that the flow of capital services to a public-sector entity is not taxed.

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[3]Joint Committee on Taxation, *General Explanation of the Economic Recovery Tax Act of 1981,* p. 75.

[4]*Id.*

Therefore, it is argued, the depreciation of the investment goods used by the public sector should not be accorded a tax benefit. In effect, it is argued, the investment gets a tax deduction without offsetting taxation of the income from the investment.

This is not actually the case, although one must probe more deeply into the economics of the leasing to understand why. Consider a standard leasing transaction. A private taxable company acquires an investment property and leases it to a city government. To cover the cost of acquisition, the private company must charge a fee that covers the true economic depreciation of the investment plus the cost of capital. This is the same (d + r) that would exist in a hypothetical world without taxes discussed above.

> ***Should Congress choose to restrict leasing to cases where a clear nontax purpose is served, it needs to consider carefully how the macroeconomic management it mandates through creation of incentives can be carried out.***

The rent received by the private leasing entity is taxable income. That taxable income is offset by the tax depreciation it is allowed and the interest it must pay to borrow the money to acquire the investment. Thus, in a simple world where the company charges a fee of (d + r) to the city, tax depreciation exactly offsets true depreciation, and the private company can borrow the full amount of the cost of the investment, there is no tax effect in this transaction. The rent received of (d + r) is exactly offset for tax purposes by a depreciation deduction (d) and an interest deduction (r). This would be the same for a taxable private business with exactly the same set of facts. The act of leasing an investment property by a taxable private-sector entity to a municipality therefore creates a taxable stream of income that offsets the depreciation and interest deductions for the private leasing company.

But there may be some differences worthy of consideration in the case of the municipality. First, the municipality does not receive an interest deduction if it were to acquire the property, but the private leasing company would. This is much less important than it would seem. If the municipality were to buy the property on its own, it could finance it through the municipal bond market and thus obtain a lower cost of capital than a private-sector entity could. From a tax point of view (and equivalently from a revenue cost perspective) this is roughly the equivalent of a deduction for interest expense by a taxable leasing company. If all leasing does is replace tax-exempt debt with private-sector debt, the interest on which is tax-deductible, there is no additional subsidy.

Public-sector entities often choose leasing for other reasons. For example, there may be limits imposed by voters or by other laws on borrowing. Rating agencies might express concern about the overall level of debt. Municipalities might also be subject to voter approval requirements for new bond issuance. These tend to be more important motivating factors, not interest cost differentials.

In addition, private-sector entities are far less likely than most municipalities to be able to borrow the entire cost of the investment project. In most cases, a significant portion of the investment must be raised through equity, not debt, the return to which is not tax-deductible. In sum, there is little reason to suspect that there are important tax-related advantages to leasing from the cost of capital perspective.

From a tax perspective, the advantage to leasing hinges on the difference between tax depreciation and actual depreciation. The fact that the private taxable entity gets a tax deduction for depreciation does not by itself constitute an advantage, since it must charge the city a fee that covers the depreciation and that fee is itself taxable. If the leasing company did not charge a rent that at least covered depreciation, it would be left at the end of the lease with a fully depreciated asset and no funds to cover the acquisition cost.

There is, however, an important way in which the leasing company could generate a profit by engaging in this transaction. It is the case when tax depreciation does not accurately reflect true economic depreciation, specifically when tax law depreciates an asset more rapidly than that asset depreciates in practice. We have considered reasons why this might be the case. Since market forces would tend to cause the leasing fee to reflect true economic depreciation, a positive cash flow develops if tax depreciation is faster and the company involved has other taxable income to which it can apply the excess depreciation on the leased transaction.

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There is a very important caveat to add. The "excess" depreciation allowed by the tax schedules is not an excess in the normal sense of the word. Both the tax schedule and true accounting depreciation will produce the same dollar value of depreciation deductions over time. The difference represents simply a timing difference in taxation, not a permanent deferral of taxes. More rapid tax depreciation means that the company has the resulting cash flow benefits sooner. That is an important benefit with real value to private-sector entities. But over the life of the asset the total tax value of the depreciation deduction and the revenue foregone by the Treasury are exactly the same.

In essence, the reasons leasing might be an attractive proposition from a tax point of view are the same for public-sector entities as for private-sector entities that are not currently subject to tax. Tax depreciation can be faster than true depreciation because no legislated one-size-fits-all depreciation schedule can possibly control for all the vagaries of the real world, or more likely, because Congress intended that that be the case. The economic rationale for this is today widely viewed

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as noncontroversial for the reasons discussed above. But this raises an important public policy question regarding investment by state and municipal governments. Critics ask why the government should provide a subsidy to promote investment in infrastructure and assets by tax-exempt entities.

The question could be posed differently. Why should the federal government put municipalities and other tax-exempt entities at a competitive disadvantage vis-à-vis private entities? In other words, once we have created a system in which investment in capital goods is encouraged through tax depreciation that is intentionally faster than economic depreciation, it makes little economic sense to deny the benefit of that depreciation to private-sector entities that either lease property to, or use property to provide services to tax-exempt entities. The debate on extending depreciation to firms that lease to public-sector entities closely parallels the debate of two decades ago regarding tax-based leasing to nonprofitable private-sector entities.

At some point this is a purely philosophical question that depends on one's attitude toward such issues as federalism and the relative roles of the public and private sectors. But if Congress chooses to address the issues involved in leasing to public-sector entities, it should realize the close parallels regarding the larger economic issues of public policy discussed with regard to loss-making private enterprises.

The first issue in the case of leasing to private-sector entities was that of the level playing field. In the case of state and local governments the question of temporary unprofitability due to the cyclical nature of the industry or the infancy of the business does not apply. There is no issue of a local government enjoying the tax benefits of incentive depreciation in some years but not others. Nor are state and local governments at a temporary competitive disadvantage with respect to the cost of capital relative to other state and local governments. On this basis, the case of extending the benefits of leasing to municipal governments to level the playing field between competing enterprises is less compelling than in the private sector. But there may be other reasons why a municipality or transit agency may not want to borrow to finance new improvements — such as cash flow issues, debt ceilings, voter concerns, and rating agency issues.

The level playing field argument does take on another dimension. The decision whether a particular good or service is best provided by the public sector or the private sector should, for economic efficiency reasons, be decided by which sector does a more cost-effective job in the absence of tax considerations. (Taxes are simply a transfer of resources within society; they do not reflect use of scarce economic resources.) The private sector often complains that the tax-exempt status of municipal governments favors the public provision of goods and services that the private sector could also provide. Incentive-oriented depreciation works in the other direction with regard to the cost of capital.

Incentive-oriented depreciation is not intended as an offsetting compensation to the private sector. Incentives for investment are often transitory in nature and tied to the business cycle. From an economic perspective, there would seem relatively little reason to encourage investment in one case and not the other. So, while the playing field argument is ambiguous, the second argument — the need for providing countercyclical stimulus — does support extending leasing benefits to municipalities. State and local finances are notoriously subject to the vagaries of the economic cycle. Although state and local revenues probably have an elasticity with respect to economic activity below one — and certainly below that of the federal government — their ability to access capital markets is far lower. Typically state constitutions have balanced-budget requirements that would prohibit borrowing to maintain spending during temporary downturns.

> ***From a strictly macroeconomic perspective, it shouldn't matter whether increased spending comes from the private sector or the public sector.***

Demands for state and local spending are generally not responsive to the business cycle and their social service component may actually rise during a downturn. The typical response of state and local authorities is to cut those expenditures that are most easily postponed — typically investment decisions. Providing access to lease financing may produce both a price and an income effect. Not only would the cost of investment be reduced, but the cash flow of municipal coffers would also benefit. In this latter regard, leasing is a particularly attractive alternative since only a fraction of the acquisition cost of the investment must be expended in the year of the downturn.

Ultimately, the purpose of Congress in passing incentive depreciation provisions would seem to be the decisive factor. Congress passes those incentives to boost the economy during flagging times. From a strictly macroeconomic perspective, it shouldn't matter whether increased spending comes from the private sector or the public sector.

Public-Private Partnerships

A second-larger public policy issue that should affect congressional consideration of leasing rules regards cooperative activities between the public and private sectors. In political discourse these are often called "public-private partnerships" and are a concept that enjoys rhetorical support across the political spectrum. While different politicians often have different understandings of what they mean by the term, in an ideal sense those partnerships are an outgrowth of the economic efficiency principle that the entity that can do the best job should be the one doing it. In a wide variety of situations — from urban redevelopment to provision of social services — both public- and private-sector agents have an advantage in providing some aspects of the good or service in question. Several capital-intensive aspects of urban development — from

transportation infrastructure to business district revitalization — are ripe for the use of leasing.

The fundamental reason for this is that municipal governments are not particularly advantaged at the maintenance of capital. Yet their involvement is crucial in those projects.

Consider a subway system. The system itself almost certainly has to be owned by the city as it involves the use of land and the amelioration of competing political interests that only the political process can provide. But this does not mean that the subway cars or even the track has to be owned by the city.

Stepping back from the political realities, municipal ownership of depreciable assets makes little sense from a financial perspective.

The cyclical problems of municipal budgets have already been noted. In the case of cities in particular, raising local property taxes during a downturn is a particularly bad option for long-term development. Most of the spending components of the city budget are largely untouchable, either legally in the case of social services, or politically, in the case of city workers. The result is that cities in financial trouble often cut maintenance spending, particularly on large infrastructure projects.

In the long run this increases the cost of running the city subway. But in the political corollary of John Maynard Keynes's dictum, "in the long run someone else is in office." There is usually no consequence to skimping on maintenance expenditures if the city owns the capital.

This is not the case in leasing. The private-sector leasing company owns the capital. Either it holds responsibility for maintenance, or, more typically, the leasing contract has provisions that require that the city maintain the capital. The leasing company has every incentive to enforce these provisions since the residual value of the property may crucially depend on them. In the interim, a lack of maintenance may result in legal liability for the company in the case of an accident. In short, leasing does impose an immediate consequence on the municipal government for skimping on maintenance expenditures.

Stepping back from the political realities, municipal ownership of depreciable assets makes little sense from a financial perspective. The fundamental role of city governments has evolved into that of service providers. The overwhelming majority of most city government budgets is composed of the provision of labor-intensive social services. The hiring and management of staff — teachers, social workers, police — is the core competency of the municipal authorities.

Even in the private sector, labor-intensive operations rarely carry much depreciable capital on their balance sheets. How many law or accounting firms actually own their offices, for example? The reasons include avoiding the diversion of managerial expertise and minimizing the need to raise long-term capital.

The appropriate roles for the public and private sectors for the provision of goods and services is an evolving one. Right now, however, there are fundamental long-term advantages to the use of leasing for improving the efficiency of public good provision.

That provision would not work if the same depreciation rules that apply to purely private operations do not also extend to private companies that lease their property to municipalities. The leasing income of the private-sector leasing company is subject to tax. If the leasing fee is to reflect the depreciation and capital costs of the property being leased (d + r), then the tax treatment of those same items must be equivalent.

Conclusion

Congress faces a difficult task in reforming the rules regarding the tax treatment of leased property. Certainly some abuses exist. But it is important to recognize the advantages of tax-based leasing to the country as a whole. Leasing helps provide a more dynamic economy and assists in macroeconomic management through the extension of investment incentives throughout the economy. It also plays an important and evolving role in the provision of public services. Careful consideration of these wider public policy issues is important in any reform effort.

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