A Transactional Approach to Lease Analysis

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A TRANSACTIONAL APPROACH TO LEASE ANALYSIS*

Neil Z. Auerbach**

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** Associate with the firm of Shearman & Sterling, New York, New York. The author is grateful to Professors Alan L. Feld and Guy B. Maxfield, and to Douglas H. Daniels, Esq., for their valuable assistance.
I. INTRODUCTION

The labels of lease and sale often attach to transactions with only subtle economic differences that, for tax purposes, engender divergent consequences. In a lease, under section 61 of the Internal Revenue Code of 1954, rentals are gross income to the lessor; they are deductible by the lessee as a current expense under section 162(a)(3). Conversely, in a sale, only the gain — the excess of amount realized over adjusted basis — is taxable to the seller, and the cost to the buyer is capitalized and recovered over the period prescribed by section 168. Each of these transactions, though different in character, share many similarities.

3. I.R.C. §§ 1001 (determination of the amount of and recognition of gain or loss), 1011 (adjusted basis for determining gain or loss), 1012 (basis of property-cost), 1016 (adjustments to basis) (West 1982 & Supp. 1985).
4. A lease and a conditional sale, for example, both call for the transfer of possession of property to one party, either the lessee or vendee, in exchange for periodic payments to the other party. A conditional sale transfers title from the vendor to the vendee upon completion of the installment payments, whereas a lease requires the lessee to relinquish possession at the expiration of the lease term. The critical difference is that, after all payments under the contract are made, the lessee relinquishes possession of the property in a lease, unlike the buyer who, in a conditional sale, retains possession.

Similarly, in a sale and leaseback, the property owner conveys ownership to a party, who then leases the asset back to the original owner for a specified term. See Reisman & Mooney, Drafting, Negotiating, and Construing the Equipment Lease — An Overview in EQUIPMENT LEASING-LEVERAGED LEASING 30-31 (B. Fritch & A. Reisman 2d ed. 1980). Physical possession does not change hands, at least for the length of the lease term. See generally Frank Lyon
have difficulty identifying the true owner of the property, and thus, the proper tax label.

The types of leases and lease provisions that challenge the traditional distinction between lease and sale are numerous. For example, the tax treatment of long term leases is frequently challenged on the ground that the lessor retains too insubstantial a residual interest in the leased asset to accord tax significance. Open-end leases, commonly involving motor vehicles, are often challenged on the ground that the lessee bears the entire risk of fluctuation in residual value. Lease provisions that blur the distinction between a lease and a sale include fixed price purchase options, put options, extended renewal options, and residual sharing arrangements with lessees and third parties.

The objective of this Article is to offer a more definitive standard for determining the tax consequences of a lease. Most courts currently apply an economic substance test to determine the tax treatment of a lease. The content of the test is the subject of much dispute in the case law.

5. See infra notes 184-93 and accompanying text.
6. See infra notes 163-83 and accompanying text.
7. See infra notes 120-26, 135-38 and accompanying text.
8. See infra note 71 and accompanying text.
9. See infra notes 211-18 and accompanying text.
11. This test also is referred to as the risk/benefit test and the burden/benefit test. See Sun Oil Co. v. Commissioner, 562 F.2d 258 (3d Cir. 1977). This author prefers the phrase economic substance test, and for sake of uniformity, the term will be used throughout this Article.
13. See, e.g., cases cited supra note 12.
ments,\textsuperscript{14} legislative enactments\textsuperscript{15} and legal literature.\textsuperscript{16} In order to accord lease treatment, courts have to identify the relevant incidents of ownership and weigh their allocation to ensure that the lessor possesses the more substantial sum.\textsuperscript{17} Because virtually all leases afford the lessee some incident of ownership,\textsuperscript{18} the weighing aspect of the test is crucial.

The thesis of this Article is twofold: First, the economic sub-

17. See Frank Lyon Co. v. United States, 435 U.S. 561, 581-83 (1978). The Court first listed 6 factors which supported the Government's position that the lessee was the true owner, and then listed 26 factors which highlighted the taxpayer's contention that it was the owner. Id. at 583. The Court never specifically stated that a balancing test was being applied. Nonetheless, the Court's test tipped the scales in favor of the lessor by permitting form to govern tax consequences "so long as the lessor retains significant and genuine attributes of the traditional lessor status," rather than requiring the lessor to retain more ownership attributes than the lessee. Id. at 584.

Other "economic substance courts" have implicitly adopted a balancing test. These courts, like the Lyon Court, engage in a broad-ranging factor-by-factor survey of all relevant lease provisions, in order to gauge the economics of the transaction. See, e.g., Estate of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1976); Hilton v. Commissioner, 74 T.C. 305 (1980), aff'd per curiam, 671 F.2d 316 (9th Cir.), cert. denied, 459 U.S. 907 (1982); Bowen v. Commissioner, 12 T.C. 446 (1949). Still other economic substance courts have focused on one or two critical features of the transaction. See, e.g., Beus v. Commissioner, 261 F.2d 176 (9th Cir. 1958); Haggard v. Commissioner, 241 F.2d 288 (9th Cir. 1956); Judson Mills v. Commissioner, 11 T.C. 25 (1948). One explanation for the different approaches is that the first set of cases concerns the lessor's depreciation deduction, whereas the second set concerns the lessee's rental deduction. See infra notes 144-48 and accompanying text.
18. For example, the lessee assumes the risks and benefits of fluctuations in fair rental value over the life of the lease. Most leases fix the lessee's rental payment. If the fair rental value subsequently increases and the lease permits subletting arrangements, the lessee, rather than the lessor, has the beneficial enjoyment of the spread between fair rental value and the stipulated rental. Likewise, the lessee of a noncancellable lease bears the risk of subsequent decline in the rental value.
stance test, properly articulated and applied, correctly identifies the tax owner of the property; other tests developed by courts are ill-suited to determine true ownership. Three prongs of the economic substance test will be defined and their interrelationships explained: 1) the risk of residual value fluctuation; 19) 2) the right to possession for substantially all the property’s useful life; 20 and 3) the risk of depreciable loss. 21 If the lease allocates either the first or second element to the lessee, then the lessee is the true owner and the transaction should be reclassified by the Internal Revenue Service. If the lease allocates the third element to the lessee, the lessee should be accorded true owner status only if the lease requires the lessee to replace the property or restores it to its original value.

Secondly, this Article demonstrates that Congress erred in the formulation of new “finance lease” rules in the Tax Equity and Fiscal Responsibility Act of 1982. 22 Because Congress has departed from its declared goal of restoring economic substance as the determinant of tax treatment, the repeal of the finance lease rules is necessary.

A transactional approach to lease analysis 23 is preferable to the deduction-oriented approach characterizing much of the case law. Such an approach would allow examination of the substance of the entire transaction and can be applied to either the lessor or lessee. This Article will examine the statutory and judicial requirements necessary for development of a transactional test. The test will focus on the substance of a transaction rather than its form, and will be completely neutral to the labels employed by the parties. The deter-
mination that the lessor or the lessee is the tax owner will be made by weighing the incidents of ownership held by each party, i.e., by utilizing a pure balancing test. Only one of the three prongs of this economic substance test, however, need point to sale treatment to result in a transfer of ownership for tax purposes. This contradiction is easily resolved. If one of the three prongs of the test is satisfied, the critical incidents of ownership — the benefit of appreciation and the burden of decline in the value of the property — are transferred.

II. THE TAX TREATMENT OF LEASES: AN IMPORTANT ISSUE IN THE DECISION TO LEASE

The tax treatment of leases plays a prominent role in the lease versus purchase decision. For example, rental income is ordinary income, gain from a sale may qualify for capital gains treatment, and borrowing and repaying principal on a mortgage loan are not taxed at all. While the timing of cost recovery deductions on property is generally independent of cash outlays, the timing of rent and interest deductions are more flexible. Furthermore, the deductibility of rent on land offers lessees an added advantage over their

27. See M. CHIRELSTEIN, FEDERAL INCOME TAXATION, §3.01 (3d ed. 1982).
purchaser counterparts, who are unable to recover purchase pay-
ments until they dispose of the land.\footnote{31} Passage of new sections 467 and 1274, and the overhaul of section 483 by the Tax Reform Act of 1984 have altered the consequences of the lease versus buy decision. Section 467 introduces time value of money concepts into leasing transactions. The provision applies to lease transactions involving payments in excess of $250,000 which call for deferred or uneven rent. Depending upon the type and nature of the transaction, and the presence of the ever-fatal tax avoidance purpose, section 467 may require rent leveling based on present value concepts, accrual of interest on accrued but unpaid rents, or recapture of some capital gain as ordinary income on disposition by a lessor of leased property. Sections 483 and 1274, on the other hand, extend application of the original issue discount (OID) rules to debt issued for nontraded property. Section 1274 generally applies to transactions involving payments in excess of $250,000; OID accrues according to a constant economic interest formula. OID computations under section 483 are similar to those under sec-

\footnote{31. Land has an indeterminate useful life, and is therefore nondepreciable. See Treas. Reg. § 1.167(a)-2 (1956).}


\footnote{35. I.R.C. § 467(d)(2) (West Supp. 1985).}


\footnote{37. I.R.C. § 467(b)(4)(B) (West Supp. 1985).}

\footnote{38. See generally J. Eustice, supra note 36; Hamilton & Comi, supra note 36.}

\footnote{39. Prior to the 1984 amendments, the OID rules were found in I.R.C. §§ 1232 and 1232A (1982).}


tion 1274; however, OID accrues under section 483 as installment payments are made.\footnote{42}

Three areas of the Internal Revenue Code pertain to lease transactions. First, section 162(a)(3) prescribes the requirements for the lessee's entitlement to the rent deduction:

(a) In General — There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including —

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.\footnote{43}

This provision imposes three restrictions on the lease transaction: The rentals must be for continued use or possession of the property in a trade or business; the lessor must retain title; and the lessee may not acquire an equity\footnote{44} in the property.

Secondly, section 167(a) provides the statutory authority for the lessor's depreciation deduction. It states:

(a) General Rule — There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) —

(1) of property used in trade or business, or

(2) of property held for the production of income.\footnote{45}

The depreciation deduction allows the property owner to recover his original cost during the useful life of the property.\footnote{46} Theoretically, the depreciation deduction should match or approximate the eco-
nomic depreciation of the property;\(^4\) Congress, however, has legislated accelerated deductions for policy reasons.\(^4\)

The Accelerated Cost Recovery System (ACRS), codified at section 168, was enacted by the Economic Recovery Tax Act of 1981\(^4\) (ERTA). ACRS provides a method of depreciation for tangible property placed in service in tax years ending after 1980.\(^5\) In most cases, ACRS greatly increases the rate of cost recovery on depreciable assets.\(^6\) Apart from the safe harbor leasing rules modified by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA),\(^7\) the Code also limits ACRS benefits to the true property owner.\(^8\)

Finally, the Investment Tax Credit (ITC)\(^4\) offers taxpayers an incentive to invest in certain types of property. This property, known as "section 38 property,"\(^5\) must have an estimated useful life of three years or more and must be either tangible personal property or

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47. One court explained that "[t]he statutory allowance [for depreciation] is available to him whose interest in the wasting asset is such that he would suffer an economic loss resulting from the deterioration and physical exhaustion as it takes place." Commissioner v. Moore, 207 F.2d 265, 268 (9th Cir. 1953), cert. denied, 347 U.S. 942 (1954).


53. See supra note 46.


other tangible property used integrally in certain industries. The Code restricts these tax benefits to the true property owner by linking “section 38 property” to the depreciation deduction.

The Internal Revenue Service has issued several Revenue Rulings and Revenue Procedures on the lease versus sale issue and related considerations. In Revenue Ruling 55-540, the Service dealt comprehensively with the issue as applied to commercial equipment leases. The ruling sets out two guidelines. First, “[w]hether an agreement, which in form is a lease, is in substance a conditional sales contract depends upon the intent of the parties as evidenced by the provisions of the agreement, read in the light of the facts and circumstances existing at the time the agreement was executed.” Second, the Service cautions that “[n]o general rule, applicable to all cases, can be laid down.” Nevertheless, the Service describes several situations in which a lease will generally be treated as a sale. A lease will be considered a sale if:

(a) Portions of the periodic payments are made specifically applicable to an equity to be acquired by the lessee.

(b) The lessee will acquire title upon the payment of a stated amount of “rentals” which under the contract he is required to make.

(c) The total amount which the lessee is required to pay for a relatively short period of use constitutes an inordinately large proportion of the total sum required to be paid to secure the transfer of the title.

(d) The agreed “rental” payments materially exceed the current fair rental value. This may be indicative that the payments include an element other than compensation for the use of

57. See supra note 46.
58. I.R.C. § 48(a)(1) (1982) limits the definition of “section 38 property” to “recovery property” or any other depreciable property with a useful life of at least 3 years.
59. Hereinafter all references to the Internal Revenue Service will appear as the IRS or the Service.
62. Id. § 4.01, at 41.
63. Id.
property.

(e) The property may be acquired under a purchase option at a price which is nominal in relation to the value of the property at the time when the option may be exercised, as determined at the time of entering into the original agreement, or which is a relatively small amount when compared with the total payments which are required to be made.

(f) Some portion of the periodic payments is specifically designated as interest or is otherwise readily recognizable as the equivalent of interest.64

. . . .

It will be presumed that a conditional sales contract was intended if the total of the rental payments and any option price payable in addition thereto approximates the price at which the equipment could have been acquired by purchase at the time of entering into the agreement, plus interest and/or carrying charges.65

If the sum of the specified “rentals” over a relatively short part of the expected useful life of the equipment approximates the price at which the equipment could have been acquired by purchase at the time of entering into the agreement, plus interest and/or carrying charges on such amount, and the lessee may continue to use the equipment for an additional period or periods approximating its remaining estimated useful life for relatively nominal or token payments, it may be assumed that the parties have entered into a sale contract . . . .66

Twenty years after the publication of Revenue Ruling 55-540, the Service released Revenue Procedure 75-21,67 which was intended to provide a clear set of guidelines indicating when the Service would be prepared to issue a favorable advanced ruling. The conditions imposed by Revenue Procedure 75-21 are:

(1) The lessor must have an unconditional “at risk” investment of at least twenty percent of the cost of the property at the beginning of the lease term, and must maintain a twenty percent minimum “at

64. Id. § 4.01(a)-(f), at 41-42 (citations omitted).
65. Id. § 4.05, at 42.
66. Id. § 4.06, at 42-43.
risk” investment throughout the lease term.\(^{68}\)

(2) The leased property must have a residual value at the end of the lease term of at least twenty percent of the original cost of the property, determined without regard to inflation or deflation, and after subtracting the lessor’s removal and delivery costs at the end of the lease term.\(^{69}\)

(3) The remaining useful life of the property at the end of the lease term must equal at least one year or twenty percent of the property’s originally estimated useful life, whichever is longer;\(^{70}\)

(4) The lessor may not have a fixed price purchase option on the property; nor may the lessor have a contractual right to cause the property to be purchased at a fixed price or at fair market value by any other party;\(^{71}\)

(5) The lessee, including any party related to the lessee within the meaning of I.R.C. section 318 (Lessee Group), may not furnish any part of the cost of the property or improvements, with the exception of certain severable and nonseverable improvements;\(^{72}\)

(6) No member of the Lessee Group may lend any money to or guarantee any indebtedness of the lessor in connection with the acquisition of the property;\(^{73}\)

(7) The lessor must show that it expects to receive a profit from the transaction independent of tax benefits;\(^{74}\)

(8) To avoid characterization of rent as prepaid or deferred, the annual rent for any year must equal between 90 and 110 percent of the average annual rent; however, during the last third of the lease term, the annual rent must be at least one-half of the average rent, and may not exceed the highest annual rent, during the first two-thirds of the lease term.\(^{75}\)

Although the guidelines do not represent the state of the law on leasing, most parties engaging in equipment leasing make a serious effort to comply with them. The courts are considerably more liberal than the guidelines in many areas, including purchase options and “at risk” investment.\(^{76}\)

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69. Id., § 4(1)(C), at 715-16.
70. Id.
71. Id., § 4(3), at 716. This contractual right is called a put option.
74. Id., § 4(6), at 716.
75. Id., § 5.01, at 716.
76. See, e.g., Estate of Thomas v. Commissioner, 84 T.C. 412 (1985) (at risk investment
III. ECONOMIC SUBSTANCE: THE DETERMINANT OF TAX TREATMENT

The past fifty years have witnessed several shifts in the judicial approach to the lease versus sale issue. The early courts were asked to construe the legal effect of three types of lease provisions: Fixed price purchase options, exerciseable either at the end of the lease term or at specified intervals; dual-character lease payments, which resemble purchase options, but credit all or a part of lease rentals toward exercise of the option; and provisions that automatically transfer title to the lessee after the lease term upon payment of a set amount of rentals. Initially, courts looked to the parties' intent to distinguish a lease from a sale. Some of these courts focused
largely, if not exclusively, on the written agreement to determine intent, while other courts examined extrinsic evidence such as the conduct of the parties before contracting and contemporaneous verbal agreements. Courts that have cast a lease as a sale have held that the recharacterization applied only as of the year title passed to the lessee and only to the party before the court. Other courts, however, have held that a sale occurred at the time the lease was entered into, and applied sale treatment to both sides of the transaction.

The Tax Court, citing the taxpayers’ need for a fixed rule to guide tax planning decisions, abandoned the intent test in successive decisions between 1948 and 1950, and adopted an economic substance test. The new test focused on whether the lessee had acquired an “equity” in the leased property, which was forbidden by the relevant Code provision. The Fifth Circuit, dissatisfied with the seeming inflexibility of the new test, rejected the economic substance test in favor of the subjective intent test in Benton v. Commissioner.

The taxpayer in Benton ran a small, but successful taxicab business in Amarillo, Texas. In early 1945, Mays, an owner of the Yel-
low Cab & Baggage Company of Amarillo (Yellow Cab), the largest taxicab company in Amarillo, approached Benton and offered to sell or lease the business to him. Benton indicated that he did not have enough money to purchase the company. After several weeks of negotiations, Benton and Mays entered into a "lease" agreement, in which Benton leased Yellow Cab for a ten month period at a monthly rental of $5,000. The agreement extended the option to purchase the company for $35,000 to Benton, with monthly installment payments of $5,000 plus 6% interest on the deferred installments. Although at the time the agreement was executed Benton expressed the hope that he would be able to exercise the purchase option, a decline in business volume and a cash squeeze made Benton's exercise of the option infeasible. To enable Benton to exercise the option, Mays formed a partnership with Benton, and the partnership thereupon exercised the option. The Commissioner denied Benton the rental deduction under section 23(a)(1)(A) of the 1939 Code for the $45,000 of monthly rentals paid in 1945 on the ground that the lease was in substance a conditional sale.

The Tax Court held in favor of the Commissioner. The court applied an economic test, comparing the value of the property with the option price. Under the Tax Court's test, if the option price exceeded the property value, lease status would prevail; if the property value exceeded the option price, the lessee would possess an equity in the property, converting the agreement into a conditional sale. The Tax Court found that Benton did acquire an equity in the property based upon the economic relation of Yellow Cab's value to the option price, and further noted that the evidence suggested an intent on behalf of the parties to sell and not to rent.

The Fifth Circuit reversed the Tax Court. In a complete shift

91. Id. at 750.
92. Id.
93. Id.
94. Id.
95. Id. at 747-48.
96. Id. at 748.
97. Id. at 750.
98. Id. at 750-51.
99. Id. at 751.
100. Id.
101. 9 T.C.M. (CCH) 811 (1950). The Tax Court opinion is quoted extensively in the opinion of the Fifth Circuit, 197 F.2d at 746-52.
102. 197 F.2d at 751-52.
103. Id. at 754, rev'g. 9 T.C.M. (CCH) 811 (1950).
of emphasis, the Fifth Circuit applied the following standard: "Whether what is in form a lease is in effect a conditional sale contract depends on the intention of the parties. The economic relation of the value of the property to the option price was only one factor to be considered in determining intent."\(^{104}\) The court emphasized that the parties' conduct, including their recordkeeping and manner of reporting the transaction on their tax returns, was consistent with a lease, and that the parties did not consider the tax consequences of the transaction at the time of contracting.\(^{105}\)

For some time after the \textit{Benton} decision, the Tax Court straddled the fence between economic substance and subjective intent,\(^{106}\) but landed firmly on the side of \textit{Benton} in \textit{Northwest Acceptance Corp. v. Commissioner}.\(^{107}\) In \textit{Northwest Acceptance Corp.}, the Tax Court, though not citing \textit{Benton} by name, followed \textit{Benton}'s lead in placing weight on the lessor's manner of reporting leases and sales on its tax books.\(^{108}\) The Tax Court viewed the generous options granted by the lessor as "\textit{intended to do no more than extend a privilege to customers of petitioner for their leasing business},"\(^{109}\) which made it possible for the taxpayer not to "have to contend with disposal of the used machinery if the options were exercised."\(^{110}\)

Both \textit{Benton} and \textit{Northwest Acceptance Corp.} established differential tests for purchase options, apparently so that the results in these cases would concur with their view of the parties' intent. The court in \textit{Benton} noted that the option price was not "unreasonably low,"\(^{111}\) and the Tax Court in \textit{Northwest Acceptance Corp.} found the purchase options compatible with true lease treatment so long as the "ultimate purchase . . . by the lessee [was not] an absolute cer-

\footnotesize{104. 197 F.2d at 752 (citations omitted).  
105. \textit{Id.} at 753.  
107. 58 T.C. 836 (1972), \textit{aff'd per curiam}, 500 F.2d 1222 (9th Cir. 1974). \textit{For a brief discussion of the case, see infra note 135.}  
108. 58 T.C. at 848-49.  
109. \textit{Id.} at 848 (emphasis added).  
110. \textit{Id.}  
111. 197 F.2d at 753.}
Since the Tax Court's decision in Northwest Acceptance Corp., most courts have again straddled the fence between economic substance and subjective intent.113

Subjective intent should be irrelevant to the lease versus sale issue. Tax law, like law in general, requires an intent criterion to characterize an act or event only when after examining the act or event itself, a choice of correct legal conclusion cannot be made,114 or where an intent to engage in the act or event is a prerequisite to the application of a specific legal conclusion.115 In the overwhelming majority of transactions, a lease can be distinguished from a sale by cursory examination of the act or event (i.e., the contract), thereby precluding the need for an intent criterion. Intent does not become relevant simply because the task of distinguishing becomes more difficult. As long as a method of rational substantive distinction exists to determine the appropriate label, intent should not enter the analysis. Nontax law does not include subjective intent as an element of a lease or a sale;116 there is no reason for tax law to be different. The

112. 58 T.C. at 848 (emphasis added) (citations omitted).
114. Examples in tax law include (1) the step transaction doctrine, see B. Bittker & J. Eustice, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS §14.51 (4th ed. 1979) (integrating transaction's separate steps to determine tax consequences); (2) the accumulated earnings tax, see I.R.C. §§ 531-537 (West 1967 & Supp. 1985) (tax is imposed in addition to § 11 (West 1984 & Supp. 1985) tax upon finding that corporation was "formed or availed of for the purpose of avoiding the income tax," § 532(a) (1982)), and (3) the disallowance of deductions, credits, etc. resulting from acquisitions of corporations or corporate control, the principal purpose of which is to evade or avoid income tax, see I.R.C. § 269 (West 1978 & Supp. 1985) (intent used to distinguish malevolent from benevolent acquisitions).
115. See, e.g., Commissioner v. Culbertson, 337 U.S. 733 (1949) (intent to join together for business purpose or for joint economic gain requisite to creation of partnership).
116. In fact, contract law "objectively" views an intent to contract (i.e., through a reasonable man standard); subjective intent of the parties is practically irrelevant. See Hotchkiss v. National City Bank, 200 F. 287, 293 (S.D.N.Y. 1911) (Hand, J.) aff'd, 201 F. 664 (2d Cir. 1912). Cf. RESTATEMENT (SECOND) OF CONTRACTS § 21 (rev. ed. 1979). The subjective intent test forces a court to examine evidence irrelevant to the existence of a lease qua lease or a sale qua sale, unlike the gift area, where intent is one of the essential elements of a gift. See Commissioner v. Duberstein, 363 U.S. 278 (1960).

The difference between a gift and a sale is easier to distinguish than the difference between a lease and a sale. Donative intent is required in order to give something without consideration, as a gift. On the other hand, leases and sales are easily distinguished only at their polar extremes. The cases "in the middle" — which courts are invariably called upon to adjudicate — have distinctions which are subtle and often complex. Before reaching a conclusion as to the parties' intent, clarification of the objective economic distinctions between a lease and a sale is necessary to determine the nature of the transaction, irrespective of the parties' intent.
courts' focus on subjective intent emphasizes form over substance in determining the tax consequences of leasing transactions.\textsuperscript{117} Courts employing the subjective intent test that have recast a lease as a sale have had to rely upon economic indicia.\textsuperscript{118}

The lack of uniformity in the case law may be partly attributed to the Supreme Court's reluctance to set definitive guidelines in this area,\textsuperscript{119} or more likely due to the Court's uncertainty about how to distinguish a lease from a sale. The following discussion will examine the key provisions of a lease and explain how the economic substance test reveals the true nature of the transaction.

Needless to say, the subjective intent courts have failed to take this intermediate step because the objective definitions are precisely what these courts have diligently labored to avoid.

\textsuperscript{117} A clarification of the distinction between the subjective intent test and the elevation of form over substance is necessary. The subjective intent test effectively elevates form over substance because of the reliance on evidence that is easily manipulated by the parties. There are other areas of tax law, however, where form is \textit{deliberately} elevated over substance. The inquiry is objective, like the economic substance test, but purposely mechanical and superficial. \textit{Compare}, e.g., Wall v. United States, 164 F.2d 462 (4th Cir. 1947) and Sullivan v. United States, 363 F.2d 724 (8th Cir. 1966), \textit{cert. denied}, 387 U.S. 905 (1967), \textit{with} Holsey v. Commissioner, 258 F.2d 865 (3d Cir. 1958). \textit{See generally}, Rev. Rul. 69-608, 1969-2 C.B. 43; B. BITTKER \& J. EUSTICE, supra note 114, at \S 9.25.

Another example of the primacy of form in tax law, is I.R.C. \S 7701(a)(4) (1982) and Treas. \S 301.7701-5 (1960) (classifying a corporation or partnership as “domestic” or “foreign” by reference to the place of incorporation or formation).

\textsuperscript{118} \textit{See}, e.g., Beus v. Commissioner, 261 F.2d 176 (9th Cir. 1958); Haggard v. Commissioner, 241 F.2d 288 (9th Cir. 1956); Oesterreich v. Commissioner, 226 F.2d 798 (9th Cir. 1955); Calbom v. Commissioner, 41 T.C.M. (CCH) 1009 (1981); Johnson v. Commissioner, 21 T.C.M. (CCH) 1126 (1962).

\textsuperscript{119} Three Supreme Court cases have addressed the lease versus sale issue. See Frank Lyon Co. v. United States, 435 U.S. 561 (1978); Helvering v. F. \& R. Lazarus & Co., 308 U.S. 252 (1939); Helvering v. San Joaquin Fruit \& Inv. Co., 297 U.S. 496 (1936). The first two cases, \textit{Frank Lyon Co. and Lazarus} — primarily sale and leaseback cases — stand for the proposition that tax consequences depend upon the substance, rather than the form, of the transaction.

\textit{San Joaquin Fruit \& Inv. Co.} is a case of mainly historical interest. A lease of real property straddled February 28, 1913, the effective date of the first Income Tax Act of 1913. The lessee exercised a bargain purchase option at the expiration of the lease in 1916, and sold portions of the property at a gain in subsequent years. \textit{Id.} at 497. Since property appreciation accruing prior to February 28, 1913 could not be taxed, the lessee argued that it acquired the property at the inception of the lease. 297 U.S. at 497-98. If the argument were successful, most of the gain due to pre-1913 appreciation would have escaped tax. The Court upheld the Commissioner's position that the lessee acquired the property on the option exercise date. \textit{Id.} at 498. The Court incorrectly compared the lessee's option with a bare option, in which the underlying property is considered held as of the exercise date. \textit{Id.} The use of the property underlying the option changes the analysis because it raises the issue of how to characterize the transaction that transfers property use, whereas no similar characterization issue arises from the granting of a bare option.
A. Residual Value Risk

1. Purchase Options. — The allocation of residual value risk is crucial under economic substance analysis. Many leases provide lessees with the option to buy the property for a fixed price during, or at the end of, the lease term. This option, called a fixed price purchase option, shifts at least part of the risk of residual value fluctuation away from the lessor. As long as the property’s fair market value remains above the option price, it should be presumed that the lessee will exercise the option; therefore, the risk of fluctuation in fair market value above the option price is borne solely by the lessee. The only risk the lessor retains is that the asset’s value on the exercise date will fall below the option price.

Fixed price purchase options alter the allocation of residual value risk, but do not affect the anticipated residual value of the asset. The quantum of residual risk passing from the lessor to the lessee depends upon the spread between the option price and the asset’s expected residual value. The alteration of residual value risk caused by a fixed price purchase option results in a risk split atypical of the “garden variety” sale or lease. In a routine sale, when an owner closes out his investment, he relinquishes his interest in the


1. options designed to offer “disaster” protection for the lessee, where the price is the lesser of fair market value or a fixed amount substantially in excess of anticipated residual value;
2. options at prices equal to the current best estimate of residual value;
3. options where the option price, although less than anticipated residual value, is nevertheless sufficiently high (relative to anticipated residual value or to the lessee’s likely ability to exercise) that there is substantial likelihood that the option will in fact be exercised;
4. options at prices in the nominal range such that exercise of the option is fairly assured.

Id.

121. Risk of residual value fluctuation refers to the risk that the actual value of the leased property at the end of the lease term will be higher or lower than the value anticipated by the parties when they entered into the lease.

122. See infra notes 151-60 and accompanying text.

123. If the actual value of the property on the exercise date falls below the option price, it should be presumed that the lessee will not exercise the option. Thus, the lessor will lose his hoped-for income from the lessee, and will invariably dispose of the property for less than the option price. Alternatively, if the actual asset value exceeds the option price, the lessee’s exercise of the option should be presumed. The lessor’s income from the option should be assured so long as the actual value exceeds the option price.

124. See supra note 121.
property's residual value. Conversely, in a lease arrangement, a lessor only temporarily parts with his possessory interest in the asset for the lease term, but expects to regain possession of a valuable asset at the end of the lease term. Thus, a typical seller parts with all of the residual value risk, whereas a typical lessor parts with none of it.

These transactions, while distinguishing a lease from a sale, represent the polar ends of the spectrum. The problem facing the courts is the difficulty of distinguishing the transactions falling in the middle. Two types of residual value analysis are useful for discerning the dividing line between lease and sale transactions. “Purchase option analysis” compares expected residual value with the purchase option price, measuring the allocation of residual value risk between the parties to the lease. 126 “Residual value analysis” compares expected residual value with the original asset cost and determines from the existence of a valuable residual whether the lessor retains a substantial economic interest in the leased asset. 126

a. Nominal Purchase Options. — The courts find nominal purchase options 127 easy to analyze 128 because these options transfer the entire risk of the residual value fluctuation to the lessee. The lessee's exercise of a nominal purchase option is virtually assured due to the substantial bargain available to the lessee for a minimal additional investment. The lessor, on the other hand, closes out his investment in the asset in exchange for the lease payments and option price. Courts consistently recast such a transaction as a sale. 129

b. Fair Value Options. — The tax analysis of fair market value

125. See infra notes 127-83 and accompanying text.
126. See infra notes 187-91 and accompanying text.
127. To measure nominality, the option price should be compared with the expected fair market value on the exercise date. See, e.g., Johnson v. Commissioner, 21 T.C.M. (CCH) 1126, 1131 (1962). There is no absolute ceiling, but practitioners and courts use 10 percent of original cost as a rule of thumb. See, e.g., LTV Corp. v. Commissioner, 63 T.C. 39, 50 (1974); Northwest Acceptance Corp. v. Commissioner, 58 T.C. 836, 846 (1972) aff'd per curiam, 500 F.2d 1222 (9th Cir. 1974). But see Home News Publishing Co. v. Commissioner, 28 T.C.M. 834 (1969) (purchase option for 10% of original cost; held, conditional sale). Arguably, new I.R.C. § 168(f)(8)(A)(i) (Supp. 1 1983) codifies the 10% cutoff.
128. See, e.g., Quartzite Stone v. Commissioner, 30 T.C. 511 (1958), aff'd, 273 F.2d 738 (10th Cir. 1959) (lessee offered a $1 purchase option on a tractor). The Tax Court found it "obvious" and "unnecessary to discuss" the lessee-acquired equity, and held that the rentals were actually nondeductible payments for the purchase of the equipment. Id. at 518-19.
129. See, e.g., Oesterreich v. Commissioner, 226 F.2d 798 (9th Cir. 1955) ($10 purchase option); Johnson v. Commissioner, 21 T.C.M. (CCH) 1126 (1962) ($1 purchase option); Quartzite Stone v. Commissioner, 30 T.C. 511 (1958), aff'd 273 F.2d 738 (10th Cir. 1959) ($1 purchase option); Van Valkenburgh v. Commissioner, 26 T.C.M. (CCH) 753 (1967) ($1 purchase option).
purchase options receives little attention in the case law. It is, none-
theless, clear that the presence of a fair market value purchase op-
tion does not violate the equity prohibition of section 162(a)(3).\textsuperscript{130} Residual value risk remains entirely in the lessor's hands. Although
the lessor relinquishes his right to reclaim possession of the property
on the exercise date, the lessee acquires nothing of value from the
option.\textsuperscript{131}

c. Fixed Price Purchase Options Above a Nominal Price.—
Courts, commentators\textsuperscript{132} and the IRS\textsuperscript{133} sharply disagree on the
proper treatment of fixed price purchase options above a nominal
price. Courts employing the economic substance test generally hold
that the inclusion of a fixed price purchase option gives the lessee an
equity in the property and transforms a lease into a conditional
sale.\textsuperscript{134} Courts using the subjective intent test, however, add other

\textsuperscript{130} See Estate of Thomas v. Commissioner, 84 T.C. 412, 434-35 (1985); Sun Oil Co. v.
Commissioner, 562 F.2d 258 (3d Cir. 1977), cert. denied, 436 U.S. 944 (1978) (fair market
value purchase option did not give lessees an equity); Rev. Proc. 75-21, § 4(3), 1975-1 C.B.
715, 716 (the Service will not issue advance rulings on leverage lease transactions with fixed
priced purchase options).

\textsuperscript{131} See infra notes 151-62 and accompanying text. The only benefit which the lessee
ensures for himself is a supply of the leased asset at the end of the lease term. Unless the asset
is scarce, little or no value should attach to this benefit.

\textsuperscript{132} See, e.g., Simonson, supra note 10, at 11 (suggesting adoption of the accounting
profession's test, which looks to whether exercise by the lessee of the purchase option was
"reasonably assured from the beginning"); Faber, Determining the Owner of an Asset for
Tax Purposes, 61 TAXES 795, 810 (1983) (claiming that the theoretically proper analysis of
fixed price purchase options requires the annual allocation of depreciation deductions to the
lessor if it appears that the option price will be higher than the property's expected value, and
to the lessee if it appears that the option price will be lower than the expected value, the
determination being made at the end of each year during the lease; admitting, however, that
the approach adopted by the courts is sensible, although imperfect).

\textsuperscript{133} See Rev. Proc. 75-21, § 4(3), 1975-1 C.B. 715 (lessee may not have an option to
purchase the property "at a price less than its fair market value at the time the right is exer-
cised"); Rev. Rul. 55-540, § 4(e), 1955-2 C.B. 39 (purchase option may be indicative of a
conditional sale if the purchase option price "is nominal in relation to the value of the property
. . . or which is a relatively small amount when compared with the total payments which are
required to be made").

\textsuperscript{134} See, e.g., Home News Publishing Co. v. Commissioner, 28 T.C.M. (CCH) 834
(1969); Quartzite Stone v. Commissioner, 30 T.C. 511 (1958), aff'd, 273 F.2d 738 (10th Cir.
1959); Bowen v. Commissioner, 12 T.C. 446 (1949); Mills v. Commissioner, 11 T.C. 25
(1948). These cases stress the equivalence of the sum of rentals and purchase option price to
the property's value.

In Bowen v. Commissioner, for example, the sum of lease rentals and the option price
equalled the value of the leased equipment plus a one percent per month value increment. Id.
at 449-50. The court concluded that the "relation of the so-called rental payments to value
. . . represented such a substantial portion of value that they constituted more than a mere
payment for hire," id. at 463, and that the lessee therefore had acquired an "equity", prohib-
ing the taxpayer-lesser from reporting the rentals as ordinary income. 12 T.C. at 466.
considerations to their analysis. For example, some courts look to whether the purchase option prices were reasonable in relation to the expected fair market value on the exercise date. If so, the lease is upheld for tax purposes; if not, the transaction is recast as a sale.

Courts are split along similar lines on the closely related issue of dual-character lease payments. Leases containing this feature provide that all or part of the aggregate lease payments will be credited toward the option price upon exercise of the option. Courts utilizing the economic substance test treat the dual-character lease differently than a normal fixed price purchase option and deny lease sta-

135. Courts utilizing different measures of “intent” in their analysis may reach different results where rent + option = asset value + interest. For example, in Haggard v. Commissioner, 24 T.C. 1124 (1955), aff’d per curiam, 241 F.2d 285 (9th Cir. 1958), the court recharacterized the transaction as a sale where the lessee paid $24,000 in term rentals over two years, id. at 1129, and $24,000 pursuant to a fixed purchase option, id., for property worth approximately $48,000. Id. at 1130. On the other hand, in Northwest Acceptance Corp. v. Commissioner, 58 T.C. 836 (1972), aff’d per curiam, 500 F.2d 1222 (9th Cir. 1974), the Tax Court upheld true lease treatment for a portfolio of leases. The term rentals over a 14 to 61 month period, id. at 839, plus the option price, approximated the amount a buyer would pay under a deferred payment plan, id. at 849; the leases also contained fixed purchase options ranging from 10 to 35% of the original cost of the equipment. Id. at 840.

136. See cases cited infra notes 137-38.

137. See, e.g., Belz Inv. Co. v. Commissioner, 72 T.C. 1209 (1979), aff’d, 661 F.2d 76 (6th Cir. 1981); LTV Corp. v. Commissioner, 63 T.C. 39 (1974); Northwest Acceptance Corp. v. Commissioner, 58 T.C. 836 (1972), aff’d per curiam, 500 F.2d 1222 (9th Cir. 1974).


139. The following example illustrates a dual-character lease: A five year lease contains a purchase option for $100,000, representing a reasonable approximation of fair market value anticipated in Year 3, and is exerciseable after the second year of the lease. Under the terms of the lease, the option price may be reduced dollar for dollar by the yearly rentals of $10,000. If the lessee chooses to exercise the option in Year 3, a payment of $70,000 will be due. In Years 4 and 5, the option price will be reduced to $60,000 and $50,000, respectively. If the option is exercised, the lease payments serve as installments on the purchase price. If the option is never exercised, the lessee has merely paid $50,000 in rent.

Arguably, the $10,000 annual reductions in the option price in Years 4 and 5 represent a decline in the asset’s fair market value, and, therefore, the rent paid in Years 4 and 5 (if the option is not exercised in Year 3) does not build any equity in the lessee. Nevertheless, rent paid in Years 1, 2 and 3 gives the lessee an equity in the property in violation of § 162(a)(3) (1982). Moreover, so long as the residual value exceeds the $50,000 option price in Year 5 — a very likely occurrence on these facts — the lessee’s choice to postpone taking advantage of the $30,000 bargain through exercise of the option in Year 3 will be influenced by the opportunity to take advantage of the deferral benefits in spreading out the $70,000 purchase price over two years. The lessee can thereby increase his original $30,000 advantage by reducing the present value of the $70,000 purchase price.
tus. Courts using the subjective intent approach, on the other hand, focus on the "primary purpose" of the lease payments. These courts reason that if the primary purpose of the payments is to build toward the exercise of the option, then conditional sale treatment prevails. These courts further compare the option duration with the lease term length and look to other factors such as the size of the option price and, unsurprisingly, the parties subjective intent.

d. Looking for Symmetry: A Workable Definition of "Equity". — Tax law employs two different standards when analyzing a lease. If the lessee is the focus of the inquiry, the test is whether the lessee has acquired an "equity" in the leased property. If the lessor is the focus of inquiry, the relevant question is whether the lessor has retained the economic burdens and benefits of ownership. The question unanswered by the courts is whether the lessee "equity" test and the lessor "economic burden and benefit" test are inherently asymmetrical.

The meaning of the term "equity" in the context of section 162(a)(3) has yet to be adequately defined by the courts. One court defined "equity" as a "right of redemption, a reversionary interest, a right to specific performance, or in general any right respecting property which traditionally would have been enforceable by means

140. See, e.g., Home News Publishing Co. v. Commissioner, 28 T.C.M. (CCH) 834 (1969); Breece Veneer & Panel Co. v. Commissioner, 22 T.C. 1336 (1954), rev'd, 232 F.2d 319 (7th Cir. 1956). In fact, courts denying lease status argue that the lease payments themselves build up "equity" the lessee's because of the simultaneous reduction in the purchase option price. Therefore, dual-character leases are an easier case for sale recharacterization, even if the purchase option price equals anticipated residual value.


142. In Gilken Corp. v. Commissioner, 10 T.C. 445 (1948), aff'd, 176 F.2d 141 (6th Cir. 1949), the Tax Court noted that the duration of the option was three years while the lease term length was 10 years, id. at 455, thereby supporting the view that the lessee's acquisition purpose was secondary to the primary purpose of paying rent. Id.

143. See, e.g., Breece Veneer & Panel Co. v. Commissioner, 232 F.2d 319, 322-23 (7th Cir. 1956); Lester v. Commissioner, 32 T.C. 711, 720 (1959); Gilken Corp. v. Commissioner, 10 T.C. 445, 456 (1948), aff'd, 176 F.2d 141 (6th Cir. 1949). "Subjective intent" and "primary purpose" are very similar inquiries. The "primary purpose" test differs to the extent that it concedes the existence of both intent to lease and intent to purchase, and measures the stronger of the two. The "subjective intent test" theorizes a singular bent of mind on the part of both parties.


145. See infra notes 158-61 and accompanying text.
of an equitable remedy."\textsuperscript{146} This definition, while premised on the traditional property law notion of equity, is both overinclusive and underinclusive. It is overinclusive because a lessee is entitled to enforce a fair market value purchase option on real property by obtaining a decree of specific performance;\textsuperscript{147} it is underinclusive because a nominal purchase option for personal property is usually not enforceable in equity.\textsuperscript{148}

The following definition of "equity" for use in section 162(a)(3) cases may be more helpful: "[A] lessee possesses an equity when he acquires a potentially valuable right in connection with the ownership of the property."\textsuperscript{149} A fixed price purchase option under this definition would produce an "equity" if the lessee's right had an ascertainable dollar value. This test applied to the above examples would yield the correct results. The lessee holding the fair market value purchase option does not have a valuable right because an interested buyer can purchase the property in the market for the same price. The holder of the nominal purchase option, however, does possess a valuable ownership right. The option right is worth at least the difference between the expected fair market value and the exercise price.\textsuperscript{150}

\begin{enumerate}
\item[146.] Oakes v. Commissioner, 44 T.C. 524, 531 (1965).
\item[147.] See generally 3 G.W. THOMPSON, THOMPSON ON REAL PROPERTY § 1154 (repl. ed. 1980).
\item[148.] An equitable decree of specific performance is unavailable, unless the personal property is unique. See RESTATEMENT (SECOND) OF CONTRACTS § 360 comment c (rev. ed. 1981); Fortner v. Wilson, 202 Okla. 563, 216 P.2d 299 (1950) (denying specific relief to purchaser of automobile on the ground that personal property was not unique and damages were adequate to compensate plaintiff). See also F.W. MAITLAND, EQUITY, A COURSE OF LECTURES 303 (2d ed. rev. 1936).
\item[149.] In Lester v. Commissioner, 32 T.C. 711, 721 (1959), the Tax Court stated that: where the 'lessee,' as a result of the 'rental' payment, acquires something of value in relation to the overall transaction other than the mere use of the property, he is building up an equity in the property and the payments do not therefore come within the definition of rent contained in section 23 (a)(1)(A) [current version in § 162(a)(3)].
\item[150.] Suppose the lessee on a five year computer lease was entitled under the terms of the lease to purchase the computer for $10 at the end of the lease term. In Year 5, when the fair market value of the computer is $1,000, the lessee offers to assign his option to purchase to Mr. X, a third party in the market for a used computer, for $900. Mr. X will gladly pay the $900; the $910 combined cost of the option assignment and exercise price is $90 below the prevailing price tag in the market. In fact, Mr. X should be willing to pay $990 for the lessee's rights under the purchase option.
\end{enumerate}
e. *A Uniform Transactional Standard.* — The tax provisions governing lessors are less specific than those with reference to lessees and, therefore, under current law, the standards are not symmetrical. There is no evidence, however, that Congress intended to make them asymmetrical, thereby further complicating the tax treatment of leases. It would be neither logical nor administratively desirable to create an asymmetrical system. While the test should govern both sides of the lease transaction, current law has failed to converge the tests. The following analysis explores the theoretical asymmetry of applying a weighing test to the lessor and the “equity” test to the lessee.

The lessor effectively relinquishes his residual interest in the property, and tax status as owner, if the property’s expected fair market value on the exercise date exceeds the option price. Between the two parties, the lessee should be deemed the owner. The lessee has possession and use of the property for the lease term, and more likely than not, will exercise the option, acquiring full title and control on the exercise date. Conversely, the lessor does not have use of the property for the lease term, and is less likely to reacquire the property. This transaction more closely resembles a conditional sale;
transfer of title is delayed until the purchaser pays the entire sale price. The lessor should not retain ownership status merely because the lessee has not fully assumed the incidents of ownership. The lessor’s retention of a residue of risk should not overshadow the lessee’s more substantial relationship to the property. The transaction, in substance, is more like a sale than a lease. The situation is comparable to a sale on credit, where the buyer’s tax position, as owner of the purchased goods, is unaffected by the fact that the seller bears some risk of the buyer’s nonperformance.

When the option price accurately reflects anticipated residual value, the parties are in a state of equipoise. The lessee possesses all of the upside risk of residual value fluctuation, and the lessor possesses an equal amount of downside risk. Both sides appear

153. The lessor retains the risk that the property’s value will decline below the option price. On the other hand, the lessee bears the risk that the property’s value will decline to a value between the anticipated residual value and the option price, and enjoys the benefit of residual value appreciation.

154. The anticipated residual value referred to in the text is the median of the statistical distribution of expected values, rather than the mean. An example will illustrate the distinction. Suppose the anticipated residual value of an asset is subject to the following distribution of expected values:

<table>
<thead>
<tr>
<th>Expected Residual Value</th>
<th>Residual Midpoint Value</th>
<th>Probability</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;80</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>80-90</td>
<td>85</td>
<td>20%</td>
</tr>
<tr>
<td>90-100</td>
<td>95</td>
<td>30%</td>
</tr>
<tr>
<td>100-110</td>
<td>105</td>
<td>25%</td>
</tr>
<tr>
<td>110-120</td>
<td>115</td>
<td>10%</td>
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<tr>
<td>120-130</td>
<td>125</td>
<td>5%</td>
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<td>130-140</td>
<td>135</td>
<td>5%</td>
</tr>
<tr>
<td>140-150</td>
<td>145</td>
<td>5%</td>
</tr>
<tr>
<td>&gt;150</td>
<td>0</td>
<td></td>
</tr>
</tbody>
</table>

The mean anticipated residual value of $103.50 is calculated by assuming that the expected values are evenly distributed within every $10 band; thus, the midpoint value multiplied by the probability of its occurrence determines the weighted value of that band. However, the median expected residual value, according to the probability distribution, is $100 because at that point the probability that the residual value will be lower than $100 is equal to the probability that the residual value will be higher than $100. It would therefore be inaccurate to assert that, at $100, the lessee’s potential upside benefit is equal to the lessor’s potential downside risk; in fact, the lessee’s potential benefit is slightly greater than the lessor’s potential loss because the range of expected residual values is skewed upward, i.e., the lessee is likely to gain more than the lessor is likely to lose. Nevertheless, the $100 option price is the point of equipoise because at that point the likelihood of exercise and nonexercise of the option are equal. Thus, the equivalence of the risk of residual value fluctuation refers to the allocation of probabilities, not
equally important to ownership status because the true owner typically benefits from increases and suffers from declines in asset value. This state of equipoise, however, should shift in favor of the lessee when the lessee’s present possession and use of the property are taken into account. As a result, the lessee should assume own-

weighted values.

155. The Treasury Regulations promulgated under I.R.C. § 83 (West 1984 & Supp. 1985) lend support to this proposition, by considering either risk of loss, see Treas. Reg. § 1.83-3(a)(6) (1978), or benefit of appreciation, see Treas. Reg. § 1.83-3(c)(1) (1978) (2d paragraph), as relevant in determining whether the deferral privileges of § 83 apply. Treas. Reg. § 1.83-3(c)(4), example (1), provides that stock rights are subject to a substantial risk of forfeiture where an employee is obliged to perform substantial services and is unable to earn a profit on stock resold to the employer. I.R.C. § 83 allows a recipient of property transferred in connection with the performance of services to postpone recognition of income until the rights in the property are either transferable or no longer subject to a substantial risk of forfeiture. See I.R.C. § 83(a) (1982).

To determine whether a transfer of property has occurred, however, risk of loss figures prominently. Treas. Reg. § 1.83-3(a)(6) (1978) states that “the extent to which the transferee does not incur the risk of a beneficial owner that the value of the property at the time of transfer will decline substantially” indicates “that no transfer has occurred.” The Regulations clearly indicate here that the substance of the transaction is determinative. See Treas. Reg. § 1.83-3(a)(2) (1978).

The § 83 regulations provide that a transferee who lacks risk of loss is not the true owner, whereas a lessee who lacks risk of loss under a fixed price purchase option is arguably the true owner. These conclusions are nevertheless consistent. Treas. Reg. § 1.83-3(a)(7), example (5) (1978) refers to a case where an employee-transferee of company stock is bound to sell to his employer-transferor without any risk of loss by the transferee upon his termination of employment. In the case of a fixed price purchase option, the transferor is bound to sell to the transferee without risk of loss to the transferee. In the latter case, the transferee is likely to retain permanent dominion over the property; in the Regulation example, presumably the employee will eventually leave the employer and sell back the stock. The § 83 analogy is also useful in analyzing lessor put options, where the lessor has the right to sell the leased property at a fixed price at the end of the lease term. The denial of ownership status to the lessor is consistent with the § 83 regulations because the use of a fixed-price put option eliminates the lessor’s risk of depreciable loss. See Simonson, supra note 10, at 14.

156. But cf. Macan, supra note 120, at 424-25. Macan seems only to admit that the attenuation of the lessor’s relationship to the property is significant in a leveraged lease; he also seemingly argues that the lessor’s downside risk supports the lessor’s retention of tax status as property owner. Id.

An alternative view of the risk-split issue supports the conclusion that the lessee is the true owner. Lessees prefer inclusion of fixed price purchase options because they do not wish to pay twice for the same property upon their eventual acquisition. A lessee exercising a fair market value purchase option could conceivably pay a price approximating the original cost of the property if the property were to appreciate in value. In reality, the lessee will never pay twice for the property. The rentals are for the use of the property and the right to income therefrom, whereas, the price to be paid upon subsequent purchase represents the discounted value of future income streams from use of the property. See generally M. Chirelstein, supra note 27, at ¶ 6.07; Kahn, supra note 48.

Notwithstanding economic theory, the risk of subsequent price increases is real. A purchaser does not bear this risk, having already acquired ownership of the property. A lessee not
ership status for tax purposes; therefore, the lessee should lose the rental deduction, and the lessor, the depreciation deduction. This symmetry, however, may not always exist. For example, where the option price exceeds the anticipated residual value, the lessee still acquires an equity because someone may be willing to purchase the option based on the possibility that the residual value will rise higher than initially expected. The lessor’s risk, however, is still more substantial than the lessee’s because the property will more likely revert to the lessor at the end of the lease term. The lessor should arguably retain the ownership status and continue taking depreciation deductions despite the lessee’s inability to deduct his rental holding a fixed price purchase option, however, does bear this risk. The fixed price purchase option shields the lessee from the risk that the property’s value will rise above the option price. This places the lessee in the same risk position vis-a-vis subsequent price increases as the purchaser. The price of the option merely reflects the quantum of risk protection; if the option price is equal to anticipated residual value, the lessee has completely shielded himself against the 50% chance that the actual residual value will exceed anticipated value.

157. But see Simonson, supra note 10, at 20, 31. Simonson argues that, in lease treatment, the format chosen by the parties should prevail where the lessor retains either the appreciation potential or the downside risk of economic loss in the residual value of the leased asset, id. at 20, based on the conclusion that “the tie goes to the runner.” Id. at 31. After factoring in the lessee’s present use of the property, however, the tie is broken in favor of sale treatment, at least in cases where the lessee’s entitled use of the property is more substantial than that of the lessor. Use of property, of course, is not a relevant factor in most cases; otherwise, lessors could rarely, if ever, qualify for tax ownership. Rather, in an even risk-split situation such as this one, factoring property use into the analysis helps to identify, among close, competing candidates, the party with the more intimate relationship with the property.

158. The price of a call option generally has two elements: The spread value, (i.e., the difference between the fair market value and the exercise price) and the time value, also known as the premium for the option privilege. See generally A. BOOKBINDER, SECURITY OPTIONS STRATEGY 61-66 (1975); L. MCMILLEN, OPTIONS AS A STRATEGIC INVESTMENT 9-15 (1980).

In equipment and real estate leasing, the time value of the option is likely to be substantial because of the distant exercise dates many options on leased equipment possess. Traditional § 162(a)(3) “equity” analysis has focused solely on the size of the spread between expected fair market value and exercise price, on the theory that a large spread reasonably assures an exercise of the option.

There are two major problems with this line of analysis. First, nothing in the language or legislative history of § 162(a)(3) suggests that “reasonable assurance” is, or should be, the touchstone for denial of the rental deduction. Second, if a “reasonable assurance” test is used, the value of the option privilege is evidence that exercise of the option is reasonably assured. The value indicates the probability that the value of the underlying asset will surpass the exercise price on the exercise date. In short, the spread value reflects the current state of the market, and the option privilege premium forecasts the odds of further upward movement in the price of the underlying asset. Under a “value” test for the presence of a lease “equity”, see supra note 150 and accompanying text, the importance of the option privilege premium is clear. Even if an option reflects anticipated fair market value, the other factors that influence the value of the option, when considered, may reveal that the lessee indeed possesses an “equity” in the asset.
This remnant of asymmetry creates complex administrative difficulties. While the courts do engage in current valuation determinations when concrete evidence is available, they are ill-equipped, especially in an adversarial setting, to identify expected fair market value with the needed precision.

The various problems resulting from the tax law view of the lessor and lessee can best be redressed by moving away from the deduction-oriented approach of sections 162(a)(3) and 167(a) and by adopting a transactional statutory or regulatory scheme. An effective rule would include a provision denying lease status to leases containing a fixed price purchase option. This would effectively eliminate decisional error and the administrative and judicial burdens imposed by a fact-sensitive rule.

Congress' Joint Committee on Taxation studied the same topic and concluded:

The fair market value purchase option requirement fulfills three purposes related to the determination of the economic substance of the transaction. First, it ensures that the lessor bear the risk implicit in ownership that no market will exist at the end of the lease. The owner of depreciable property is the person who

159. This anomaly results from the Code's use of different standards when testing the allowability of the rental and depreciation deductions. Although the "equity" test of § 162(a)(3) contains no cross-reference to the ownership test implicit in § 167 (West 1978 & Supp. 1985), many lessee rental-deduction cases have relied upon lessor depreciation-deduction cases and vice versa. See, e.g., LTV Corp. v. Commissioner, 63 T.C. 39 (1974) (lessee case; followed Northwest Acceptance Corp. v. Commissioner, 58 T.C. 836 (1972), aff'd per curiam, 500 F.2d 1222 (9th Cir. 1974), a lessor case); Kitchin v. Commissioner, 22 T.C.M. (CCH) 1738 (1963), rev'd, 340 F.2d 895 (4th Cir. 1965) (lessor case; followed Gilken Corp. v. Commissioner, 10 T.C. 445 (1948), rev'd, 176 F.2d 141 (6th Cir. 1949), a lessee case).

This lack of symmetry has precedent in tax law. For example, compare the treatment of the seller's amount realized upon a sale of property encumbered by nonrecourse debt in excess of fair market value and property basis, with treatment of the buyer's inclusion of such nonrecourse debt in basis. Compare e.g., Crane v. Commissioner, 331 U.S. 1 (1947), and Commissioner v. Tufts, 461 U.S. 300 (1983), with Estate of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1976); Rev. Rul. 81-278, 1981-2 C.B. 159; Rev. Rul. 80-42, 1980-1 C.B. 182; and Rev. Rul. 77-110, 1977-1 C.B. 58 (liability created by the nonrecourse note given by the buyer to the seller may not be included in the basis of film rights). See generally Andrews, On Beyond Tufts, 61 TAXES 949 (1983) (discussing historical and current treatment of nonrecourse debt).

160. For example, I.R.C. § 1001(b) (1982) requires a determination of "the fair market value of the property . . . received." Treas. Reg. § 1.1001-1(a) (1957) states that fair market value is a "question of fact." However, the § 1001(b) valuation determination is after the fact, the property already having been "received."

161. For a discussion of the "transactional" approach, see supra note 22.
bears any decline in value of the asset. Second, it ensures that the lessor has retained an equity interest in the property. Any fixed price option represents a limitation on the lessor's right of full enjoyment of the property's value. Third, it limits the ability of the parties to establish an artificial rent structure to avoid the cash flow test.162

The Joint Committee supports the view that fixed price purchase options are inconsistent with a true lease. If, in future legislation, Congress permits fixed price purchase options based on a reasonable approximation of residual value, it should do so only to encourage leasing activity.

2. Residual Value Guarantee Classes. — Courts163 are in gen-

162. STAFF OF THE JOINT COMM. ON TAX’N, 97TH CONG., 2D SESS., supra note 15, at 8.


In Swift Dodge v. Commissioner, a car dealer sold and leased motor vehicles to its customers. The leases contained a residual guarantee clause, which required the lessee to pay the excess of the estimated “depreciated value” of the vehicle over its actual wholesale value. If the vehicle's wholesale value exceeded the “depreciated value”, the lease required that the lessee “receive any gain which resulted from final disposition of the vehicle.” 692 F.2d at 652.

The Commissioner argued that each lease constituted a conditional sale, and disallowed Swift Dodge's investment tax credit. 76 T.C. at 562-63. The Tax Court rejected the Commissioner’s position, noting that fixing “depreciated value” at wholesale value reduced the lessee's risk of loss. 76 T.C. at 569. The lessee could pay the specified wholesale value, keep the car and sell it to a third party at retail, to “offset any potential loss attributable to fluctuations in the vehicle's residual value.” 76 T.C. at 569.

In its reversal of the Tax Court, the Ninth Circuit employed a novel four-pronged examination concerning the allocation of duties, legal rights, risks and intentions of the parties. The approach is interesting, but it was ill-executed. For example, the court remarked, in analyzing the parties' legal rights, that:

Swift Dodge retained the legal title to the vehicle and the right to assign the user's payments from the agreement to third parties. Swift Dodge would retain these rights under a conditional sales contract. . . . Upon premature termination of the agreement, Swift Dodge also had the right to take possession of the vehicle and resell it. This is essentially the same right Swift Dodge would have under a typical conditional sales contract.

692 F.2d at 653 (citations omitted).

The problem with the court's analysis is that the facts support Swift Dodge's claim to lessor status. None of the rights retained by Swift Dodge are inconsistent with its ownership of the vehicle. The fact that a conditional sales contract allows the seller to retain such ownership rights adds no force to the court's argument. The only support the court finds for its holding, upon which the correctness of the court's conclusion rests, is the allocation of residual value risk. See id. at 654.
eral agreement with the Service\textsuperscript{164} that a lease containing a residual guarantee clause\textsuperscript{165}— even without a purchase option — is, in substance, a conditional sale since the lessee assumes the residual value risk. A residual value guarantee clause, most often found in motor vehicle leases, is normally comprised of two elements. The first element is a guaranteed residual value for the leased asset.\textsuperscript{166} If, at the expiration of the lease, the actual fair market value is less than the guaranteed value, the lessee must pay the difference to the lessor.

The Ninth Circuit found that the lessee assumed the risk of depreciable loss, \textit{id.}, an argument that supports the Commissioner's position. The Tax Court and the Ninth Circuit refer to this risk (i.e., risk shifted by the residual guarantee clause) as “risk of depreciable loss,” rather than residual value risk. A distinction should be made between a lessor's attempt to ensure that the returned leased asset will be substantially as valuable as when initially leased, and the lessor's attempt to vest the lessee with the benefit or burden of future appreciation or decline in the residual value of the asset. In the former situation, referred to herein as the risk of depreciable loss, \textit{see infra} notes 219-72 and accompanying text, the lessor protects himself against \textit{anticipated and unanticipated} declines in asset value. In the latter, the lessor is protected by a residual guarantee clause, but only against an \textit{unanticipated} decline in asset value; the lessor will suffer the burden of \textit{anticipated} depreciable loss.

\textsuperscript{164} See I.R.S. Letter Ruling 8240018, No. 293 (CCH) (Oct. 13, 1982) [hereinafter cited as LTR 8240018]. The taxpayer in LTR 8240018 was a commercial bank engaged in personal and business automobile leasing. The Service denied a favorable ruling request, treating the open-end leases as sales for tax purposes on the following rationale:

Basically, most, if not all, of the risks of decrease in value of the vehicles are the responsibility of the customer, not taxpayer. Upon the scheduled termination of the agreements, the customer is liable to taxpayer to pay \textit{... any amount by which the unpaid lease balance or estimated wholesale value exceeds the actual wholesale value}. In addition, the customer is liable for damage to the vehicle that is attributable to improper customer maintenance. Finally, the customer under “personal use” agreements must pay a certain amount to the taxpayer if the customer’s mileage exceeds the estimated mileage figure in the agreement and the actual wholesale value is less than the estimated wholesale value.

In the event of an early termination, the customer is responsible for \textit{... the difference between actual wholesale value and the unpaid lease balance}. In contrast to the above responsibilities and obligations of the customer, taxpayer’s only risk or obligation under the agreement is the risk of customer’s default. However, such a risk is the same type of risk that a secured lender would be subject to in a conditional sales contract.

\textit{Id.} (emphasis added).

The facts of LTR 8240018 are very similar to those of \textit{Swift Dodge} and the reasoning is consistent with that of the Ninth Circuit in that case.

\textsuperscript{165} A residual value guarantee clause is also known as a terminal rental adjustment clause, \textit{see} Prop. Treas. Reg. § 1.168(f)(8)-12, 47 Fed. Reg. 52730 (1982) (to be codified at 26 C.F.R. pt. 1) (proposed Nov. 23, 1982) [hereinafter cited as Prop. Treas. Reg. § 1.168(f)(8)-12] and is the premier feature of an open-end lease, \textit{see} M & M Leasing Corp. v. Seattle-First Nat’l Bank, 391 F.Supp. 1290, 1293 (W.D. Wash. 1975), aff’d in part and rev’d in part, 563 F.2d 1377 (9th Cir. 1977), cert. denied, 436 U.S. 956 (1978). The term “residual value guarantee clause” is more descriptive than other phrases. For the sake of consistency, this term will be used throughout this discussion.

\textsuperscript{166} \textit{See}, \textit{e.g.}, \textit{M & M Leasing Corp.}, 391 F. Supp. at 1293.
Likewise, if the actual fair market value at the expiration of the lease exceeds the guaranteed value, the lessor must pay the difference to the lessee. The second element consists of an informal purchase option exercisable on the lease expiration date for the stipulated anticipated value; such an exercise cancels the lessee's obligation to refund any loss of residual value.

While a lease that contains both elements of a residual value guarantee clause should be treated as a sale — based on the inclusion of a fixed price purchase option — the proper tax treatment of a lease containing only the first element requires a different, and more precise analysis. A fixed, guaranteed value for the asset at the end of the lease term protects the lessor against the risk of a large, unanticipated decline in residual value in exchange for the lessor's relinquishment of his residual value appreciation above the asset's expected value. Since the lessor repossesses the asset after the lease, however, he may still benefit from post-repossession appreciation. In sum, the lessor shifts two important attributes of ownership to the lessee: (1) the risk of residual value decline below the stipulated price; and (2) the potential for residual value appreciation above the stipulated price.

It is difficult to force the "one element" transaction — a guaranteed residual value arrangement — into either a lease or sale pigeonhole. Although the risk/benefit allocation is similar, a "one element" residual guarantee clause does not transfer the right to possession at lease end. The lessee's enjoyment of the appreciation in residual value is frozen in time, whereas a purchase option holder may enjoy further appreciation after the exercise date. On the other hand, a residual value guarantee clause, unlike a fixed price purchase option, transfers the risk of residual value decline below stipulated value to the lessee.

In Proposed Regulation section 1.168(f)(8)-12, the Treasury concurred that a residual value clause in a motor vehicle lease will cause the transaction to be characterized as a conditional sale contract. The Treasury makes no distinction between a sale to a third

167. Id. at 1294. The enforceability of such an option is unclear.
168. The proposed regulation was issued shortly after passage of § 210 of TEFRA. Section 210 is not incorporated into the Code but is an appended note to I.R.C. § 168. It states, in pertinent part:
(a) In General.—In the case of any qualified motor vehicle agreement, the fact that such agreement contains a terminal rental adjustment clause shall not be taken into account in determining whether such agreement is a lease.
(b) Definitions.—For purposes of this section—
party, and affixing of fair market value through bidding without a

(1) QUALIFIED MOTOR VEHICLE AGREEMENT.—The term "qualified motor vehicle agreement" means any agreement with respect to a motor vehicle (including a trailer) —

(A) which was entered into before —

(i) the enactment of any law, or

(ii) the publication by the Secretary of the Treasury or his delegate of any regulation, which provides that any agreement with a terminal rental adjustment clause is not a lease . . .

(C) with respect to which the lessee under the agreement uses the property subject to the agreement in a trade or business or for the production of income.


The commercial property limitation in TEFRA, § 210(b)(1)(C), produced anomalous results in Leslie Leasing Co. v. Commissioner, 80 T.C. 411 (1983). The Tax Court in Leslie Leasing Co. applied § 210 to a taxpayer engaged in motor vehicle leasing. Id. Eighty-five percent of its leases were commercial and 15% were consumer. Id. at 413. The Tax Court held that the commercial leases were true leases and the consumer, or non-business, leases were conditional sales contracts. Id. at 419. Risk allocation was identical in each lease, but the Tax Court could circumvent neither the express application of § 210 to commercial leases nor the authority of Swift Dodge beyond the confines of § 210.

169. See Prop. Treas. Reg. § 1.168(f)(8)-12, supra note 165, which states:

Example (1) A purchases automobiles, financing the purchases with amounts borrowed from C. A provides automobiles to customers who will use the automobiles in their trades or businesses. A enters into the following agreement with all of its customers. The agreement, which is labeled a lease, provides that the customer may use the automobiles for a specified period of time in exchange for a specified monthly payment. The parties have not elected to treat these agreements as leases under section 168(f)(8). Under the agreement, the customer is responsible for all operating expenses, including maintenance and repair on the automobile, and is required to carry insurance indemnifying A against damage to or loss of the vehicle. The customer is also responsible for sales, use, excise and personal property taxes levied against the automobile. The agreement provides that at the end of the lease, or when the customer cancels the lease, or if the customer defaults on the lease, A will sell the vehicle within 30 days. Under a terminal rental adjustment clause, if the net sales proceeds (sales price less A's selling expenses) exceed the projected value of the automobile at the end of the lease (or a predetermined amount in the event of a cancellation or early termination of the lease), A will credit the customer with an amount equal to the excess. Correspondingly, if the net sales proceeds are less than that amount, the customer will pay an amount equal to the shortfall to A.
sale,\textsuperscript{170} or a credit to the lessee on his purchase of the used vehicle or another vehicle.\textsuperscript{171}

Congress added section 168(f)(13) to the Code in the Tax Reform Act of 1984.\textsuperscript{172} Section 168(f)(13) grants lease status to a "qualified motor vehicle operation agreement" containing a terminal rental adjustment clause, i.e., a residual value guarantee clause, if, but for that clause, the agreement would be treated as a lease. A "qualified motor vehicle operating agreement" must meet three requirements:\textsuperscript{173} (1) the lessor must be personally liable for, or must pledge property other than the leased property, to secure repayment of amounts borrowed to finance the acquisition of the vehicle; (2) the lessee must certify in writing an intention to utilize more than fifty percent of the leased property in the lessee's trade or business; and, (3) the lessor must have no knowledge that the lessee's certification is false.

A terminal rental adjustment clause is defined as a provision that "permits or requires the rental price to be adjusted upward or downward by reference to the amount realized by the lessor under

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Under these facts, A has not retained significant and genuine attributes of ownership. Therefore, the agreement between A and its customer is a conditional sales agreement, not a lease, and the customer, not A, is entitled to the cost recovery deductions and the investment tax credit with respect to the automobile.

\textit{Id.}

\textsuperscript{170} \textit{Id.}; example (2) states:

Example (2). The facts are the same as example (1) except that upon termination of the agreement, A will solicit bids to purchase the automobile. A will use the highest bid to determine the actual value of the automobile for purposes of applying the terminal rental adjustment clause. Under these facts A has not retained significant and genuine attributes of ownership. Accordingly, the results will be the same as example (1).

\textit{Id.}

\textsuperscript{171} \textit{Id.}; example (3) states:

Example (3). The facts are the same as example (1) except that the terminal rental adjustment clause only provides that the customer shall reimburse A if the sales proceeds fall below the projected value of the automobile at the end of the agreement. No credit is anticipated to be made to the customer if the sales proceeds exceed the projected value (or predetermined amount in the event of a cancellation or early termination of the agreement) of the automobile although A will, if the customer so requests, credit the customer with an amount equal to the excess if the customer buys the automobile or obtains another automobile from A. Under these facts, A has not retained significant and genuine attributes of ownership. Therefore, the agreement will be characterized as a conditional sales contract, not a lease, with the same results as in example (1).

\textit{Id.} at 52730-31.


the agreement upon sale or other disposition of such property." 174 Thus, the purchase option element of a residual guarantee arrangement is not part of the statutory definition and, therefore, is subject to the "but for" requirement that the agreement otherwise qualify as a true lease for tax purposes.

Congress bowed to long-standing industry practice by heading off the Treasury Department's attempt to thwart the use of terminal rental adjustment clauses. The legislative history notes that terminal rental adjustment clauses provide a financial incentive for the user to keep the vehicle in good repair. 175 Although Congress did not overrule existing case law or preclude Treasury regulations from treating leases containing terminal rental adjustment clauses as conditional sales, 176 it created a safe harbor to protect standard industry practice. The legislative history specifically disavows any inferences as to the tax consequences of such clauses outside of the confines of the statutory safe harbor. 177

The manner in which the lessee benefits from residual value appreciation need not be limited to acquiring permanent possession of the leased asset. Assuming the vehicle has appreciated in excess of the stipulated value and is not unique, the lessee can easily take the cash received from the lessor and apply it toward the purchase of a substantially similar vehicle in terms of model, year, mileage and general operating condition. Furthermore, even in the absence of a purchase option, the lessor will most likely sell the vehicle to the lessee for the stipulated amount 178 whether or not the lessor has another interested buyer. 179 In sum, a residual value guarantee clause

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175. See General Explanation, supra note 40, at 87.
176. Id. at 86.
177. Id. at 88.
178. The following equation proves the point: Fair Market Value (FMV) of vehicle minus (FMV of vehicle minus Stipulated Amount, i.e., residual guarantee) equals Stipulated Amount. For example, if the lessee agreed that the vehicle would be worth $1,000 at lease expiration, but the vehicle was actually worth $1,500, the lessor would only net $1,000 upon resale to a third party, since the lessee would be entitled to a $500 credit under the residual guarantee clause. The lessor will probably prefer to sell the vehicle to the lessee for $1,000 due to the likelihood of lower transaction costs.
179. Prop. Treas. Reg. § 1.168(f)(8)-12(c), supra note 165. According to example (1), supra note 169, the lease will be recharacterized as a sale if the lessor sells the property to a third party at the end of the lease and credits or charges the lessee with the difference between the sales proceeds and the guaranteed residual. The Regulation fails to provide for the possibility that the lessee may conduct the sale. The Treasury probably does not intend to distinguish between the two; in any event, tax law would treat the lessor as the real seller on an agency or conduit theory.
is even more effective than a fixed price purchase option in transferring the risks of ownership to the lessee. The inclusion of such a clause should cause the transaction to be characterized as a sale.

Alternatively, a residual value guarantee clause that compensates the lessor for excessive depreciation, without a reciprocal benefit to the lessee for residual value appreciation, should not cause the lease to be cast as a sale. Vehicle depreciation may be measured in increments of time and mileage. Although external market forces such as economic conditions and changing consumer preferences affect residual value, accumulated mileage is a dominating influence, together with vehicle maintenance, on depreciation and residual value. A residual value guarantee clause limited to compensating the lessor would effectively convert time-based rent to mileage-based rent. The lessee should be required to pay the greater of either the total rent computed over time or the total rent computed by multiplying total mileage by a fixed rate. Inclusion of the actual residual value in the computation would probably alert the Service, and would offer the lessor little added protection against residual value decline. In any event, even if the residual value were the measuring stick for the lessee’s payment, courts would be unlikely to characterize the transaction as a sale where the lessee is not entitled to either ultimate possession or its monetary equivalent.

Under the foregoing analysis, Congress was too generous in enacting section 168(f)(13). Even Congress’ stated purpose of ensuring proper vehicle maintenance by lessees could have been accomplished by permitting transfer of only the downside risk to the lessee. This would protect the lessor from excessive vehicle use and improper vehicle maintenance by the lessee without departing from economic substance principles.

180. For example, a cash rebate or discount on the lease or purchase of another vehicle would constitute a reciprocal lessee benefit.

181. Tax law implicitly recognizes this by permitting standardized mileage allowances instead of separately computed depreciation, maintenance, repairs, etc., in certain situations. See Rev. Proc. 82-61, 1982-2 C.B. 849.

182. Admittedly, such a residual guarantee clause would not perfectly convert time-based rent to mileage-based rent. In practice, however, the correlation would be very strong.

Another view in support of a residual value guarantee clause limited to insuring the lessor’s risk is that such a clause merely burdens the lessee with the maintenance and repair obligations commonly shifted to the lessee in a net lease. The lessee is charged with the cost of inadequately discharging its obligation during the lease term.

183. The Service could argue that the lease transfers risk of loss and, hence, ownership to the lessee by shielding the lessor from residual value decline.
B. Right to Possession for Substantially All of an Asset's Useful Life

The amount of the lessor's residual interest is highly relevant to the classification of the lease for tax purposes. If the lessor lacks a significant residual interest in the asset, the lease is indistinguishable from a sale and tax law should characterize the transaction as such.

1. Lease Term Length. — There is little case law discussing the impact of leases whose terms approximate the useful life of the property. The Service guidelines, however, require that leveraged equipment lease terms not exceed eighty percent of the useful life to qualify for an advanced ruling. The Service has expressed no opinion on leases of real property.

It is economically sound for a lease which entitles the lessee to possess the leased asset for substantially all of the asset's useful life, leaving the lessor without a significant residual interest, to be labeled a sale. The tax treatment will then match the economic substance of the transaction because a lessor deprived of a substantial residual effectively closes out his investment in the property.

184 Alaska Realty Co. v. Commissioner, 141 F.2d 675, 676 (6th Cir. 1944), represents one of the few cases where the Commissioner argued, albeit unsuccessfully, that the length of the lease term should be compared with the useful life of the property. The issue in Alaska Realty was whether a particular lease provision shielded the lessor from risk of depreciable loss. Id. See infra notes 252-61 and accompanying text.

185 Rev. Proc. 75-21, supra note 67, § 4(1)(C) at 715. If the leased property has a useful life of less than five years, the remaining useful life at the expiration of the lease term must equal at least one year. Id. Technically, the requirements of Rev. Proc. 75-21 are not substantive law; they are only guidelines for obtaining an advance ruling. Id., § 3.

186 Rev. Proc. 75-21, supra note 67, § 3, at 715, sought to clarify ambiguities in the scope of Rev. Rul. 55-540, 1955-2 C.B. 39. Rev. Rul. 55-540 expressly applies to equipment leases. Id. at § (1). But see Rosenberg & Weinstein, Sale-leasebacks: An Analysis of These Transactions After the Lyon Decision, 45 J. Tax'n 146, 147 n.1 (1976). The authors assert that Rev. Proc. 75-21 also applies to real estate. Id. They sharply dispute the relevance of personal property guidelines to the real property setting because real property customarily has a longer average useful life and is more likely to have a residual value. Id. However, the guidelines in Rev. Proc. 75-21 are phrased in percentages, not absolute numbers, which makes it difficult to understand the authors' point. Rosenberg and Weinstein cite a letter written by the Director of the Corporate Tax Division of the IRS, expressing the view that some, if not many, of the ruling guidelines articulated in Rev. Proc. 75-21 apply to both real and personal property. Id. This is the better view.


188 The lessor will compute the return on his investment based upon the lease payments. In closing out his investment, the lessor does not necessarily assume the passive status of a net lessor. Indeed, he may still possess some ownership responsibilities — such as maintenance, repair, etc. — but he no longer possesses material risks and rewards of ownership, other than the risk of the lessee's default; thus, the lessor should no longer be considered the true owner of the property. Courts have acknowledged that the lessor lacks a depreciable interest,
ways to determine when this occurs: (1) by comparing the length of the lease term with the expected useful life of the property, or (2) by comparing the value of the lessor’s residual interest with the original cost of the property. The latter method is imprecise because it compares a future dollar (value of residual interest) with a present dollar (original cost). The more accurate comparison is between the present value of the residual interest and the property’s original cost, because the more distant in time the lessee’s residual interest, the smaller that interest will be. Neither method standing alone, however, produces acceptable results. Because the formula is expressed in dollars, rather than time, a comparison of the value of the lessor’s residual interest with the original cost of the property more accurately determines when a lessor has effectively closed out his investment; it can also produce harsh results. Hypothesize, for example, a twenty-five year lease on an office building with a forty-five year useful life and a minimum requirement that the present value of the

but only in the context of a purchaser of real estate subject to an existing leasehold. See, e.g., Commissioner v. Moore, 207 F.2d 265 (9th Cir. 1953), cert. denied, 347 U.S. 942 (1954); Bernstein v. Commissioner, 22 T.C. 1146 (1954), aff'd per curiam, 230 F.2d 603 (2d Cir. 1956). In other cases allowing the lessor depreciation deductions, the courts based their decisions on the effect of asset replacement clauses. See cases cited infra note 256.

Suppose the lessor is denied depreciation deductions on the ground that he sold the leased property: Is the lessee entitled to the deductions? The Supreme Court, in Weiss v. Wiener, 279 U.S. 333 (1929), said no. See also New York Cent. R.R. v. Commissioner, 79 F.2d 247 (2d Cir.), cert. denied, 296 U.S. 653 (1935). The Wiener Court contended that the lessee had invested no capital in the property, a prerequisite for entitlement to the depreciation deduction. 279 U.S. at 335-36. The Court apparently failed to consider the possibility that rent payments might be a capital investment. See infra notes 241-51 and accompanying text. This questionable assumption led subsequent courts to conclude that neither the lessor nor the lessee is entitled to the depreciation deduction. See, e.g., New York Cent. R.R., 79 F.2d at 251.

An asset’s true economic depreciation follows an accelerated course of depreciation. See, e.g., Kahn, supra note 48. If this is true, the present value of the residual of an asset after 80% of its useful life has expired will be miniscule; therefore, the lessor should not be considered the tax owner of the property. If Professor Chirelstein’s sinking-fund model of depreciation, see M. CHIRELSTEIN, supra note 27, which postulates that an asset depreciates faster in the out years of an asset’s useful life, represents a more accurate description, the maximum lease term/useful life ratio tolerated under new true lease guidelines should be raised. The controversy over the appropriate model of depreciation to govern tax expenditure classifications has sparked lively debate. See, e.g., Blum, Accelerated Depreciation: A Proper Allowance For Measuring Net Income???, 78 Mich. L. Rev. 1172 (1980); Kahn, Accelerated Depreciation Revisited — A Reply To Professor Blum, 78 Mich. L. Rev. 1185 (1980).


190. Rev. Proc. 75-21, supra note 67, § 4(1)(C), at 715-16, fails to incorporate both present value discounting and inflation. Accurate comparison of residual value and original cost requires discounting the residual value at the “real” rate of interest (i.e., nominal interest rate minus inflation).
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residual equal or exceed ten percent of original cost. At a six percent discount rate and an expected residual value, ignoring inflation, of forty percent of original cost, the transaction would be deemed a sale, which is too harsh a result.¹⁹¹

A better means of ensuring both accurate and fair results would be to employ both measurement methods in conjunction with one another, rather than in the alternative. Under this analysis, a lease would violate the residual value requirement only if the lease term exceeded a specified percentage of the asset's useful life and the present value of the residual fell below the specified percentage of the original cost.¹⁹² This would permit uniform application to both personal property and real property.¹⁹³

Despite the usefulness of the conjunctive test, there is a need for an upper limit on lease term length, because the present value of the lessor's residual interest in a long term lease is too minute to distinguish between a lease and a sale.¹⁹⁴ For example, if the anticipated

¹⁹¹ The present value of $1 to be received in 25 years at a 6% discount rate is $.233. Thus, if the original cost of the office building was $1,000,000, the present value of the $400,000 residual value would be $93,200, which is less than the 10% of original cost threshold for true lease treatment.

¹⁹² This improves on Rev. Proc. 75-21, supra note 67, § 4(1)(C), at 715-16, by requiring a present value dollar comparison of residual value and current cost. Tax law has been slow to incorporate present value concepts long familiar to economists. See generally Canellos & Kleinbard, The Miracle of Compound Interest: Interest Deferral and Discount After 1982, 38 Tax L. Rev. 565 (1983). The Tax Reform Act of 1984 has revised much of the tax code to account for the time value of money. See J. Eustice, supra note 36, ch.2.

¹⁹³ The conjunctive test does not work with land leases because the useful life of land is indeterminate.

Present value analysis underscores the economic folly of treating a 99 year lease of real property as a true lease. Precisely where the dividing line is between significant and insignificant residual values is admittedly an arbitrary decision. Arbitrary cutoffs, however, characterize much of tax law. The line being drawn today, nonetheless, is indefensible because of the failure to incorporate present value concepts.

Leases of land should not be excluded from a minimum residual value requirement incorporating present value concepts. It is absurd to treat a 999 year lease as a true lease as the Fourth Circuit did in Atlantic Coast Line R.R. v. Commissioner, 81 F.2d 309 (4th Cir.), cert. denied, 298 U.S. 656 (1936). This can be corrected be either extending a minimum residual value to real property, as well as personal property leases, or by establishing a maximum lease term length to be accorded true lease treatment.

¹⁹⁴ The lease more closely resembles a sale when the rentals are noncancelable. If the lease is cancelable only upon the occurrence of a remote contingency or any other condition which makes cancellation unlikely, the lease should be considered noncancelable. Tax law could profit by borrowing the definition of “noncancelable” from the accounting profession. See Financial Accounting Standard Board (FASB) Statement No. 13, §§(f) (1976).

Shifting the risk of loss from obsolescence to the lessee is obviously helpful to the sale analogy; the converse, however, is not true. Even if the lessor retains the risk of depreciation and obsolescence loss, the lessee acquires the most important right of ownership: The use of
residual value of a building in fifty years, ignoring inflation, is fifty percent of the original cost of the building, the present value of the residual at a six percent discount rate is only 2.7% of original cost. A line must be drawn at some point to determine how much residual value retained by the lessor qualifies the transaction as a true lease. Tax law often draws arbitrary lines that result in different tax consequences; those lines are and should be drawn at the most sensible places. It seems senseless to have a rule that permits any amount of residual value retained by the lessor, no matter how small, to qualify the transaction as a lease. A more sensible rule would require the retention by the lessor of some significant amount of residual value, perhaps five percent of original cost on a present value basis, thus unifying, at least conceptually, the tax treatment of leases of real and personal property.195

2. Limited Use Property. — The Service has declined to issue advance rulings on leases involving limited use property since the lessee has the benefit of use of the property for substantially its entire useful life.196 In explaining its position, the Service posits that a transaction permitting the lessee to lease the property for substantially its entire useful life is a transfer of equitable ownership.197 Congress' enactment provides a safe haven that would allow leasing of limited use property, but the effective date of the legislation is delayed until 1988.198 The Code defines limited use property as prop-

195. Rev. Proc. 75-21, § 4(1)(C), 1975-1 C.B. 715, which applies to personal property, requires a lessor applying for an advanced ruling to represent and demonstrate that the property's residual value is at least 20 percent of original cost, ignoring inflation or deflation.


In Rev. Rul. 82-61, the Service held that an undivided interest in an electric generating facility did not constitute "limited use property" as defined by Rev. Proc. 76-30. Rev. Rul. 82-61, 1982-1 C.B. 13, 16. This was an extension of the Service view expressed in Rev. Proc. 76-30 § 5, examples (5) & (6), which dealt with leases of entire electric generating facilities. The Service ruled for the lessee-taxpayer in Rev. Rul. 82-61 because the lease term length was not excessive, id. at 13, 15; the lessor, at the end of the lease term, could take and dispose of its ratable share of the power generated by the facility, id. at 14, 15; and the lessor's interest was disposable to a third party. Id.


property “of a type not readily usable by any person other than the Lessee.” This definition should encompass any property where the lessor’s reclamation and refurbishing costs exceed the asset’s realizable value upon disposition to a third party, whether or not the asset is physically attached to the lessee’s premises. The law, however, is not clear.

Limited use property locks the lessor into reletting or selling the property to the lessee because of the commercial infeasibility of transferring possession of the property to another party. Thus, the lessee becomes entitled to use the property for the remainder of its useful life. A monopoly on the useful life of the property by the lessee also results from lease terms of excessive length; however, in the limited use property situation the monopoly arises by fiat, rather than by contractual right.

In Estate of Starr v. Commissioner, possibly the only recorded case to squarely address the characterization of limited use property leases, the deceased taxpayer’s company (the lessee) leased a fire sprinkler system that the lessor installed in the lessee’s plant. The Ninth Circuit concluded that the lessor would probably never remove the system, even though the lessor reserved the con-

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199. I.R.C. § 168(f)(8)(A)(ii) (Supp. I 1983) (effective Jan. 1, 1988). In Rev. Proc. 76-30, supra note 196, § 2 at 648, the Service defined limited use property as “property not expected to be useful to or useable by the lessor at the end of the lease term except for purposes of continued leasing or transfer to a member of the lessee group.” Id.


201. 274 F.2d 294 (9th Cir. 1959), rev’g, 30 T.C. 856 (1958).

202. In Electric & Neon, Inc. v. Commissioner, 56 T.C. 1324 (1971), aff’d per curiam, 496 F.2d 876 (5th Cir. 1974), a case which could have been decided upon limited use property considerations, the lessor, an accrual basis taxpayer, constructed custom-made electric, neon and plastic signs and displays, which it leased and sold to customers. Id. at 1326. The signs had no residual value to Electric & Neon (E & N), id.; upon lease expiration or lessee default, E & N would junk the sign. Id. E & N treated the construction costs of each sign as current expense, but reported lease payments as income over the life of the lease. Id. at 1326-27. The Commissioner, pursuant to his authority under I.R.C. § 446(b) (1982), contended that E&N's method of accounting did not clearly reflect income because it should have depreciated the signs over their useful life. The Tax Court agreed. Id. at 1324.


203. 274 F.2d at 294.
tractual right to remove the system if the lessee chose not to renew the lease.\textsuperscript{204} Both the Ninth Circuit in \textit{Estate of Starr} and the Service in Revenue Procedure 76-30, concluded that the central feature of limited use property leases is that the leased asset either attaches to or becomes dependent upon an asset held by the lessee.\textsuperscript{205} The property is either incapable of being relet to a third party\textsuperscript{206} or may only be relet to a third party at a cost to the lessor in excess of the asset's realizable value.\textsuperscript{207}

The New York State Bar Association\textsuperscript{208} recently issued a proposal on how to prevent a lessee from using limited use property after the lease expires; the Association asserted that the combination of contractual rights and the Association's suggested appraisal mechanism would prevent such use if the lessee fails to renew the lease or purchase the asset at the appraised value.\textsuperscript{209} The appraisal mechanism would ensure the lessor a substantial residual value at the end of the lease term.

The principal flaw in the New York State Bar Association's proposal, however, is that it does not alter the probability of the lessee's continued use of the property for the property's entire useful life.\textsuperscript{210} The lessee must have the right \textit{not} to exercise the option; otherwise, the transaction must be characterized as a sale. If the lessee refuses to exercise the option, the lessor's only motivation to reclaim the property will be revenge. A lessor will not reclaim an asset with a negative residual value, i.e., an asset that costs more to reclaim and refurbish than the asset is worth. The appraisal mechanism fails

\textsuperscript{204} Id. at 295.
\textsuperscript{206} See supra note 205.
\textsuperscript{208} Committee on Depreciation & Investment Credit, Comments on the Treasury Regulations Project on True Leases, 1983 N.Y. St. B.A. TAX SEC. 1.
\textsuperscript{209} Id. at 20.
\textsuperscript{210} See Rev. Proc. 76-30, supra note 196, § 3 at 648. The proposal does not resolve the problem of disposability of the property to third parties. If the lessor and lessee fail to agree on a renewal rate or purchase price, the lessor can do one of three things: (1) remove the property, if feasible (he will presumably scrap the property once removed because of its limited use character); (2) leave the property in the lessee's hands but enjoin him from using it; or (3) allow the lessee to use the property and sue him for unjust enrichment, forcing the court to establish a fair market value for the property. What the lessor cannot feasibly do, however, is dispose of the property to a third party if the leased property is attached to other property owned by the lessee. See Estate of Starr, 274 F.2d 294.
to make repossession by the lessor economically attractive.

3. Renewal Options. — A renewal option offers the lessee an extension of the lease in exchange for additional rentals. The additional rentals may be fixed by the lease agreement or determined by the fair value at the time of renewal. If a renewal option is set at a fixed price below the fair rental value for the renewal term, and the length of the entire lease term is excessive in relation to the asset’s useful life, the lessee should be deemed the tax owner of the asset.

The courts and the Service concur that bargain renewal options may cause a transaction to be characterized as a sale for tax purposes. In Revenue Ruling 60-122, for example, the Service considered two lease agreements with bargain renewal options. In the first lease, the property’s useful life exceeded the total lease term including renewal periods; in the second lease, the total lease term covered substantially all of the property’s useful life. The Service ruled that the first transaction was a lease and the second transaction was a sale.

Three elements of purchase option analysis also apply to re-

211. Mt. Mansfield Television, Inc. v. United States, 239 F. Supp. 539 (D. Vt. 1964), aff’d per curiam, 342 F.2d 994 (2d Cir. 1965); Estate of Starr v. Commissioner, 274 F.2d 294 (9th Cir. 1959); Home News Publishing Co. v. Commissioner, 28 T.C.M. (CCH) 834 (1969). But see Lockhart Leasing Co. v. Commissioner, 446 F.2d 269 (10th Cir. 1971); Gem, Inc. v. United States, 192 F. Supp. 841 (N.D. Miss. 1961); Kansas City S. Ry. v. Commissioner, 76 T.C. 1067 (1981); LTV Corp. v. Commissioner, 63 T.C. 39 (1974) (either the renewals were related to fair market value or there was no reasonable certainty that renewal option at a reduced rate would be exercised).

The critical fact that distinguishes Kansas City S. Ry. from Estate of Starr and Mt. Mansfield Television is that the Tax Court in Kansas City S. Ry. found that the “[lessor] retained a realistic residual interest in the equipment,” Kansas City S. Ry., 76 T.C. at 1099, and had resold many pieces of equipment for “significant amounts” of money. Id. The court evidently believed that the taxpayer had met its burden to show that it did not retain the leased property for the entire useful life, despite the Commissioner’s argument that the “lessee retained the equipment and used it during its entire useful life and also during its entire economic life.” Id. at 1098. In Estate of Starr and Mt. Mansfield Television, on the other hand, the lessee retained possession of the property during its entire useful life, tantamount to ownership of the property. See id. at 1100 n.19 (cases distinguished from Kansas City S. Ry.).


213. In treating the first lease as a true lease, the Service noted that the useful life of the property was substantially longer than the sum of the primary and renewal terms. Rev. Rul. 60-122, 1960-1 C.B. 56, 57. The Service recast the second lease as a sale because the lessee could renew the lease indefinitely at a rental slightly above the lessor’s ordinary maintenance charge. Id. at 57. The Service presumed in both cases that the lessee would renew the lease for the entire useful life of the property. But see Gem, Inc. v. United States, 192 F. Supp. 841 (N.D. Miss. 1961) (placing burden on Service to prove “reasonable certainty” of renewal). See infra note 215.
First, a renewal option becomes a bargain renewal option when the renewal rate falls below the present expected fair rental value on the renewal date, thereby inducing the lessee to exercise the option to reap the economic benefit. Even if the lessee no longer has use for the asset, he may be able to sublet the asset to a third party at a profit. Second, expected fair rental value is as difficult to ascertain as expected fair market value. It may be easier administratively to aggregate all fixed renewal option terms when measuring whether the lease covers substantially all of an asset’s useful life than to sort out bargain renewal from non-bargain renewal terms through difficult future value determinations. Third, a fair market value renewal option should never cause a lease to be recharacterized as a sale. The lack of an economic inducement to renew the lease breaks the connection between the original lease term and the renewal term; upon renewal, the lessee is treated as though he never had possession of the property. Thus, a party leasing an asset with a five year useful life for a one year term, with three optional one year renewal terms (at the then fair rental value), will be treated similarly to one leasing four different assets for four successive one year periods.

While the analysis of renewal and purchase options is similar,
differences do exist. The key factor in analyzing bargain renewal options is the transfer of residual value, not residual value risk (as in a purchase option), to the lessee. Thus, if a two year lease of property having a five year useful life contains a one dollar purchase option, the transaction is deemed a sale; if the lease contains a one dollar renewal option for one year, the transaction is a lease. The Service, however, will spread the rent deductions evenly over the three year term.\textsuperscript{218} In sum, the distinctive ingredient in a renewal option case which characterizes a lease as a sale is an aggregate lease term which is excessive in relation to the property's useful life.

C. Risk of Depreciable Loss

Another significant factor for lease classification purposes involves the placement of the "burden," or risk, of depreciable loss.\textsuperscript{219} If the burden shifts to the lessee, the lessor no longer deserves depreciation deductions nor qualifies for tax status as an owner; the transaction should be characterized as a sale. Arguably, the lease provisions discussed in sections III, A. and III, B.\textsuperscript{220} also cause a transfer of risk of depreciable loss to the lessee whenever a sale occurs, because the tax status of the owner vests in the lessee. The lease provisions discussed here operate differently; rather than providing the lessee with permanent or extensive dominion over the property, the lessee guarantees the lessor that the asset will be undiminished in value at the lease's expiration. An additional source of confusion arises from the fact that in most of the relevant cases, the lease term length is excessive; this factor alone should result in recharacterization of the lease as a sale. The cases, with rare exception, do not even regard lease term length as an issue. The lease provisions shifting the risk of depreciable loss should be separately considered because their relevance is independent of the usual long-term lease setting.

Three different lease provisions protect the lessor from depreciable loss: (1) clauses that require the lessee to return to the lessor at lease end an asset equal in value to the asset originally leased;\textsuperscript{221} (2) clauses that require the lessee to return the property in as good condition as when leased and to replace the property as it wears out or


\textsuperscript{219} See supra note 21.

\textsuperscript{220} See supra notes 120-83, 184-218 and accompanying text.

\textsuperscript{221} See infra notes 224, 225-51 and accompanying text.
at fixed time intervals;\textsuperscript{222} and (3) clauses that require the lessee to make improvements to the property.\textsuperscript{223} These classifications are by no means mutually exclusive; a lease provision may include any or all of the above clauses.

1. Lease Provisions Requiring the Return of an Asset of Equal Value. — The first category may be coined “the missing depreciation deduction.” A provision in this category may require the lessee of a building to return either that building, or a new one, equal in value to the original, in order to protect the lessor from a decline in the leased property’s value. When the lessor shields himself entirely from depreciable loss by employing such a lease provision, tax law allows neither the lessor nor the lessee to claim depreciation deductions on the property.\textsuperscript{224} After the lease expires, the lessor may amortize his original cost over the asset’s remaining useful life.

The seminal case in this category is Weiss v. Wiener.\textsuperscript{225} The leases in Wiener ran for ninety-nine years each, covering thirteen parcels of real estate.\textsuperscript{226} Wiener, the lessee and taxpayer in the suit, acquired the leases by assuming noncancelable rent obligations; no bonus payments were made.\textsuperscript{227} Each lease required the lessee to replace the building on the premises with a building of equal or greater value in the event of a fire or other destruction.\textsuperscript{228} The lease also obligated the lessee to maintain the buildings on the various parcels at their “fair cost or value.”\textsuperscript{229} Some leases specified that the lessee was required to erect new buildings at an agreed upon future date.\textsuperscript{230} During the taxable years in litigation, however, the lessee

\textsuperscript{222.} See \textit{infra} notes 252-61 and accompanying text.  
\textsuperscript{223.} See \textit{infra} notes 262-72 and accompanying text.  
\textsuperscript{224.} See, e.g., cases holding that the lessee should not receive a depreciation deduction: Weiss v. Wiener, 279 U.S. 333 (1929); Atlantic Coast Line R.R. v. Commissioner, 81 F.2d 309 (4th Cir.), \textit{cert. denied}, 298 U.S. 656 (1936); New York Cent. R.R. v. Commissioner, 79 F.2d 247 (2d Cir.), \textit{cert. denied}, 296 U.S. 653 (1935) (no depreciation deduction for lessor or lessee). See also, e.g., cases holding that the lessor should not receive the depreciation deduction: Royal St. Louis Co. v. United States, 578 F.2d 1017 (5th Cir. 1978); Kem v. Commissioner, 432 F.2d 961 (9th Cir. 1970); Georgia Ry. & Elec. Co. v. Commissioner, 77 F.2d 897 (5th Cir.), \textit{cert. denied}, 296 U.S. 601 (1935); Commissioner v. Terre Haute Elec. Co., 67 F.2d 697 (7th Cir. 1933), \textit{cert. denied}, 292 U.S. 624 (1934); Appeal of A. Wilhelm Co., 6 B.T.A. 1 (1927).  
\textsuperscript{225.} 279 U.S. 333 (1929), \textit{rev’g} 27 F.2d 200 (6th Cir. 1928), \textit{rev’g} 17 F.2d 650 (N.D. Ohio 1926).  
\textsuperscript{226.} \textit{Wiener}, 17 F.2d at 651.  
\textsuperscript{227.} Id.  
\textsuperscript{228.} Id.  
\textsuperscript{229.} \textit{Wiener}, 27 F.2d at 200.  
\textsuperscript{230.} Id.
made none of the capital expenditures called for under the leases.\textsuperscript{231} Of the thirteen leases, seven were assigned, cancelled or surrendered by the lessee after the years in dispute.\textsuperscript{232} The lessee took depreciation deductions on the leased buildings; the Department of Internal Revenue, however, disallowed the deductions.\textsuperscript{233}

The district court held that the lessee’s depreciation deductions were properly disallowed.\textsuperscript{234} The court stressed that the lessee had not invested its capital in the buildings and that the lessee’s obligation to make capital expenditures was contingent and remote.\textsuperscript{235} The Sixth Circuit reversed\textsuperscript{236} and held — based on a close reading of the statutory language of the section authorizing the depreciation deduction\textsuperscript{237} — that the taxpayer’s right to the deduction did not depend upon a capital investment, but rather required that the taxpayer “suffer and bear the burden of the loss or depreciation,”\textsuperscript{238} which the lease allocated to the lessee.

The Supreme Court reversed the Sixth Circuit and affirmed the district court’s decision in favor of the Department.\textsuperscript{239} Justice Holmes, delivering the opinion for the Court, followed the reasoning of the district court, noting that the lessee had not invested its capital and was only contingently obligated to do so in the future.\textsuperscript{240}

Two aspects of the \textit{Wiener} case warrant comment. First, both the district court and Supreme Court placed greater emphasis on the lessee’s lack of capital investment than on the lessee’s clear obligation to protect the lessor against depreciable loss.\textsuperscript{241} The lessee’s obligations were not contingent since a depreciable loss was certain to

\begin{itemize}
  \item \textsuperscript{231} \textit{Id.}
  \item \textsuperscript{232} \textit{Wiener}, 17 F.2d at 651.
  \item \textsuperscript{233} \textit{Wiener}, 27 F.2d at 200.
  \item \textsuperscript{234} \textit{Wiener}, 17 F.2d at 650.
  \item \textsuperscript{235} \textit{Id.} at 651. The court emphasized that “the important fact is that . . . the plaintiff did not make any such capital expenditures . . . . It will be time enough to consider the question of allowing depreciation, under any of the conditions above stated, when the contingency shall have happened.” \textit{Cf.} Albany Car Wheel Co. v. Commissioner, 40 T.C. 831 (1963), aff’d per curiam, 333 F.2d 653 (2d Cir. 1964) (a contingency — employee severance pay liability — is not to be included in the basis of assets until the liability actually arises).
  \item \textsuperscript{236} \textit{Wiener}, 27 F.2d at 201.
  \item \textsuperscript{237} Section 214(a)(8) of the Revenue Act of 1918, which allowed a deduction for the “exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence,” is similar to the present I.R.C. § 167(a) (1982).
  \item \textsuperscript{238} \textit{Wiener}, 27 F.2d at 201. The court also noted the statutory requirement that the property be used in a trade or business of the taxpayer. \textit{Id.}
  \item \textsuperscript{239} \textit{Wiener}, 279 U.S. at 336.
  \item \textsuperscript{240} \textit{Id.}
  \item \textsuperscript{241} \textit{See supra} notes 235, 240 and accompanying text.
\end{itemize}
occur. Subsequent events do not transform certain liabilities into contingent ones; instead, such events should discharge or postpone the liabilities. Discharge and assumption of indebtedness often serve as the consideration for conveyances of property, which is arguably what occurred in *Wiener*. Furthermore, the taxpayer in *Wiener* attempted the impossible: He sought tax status as both lessee and owner in the same transaction. He not only deducted depreciation on the buildings, but deducted the rent as well.

The Supreme Court's holding in *Weiss v. Wiener* is questionable when compared with cases disallowing depreciation deductions to the lessor during the lease term where the lease wholly protects the lessor from depreciable loss. The cases suggest that the depreciation deduction suddenly disappears because the lessor has the capital investment, yet the lessee sustains the risk of depreciable loss. The capital investment without the risk of depreciable loss or the risk without the capital investment keeps either party from claiming depreciation.

Case discussions generally avoid the larger question of whether the transaction should be recharacterized as a sale. If it is a sale, the *Wiener* dilemma is solved; the agreement to pay "rent" transforms


243. Compare, e.g., the treatment of contingent liabilities in basis of assets acquired in Albany Car Wheel Co. v. Commissioner, 40 T.C. 831 (1963), aff'd per curiam, 333 F.2d 653 (2d Cir. 1964) (contingent employee severance pay liability not included in basis of assets until liability actually arises), with the treatment of bad debt discharges under § 166(a) (1982) (reversing prior inclusion in income of note or account receivable on theory that subsequent events suggest uncollectibility of item; otherwise, taxpayer redress available under § 1341 (1982) or through amendment of prior, erroneous return, see Treas. Reg. § 1.451-1(a) (1957)). The district court and Supreme Court in *Wiener* improperly looked to subsequent events to gauge whether the taxpayer's liabilities were contingent at the time of contracting. Accord *Gem, Inc. v. United States*, 192 F. Supp. 841, 846 (N.D. Miss. 1961) (determining probability of renewal option exercise from facts known during taxable year at issue).

244. See supra note 232 and accompanying text. The lessee conveyed his leasehold interests in exchange for assumption or cancellation (on reconveyance to the lessor) of his indebtedness under the lease agreements.

245. *Wiener*, 17 F.2d at 650, 651. The lessee also deducted the depreciation on improvements he made, id. at 651, but this does not constitute a double deduction.

246. See, e.g., Atlantic Coast Line R.R. v. Commissioner, 81 F.2d 309 (4th Cir.), cert. denied, 298 U.S. 656 (1936). The lessor and lessee were both before the court, but the Fourth Circuit denied depreciation deductions to either party. Id. at 310.

247. See, e.g., id.
into the capital investment, thereby entitling the lessee to the depreciation deduction. In effect, *Wiener* was an easy case, since the lessee had use of the property for ninety-nine years — far in excess of the useful life of the buildings — and the lessee agreed to assume all risk of depreciable loss. The lessor retained only legal title. *Wiener*, the lessee, was the owner of the property for tax purposes; thus, Wiener's rental deduction should have been disallowed.

The Code establishes a distinct relationship between a sale of property and entitlement to the depreciation deduction. For example, in section 167(g), the basis used to determine the depreciation deduction is the adjusted basis determined in section 1011 to compute gain or loss on the *sale or other disposition* of property. It follows from these Code sections that if property is sold, the seller may no longer depreciate the property because the asset's basis has been removed from his tax books.

A consideration of the sale issue would broaden the court's focus and direct its attention to the principal parties of the transaction, even though only one party is before the court. This would enable the court to analyze the transaction as a whole, and to fully assess the transaction's consequences. Consequently, a finding of a sale would direct the lessor to realize a gain or loss, capital or ordinary, as well as the loss of depreciation deductions.

2. Lease Provisions Requiring the Preservation and Replace-

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248. *See supra* notes 184-94 and accompanying text.
249. The subsequent reconveyances do not alter this conclusion. Wiener sold the underlying property instead of selling or abandoning his leasehold interests for tax purposes.
250. I.R.C. § 167(g) (1982) states that "the basis on which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 1011 for the purpose of determining the gain on the sale or other disposition of such property."

I.R.C. § 1001(a) (1982) also refers to § 1011 (1982) in the computation of gain or loss from the "sale or other disposition of property."

The parochial approach of the courts in *Weiss v. Wiener*, *see supra* notes 225-49 and accompanying text, to the depreciation deduction issue illustrates the consequence of failing to establish a link between the deduction and property disposition sections of the Code. Courts have generally tested the deductibility of rent to a lessee, or the character of payments received by a lessor under lease agreements that contain fixed price purchase options, by phrasing the issue quite correctly in lease versus sale terms. *See cases cited supra* notes 12, 17.

Strangely, courts have not followed this lead when faced with depreciable risk questions of the *Wiener* variety, *see cases cited supra* note 224. This is probably because, at lease termination, the property reverts to the lessor. The proper result in *Wiener* would have been to capital-ize the rent payments as installments on the acquisition of the buildings.

251. Ordinary income treatment will prevail if the asset does not qualify under § 1221 (1982) as a "capital asset" or the gain comes within I.R.C. §§ 1239, 1245 or 1250 (West 1982 & Supp. 1985).
ment of the Property. — A typical lease clause requiring preservation and replacement of the leased property might read as follows: “Lessee shall preserve, replace, renew and maintain the leased property, and upon reversion to the lessor, the property shall be in at least as good condition as at the beginning of the term.”  

Courts distinguish between an obligation regarding the quality of the property’s condition upon return, and an obligation that identifies, explicitly or implicitly, a dollar value of the property upon return. An obligation to keep property “in good order and repair” or return property “in as good condition as when leased” is construed to require the lessee to repair and maintain the property, and perhaps make necessary leasehold improvements. Courts have noted that the lessor will still be entitled to a depreciation deduction because of the inevitable deterioration of the property that occurs with the passage of time and the loss in property value due to technological improvements and changing consumer preferences.

Lease provisions in this category, however, have received disparate treatment due to the courts’ heavy reliance on factual findings to decide the cases. If the court construes the clause to permit the lessee to return property of lesser value than the property originally leased, the court often allows the lessor to deduct the depreciation actually suffered by him over the term of the lease. Alternatively, if the court construes the lease provision as requiring the lessee to

252. This is a streamlined version of the lease clause in dispute in North Carolina Midland Ry. v. United States, 163 F. Supp. 610, 611 (Ct. Cl. 1958).

253. See, e.g., Alaska Realty Co. v. Commissioner, 141 F.2d 675, 676 (6th Cir. 1944); North Carolina Midland Ry. v. United States, 163 F. Supp. 610, 614 (Ct. Cl. 1958). But see Royal St. Louis, Inc. v. United States, 578 F.2d 1017, 1020 (5th Cir. 1978) (holding that phrase “first class condition” precluded economic loss and hence, lessor’s depreciation deduction).


255. See cases cited supra note 254 and infra note 256. One route used by some courts has been to find that the lease did not protect the lessor against “depreciation through obsolescence.” Helvering v. Terminal R.R. Ass’n, 89 F.2d 739, 742 (8th Cir. 1937). See also Terminal Realty Corp. v. Commissioner, 32 B.T.A. 623 (1935). Depreciation and obsolescence are two separate concepts, the former referring to the wear and tear on property caused by the passage of time, the latter referring to periodic advances in technology that render property undesirable and less valuable. The Code, however, provides for depreciation and obsolescence in a single deduction. I.R.C. § 167(a) (1982).

return property of equal value, the transaction should be treated as a sale for tax purposes.\textsuperscript{257} The court may be influenced by the lease term/useful life ratio\textsuperscript{258} or by the precise language of the lease provision, as well as by evidence of the parties' intent.\textsuperscript{260} The court would probably consider the lease term/useful life ratio relevant in a lease provision to replace worn out property, since, if the lease term covers the useful life of the property,\textsuperscript{260} the lessor is effectively shielded from sustaining any depreciable loss.\textsuperscript{261}


\textsuperscript{258} In Terminal Realty Corp. v. Commissioner, 32 B.T.A. 623 (1935), a freight terminal was the subject of a 23 year lease, \textit{id.} at 624-25, which required the lessee to maintain the property in "equally as good and safe [a condition] as the same may be at this time [date of lease], or may be put at any time during the continuance of this lease." \textit{Id.} at 626. The useful life of the property was 25 years at the inception of the lease. \textit{Id.} The court held:

The probable physical life of the properties in question was somewhat longer than the period of the lease. No doubt, by proper maintenance, they could be kept throughout the period of the lease in a condition equally as good and safe as they were at the beginning of the lease. . . . It seems clear that the lessees were not required by the terms of the lease to replace at the end of the lease the partially worn out buildings with new ones.

\textit{Id.} at 629-30. \textit{But see} Alaska Realty Co. v. Commissioner, 141 F.2d 675, 676 (6th Cir. 1944) ("The distinction which is sought to be drawn by the Commissioner, that the lease in the Terminal case covered a period less than the useful life of the property, seems immaterial").

\textsuperscript{259} See, e.g., Royal St. Louis, Inc. v. United States, 578 F.2d 1017, 1019-20 (5th Cir. 1978); Alaska Realty Co. v. Commissioner, 141 F.2d 675, 676 (6th Cir. 1944). \textit{See also} Rev. Rul. 62-8, 1962-1 C.B. 31.

\textsuperscript{260} In Royal St. Louis, Inc. v. United States, 578 F.2d 1017 (5th Cir. 1978), the court denied the depreciation deduction to a hotel trade property lessor. The court reasoned that a lease provision requiring the lessee to maintain the leased property in "first class condition" precluded the lessor's economic loss. \textit{Id.} at 1020. However, in Alaska Realty Co. v. Commissioner, 141 F.2d 675 (6th Cir. 1944), the court upheld the lessor's depreciation deduction where a 99 year lease, renewable forever, contained a lease provision similar to the one in \textit{Royal St. Louis, Inc.}. It appears that neither case was correctly decided. In \textit{Alaska Realty Co.}, the lessee's obligation to replace worn-out property virtually eliminated the lessor's risk of depreciable loss because the lessee would inevitably have to fully restore the property's value. In \textit{Royal St. Louis, Inc.}, the property was leased in three year cycles; the lessee would not be required to incur substantial restoration expenses because the property probably had a longer useful life. Furthermore, the lease permitted the lessee to satisfy part of its rent obligation through restoration expenses. Treatment of the restoration obligation as substitute rent seems more plausible. \textit{Cf.} M.E. Blatt Co. v. United States, 305 U.S. 267, 277 (1938); Commissioner v. Cunningham, 258 F.2d 231 (9th Cir. 1958) (agreement must disclose intent to treat improvements as rent). \textit{But see} Rev. Proc. 79-48, \textsection 3, 1979-2 C.B. 529, 530 (nonseverable improvements generally do not constitute rent).

\textsuperscript{261} From a transactional perspective, it is difficult to characterize a transaction where the lessor shields himself from depreciable loss for a period of time substantially shorter than the useful life of the property. The lessor may bear no risk of depreciable loss during the lease term, but retain the risk of depreciable loss in a leased asset of substantial residual value at the end of the lease term. Assuming the returned asset is the same as the one originally leased, it is difficult to say that a sale has occurred. However, it is improper to permit the lessor to
3. Lease Provisions Requiring Improvements to Property. —
Case law on leasehold improvements and lease characterization is minimal.\textsuperscript{262} The Service, however, considered the subject in Revenue Procedure 79-48,\textsuperscript{263} and restricted lessee improvements to prevent the lessee from acquiring an equity in the leased property.\textsuperscript{264} Revenue Procedure 79-48, for example, distinguishes between severable and nonseverable lessee improvements,\textsuperscript{265} and limits nonseverable improvements to no more than ten percent of the property’s cost.\textsuperscript{266} Although Revenue Procedure 79-48 deals explicitly with leveraged leases of personal property,\textsuperscript{267} it is also relevant to nonleveraged transactions.

The restrictions on leasehold improvements in Revenue Procedure 79-48 cannot be understood or justified without attempting to deduct depreciation during the lease term because she lacks the risk of depreciable loss. To illustrate the problem, assume a five year lease of widgets. The lessor has a $10,000 basis in the widgets at the inception of the lease; the widgets are five year ACRS property with a 10 year useful life and no salvage value. The widgets’ anticipated residual value at the end of the five year lease is $4,000, but due to a lease provision requiring restoration of the widgets to their original condition, the lessee will invest $6,000 (in current dollars) at or near the end of the lease term. As a result, the useful life of the widgets will be extended five more years. Although the lessor has shielded herself from risk of loss during the lease term, she retains the risk of loss in $4,000 worth of residual value. Perhaps the parties should be viewed as co-owners of the property in proportion to their risk positions in the property, i.e. 60/40 in favor of the lessee. The lessee would be entitled to deduct ACRS during the first five years, and the lessor would deduct her portion of the cost under ACRS over the second five years. Another possible solution is for the lessor to be viewed as lending the asset to the lessee in exchange for interest payments denominated as rent during the lease term. The $6,000 of restoration expenditures made by the “lessee” would be treated as repayment of the principal in kind. The “lessor” would commence deducting depreciation upon the lessee’s return of the asset.


\textsuperscript{264} Id. § 3 at 529-31.

\textsuperscript{265} Id. at 529-30. Severable improvements are defined as “readily removable without causing material damage to the leased property.” Id. at 529. Rev. Proc. 79-48 generally permits severable improvements with two minor restrictions. Id. Nonseverable improvements are defined as “not readily removable without causing material damage to the property,” id. at 530, and are subject to many restrictions. The first major restriction prohibits the lessee from acquiring any equity in the property through receipt of compensation for its interest in the improvement. Id. Furthermore, the nonseverable improvement must meet either of two conditions: (1) it must be furnished to comply with some government regulations; id.; or (2) it must not substantially increase the productivity or capacity of the property compared with the date the property was first placed in service, or modify the property for a materially different use. Id. (“An increase in productivity or capacity is substantial only if the increase is more than 25 percent.”). Id.

\textsuperscript{266} Id. at 530.

extract the purpose of the restrictions. The Service may be concerned that the lessor’s requirement that leasehold improvements be made by the lessee may be a disguised mechanism to ensure that the lessee returns an asset at the lease-end equal in value to the asset originally leased. Lease obligations of this type shift risk of depreciable loss to the lessee and are inconsistent with a true lease. Thus, Revenue Procedure 79-48 prohibits lessee improvements from substantially increasing the productivity and capacity of the leased property, and further limits the cost of improvements to no more than ten percent of the cost of the property. Revenue Procedure 79-48, however, does not apply to leases that do not contain a value restoration clause. Without such a clause, the lessee’s improvements do not shield the lessor from the risk of depreciable loss because the lessee has no obligation to furnish the improvements. Moreover, the twenty-five percent restrictions on productivity and capacity increases and the ten percent cost ceiling in Revenue Procedure 79-48 are needlessly arbitrary. The Service should determine on a case-by-case basis whether the lessee has completely restored the lost value of the asset.

D. Insignificant Factors in Lease Analysis

Several of the factors used by courts to distinguish a lease from a sale are arguably irrelevant to the analysis.

268. One view is that the rules of Rev. Proc. 79-48 have no purpose. See Committee on Depreciation & Investment Credit, supra note 208 at 29.

269. In addition, the Service may fear that lessee improvements may be used to disguise a joint venture or co-ownership as a lease.

270. See supra notes 224-51 and accompanying text.

271. See supra notes 265-66 and accompanying text.

272. The appropriate time to measure risk allocation is at the inception of the agreement. Without a contractual obligation to require restoration of the leased asset’s initial value, the lessor cannot be assured that improvements made by the lessee will shield the lessor from depreciable loss. The lessor is no more protected in this situation than when the lessor purchases a building in an area of rapidly escalating real estate prices. The chance that the market value will experience a decline is sufficient to warrant a depreciation allowance. Cf. Prop. Treas. Reg. § 1.704-1(b)(2)(iii)(C) 48 Fed. Reg. 9871 (1983) (status unchanged) (proposed Mar. 9, 1983) (for purposes of determining whether an allocation of an ACRS deduction to a partner has substantial economic effect, the decline in value is deemed to occur).

273. Another restriction imposed by the Service guidelines and many courts, the economic profit requirement, is beyond the scope of this Article. Several judicial doctrines, such as “business purpose,” “sham transaction,” “prudent abandonment,” and the Service’s “cash flow” test, have been formulated to deny participants their intended tax benefits in transactions devoid of economic substance. This Article only attempts to classify the existing economic substance as a lease or a sale; whether or not economic substance exists is another matter. See Rice’s Toyota World v. Commissioner, 81 T.C. 184 (1983), aff’d in part and rev’d in part, 752
1. The Net Lease. — In a net lease arrangement, the lessee assumes responsibility for repairs, maintenance, insurance and taxes while the lessor collects the rent. The Treasury regulations treat the lessee’s expenditures as an additional rent expense to the lessee and gross income to the lessor. Accordingly, the lessor receives an offsetting deduction for the expenses incurred by the lessee. Net leases are standard practice in an overwhelming number of varying transactions. Any restrictions the tax law might place upon the transfer of the net lease burdens to the lessee could be easily circumvented through increased rental charges; the allocation of these “burdens” should not be significant in distinguishing a lease from a sale.

2. Condemnation Proceeds and Other Contingencies. — Real estate leases often contain a provision allocating the right to condemnation proceeds between the parties. In Estate of Franklin v. Commissioner, for example, the Ninth Circuit implied that condemnation proceeds were important in analyzing the allocation of the burdens and benefits of ownership regardless of the likelihood that condemnation will occur.

F.2d 89 (4th Cir. 1985) (transaction lacked economic substance because there was no realistic hope for profit); Rev. Proc. 75-21, supra note 67, § 4(6) at 716.

274. In a net lease, the lessee pays all of the administrative and operative expenses of the property, including liability and property damage insurance, maintenance, repairs, licensing and recording fees, utilities, and sales, use, property and other taxes (except for income taxes, franchise taxes, etc.). Particular clauses may vary from lease to lease. See Fritch & Shrank, Leveraged Leasing, in EQUIPMENT LEASING-LEVERAGED LEASING 211-23 (B. Fritch & A. Reisman 2d ed. 1980).

278. The allocation of net lease burdens may have greater relevance to the lease versus sale issue when the lessor is unable to shift the burden to the lessee through higher rent because no rent is charged at all. In Alstores Realty Corp. v. Commissioner, 46 T.C. 363 (1966), for example, the Tax Court held there was a genuine sale and leaseback, id. at 371, where the lease had allocated the responsibility to provide heat, electricity and water and to bear the risk of loss to the premises from damage or destruction of the premises to the lessor. Id. at 372. The court found that the cash passing from Alstores, the purchaser-lessee, to Steinway, the seller-lessee, represented the price of the fee interest, less the rent due on the 2½ year lease term reserved by Steinway. Id. at 373. See also Steinway & Sons v. Commissioner, 46 T.C. 375 (1966). Had the lease-term burdens shifted to Steinway, Steinway could have been compensated by increasing the sales prices of the fee. This would have been reflected either in the buyer’s basis, and recoverable only through depreciation deductions or upon disposition of the asset, or would more likely result in a decrease in the amount of prepaid rent included in the lessor’s income, effectively accelerating the lessee’s § 162 deduction. Therefore, some attention to the manner of allocating net lease burdens is probably warranted.

279. 544 F.2d 1045, 1047 n.2 (9th Cir. 1976).
The Tax Court has held, however, that the allocation of condemnation proceeds to the lessor does not evidence a genuine lease absent a prospect or expectation of condemnation. In *Hilton v. Commissioner*, the Tax Court correctly refused to find economic substance in a tax shelter arrangement that allocated condemnation proceeds to the lessor but otherwise accorded the lessor only a remote prospect of economic gain.

The added importance that the allocation of condemnation proceeds should receive in lease analysis — such as when condemnation changes from a contingency into an expected occurrence — should also hold true for other types of contingency provisions. An analysis of the allocation of these risks should follow the analysis of risk of depreciable loss if the risk is borne during the lease term. If condemnation remains a contingency, the allocation of condemnation proceeds can only confirm the identity of the tax owner.

3. The *Frank Lyon* Case: Clouding the Economic Substance Test. — In *Frank Lyon Company v. United States*, the Supreme Court listed twenty-six factors relevant to determining whether the lessor should be permitted the depreciation deductions on the property in question. Although the Court primarily focused its attention on distinguishing a secured mortgage loan from a purported sale and leaseback, some of the factors analyzed by the Court apply to

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281. *Id.* But see supra note 279 and accompanying text.
282. 74 T.C. 305, 359 (1980).
283. The IRS has not formally stated its position on the inclusion of an unwind clause, which gives the lessor the right to sell the asset to the lessee if certain contingencies arise. See Shapiro, *Peripheral Problems in Leasing*, in *Equipment Leasing-Leveraged Leasing* 1041-47 (B. Fritch & A. Reisman 2d ed. 1980); Committee on Depreciation & Investment Credit, *supra* note 208 at 36-37. Rev. Proc. 75-21, *supra* note 67, § 4(1)(A), at 716, may be interpreted to prohibit an unwind clause. If the contingencies covered by the unwind clause are very unlikely to occur, Hilton’s treatment of allocation of condemnation proceeds should be followed.
284. *See supra* notes 219-72 and accompanying text.
287. In sale-leaseback cases, courts must distinguish between a genuine sale-leaseback and a disguised financing arrangement, or a tax-avoidance scheme. See, e.g., Sun Oil Co. v. Commissioner, 562 F.2d 258 (3d Cir. 1977), cert. denied, 436 U.S. 944 (1978); Rice’s Toyota World v. Commissioner, 81 T.C. 184 (1983), *aff’d in part and rev’d in part*, 752 F.2d 89 (4th Cir. 1985) (no business purpose for transaction aside from tax avoidance, thus, no economic
the general lease versus sale issue. Three of these factors are especially relevant here: (1) the presence of depreciation risk on the lessor; (2) the risk of lessee default or bankruptcy; and (3) the absence of a private understanding that the lessee will exercise the purchase option.

The Lyon Court evidently considered the lessor's possession of the risk of depreciable loss to be inconsistent with a secured lender's posture. This argument could apply equally to a lease versus sale substance. Sale-leasebacks of real estate versus equipment may have factual differences, e.g., useful life, likelihood of residual value appreciation, presence of obsolescence risk, etc., but the legal analysis is very similar. Compare, e.g., Rice's Toyota World v. Commissioner, supra, with Hilton v. Commissioner, 74 T.C. 305 (1980), aff'd per curiam, 671 F.2d 316 (9th Cir.), cert. denied, 459 U.S. 907 (1982).

Apart from the three factors discussed in the text, see infra text accompanying notes 289-91, seven of the Court's other factors are relevant to the sale versus lease question. These are:

1. the banking regulator's suggestion that the lessees possess a purchase option;
2. the lessor's sole liability on the mortgage notes;
3. the reasonableness of the rentals and option prices;
4. the likelihood that the lessee would "walk away" from the arrangement if the option price exceeded the then-fair market value of the building at the end of the primary term;
5. the lessor's "inescapable" succession to full ownership of the building if the lease were not renewed;
6. the arm's length nature of the transaction; and
7. the absence of any tax rate differential to spur the transaction.

In the wake of Lyon, courts have had to struggle with the Supreme Court's confused articulation of the economic substance test. Most of the important cases have concerned the validity of sale and leaseback transactions in light of Lyon's non-tax benefit test. Compare Dunlap v. Commissioner, 670 F.2d 785 (8th Cir. 1982) (affirming Tax Court's judgment that taxpayer could not claim loss deduction unless and until option is terminated); Hilton v. Commissioner, 74 T.C. 305 (1980), aff'd per curiam, 671 F.2d 316 (9th Cir.), cert. denied, 459 U.S. 907 (1982) and Schaefer v. Commissioner, 41 T.C.M. (CCH) 100 (1980) (denying the validity of a sale and leaseback with Belz Inv. Co. v. Commissioner, 72 T.C. 1209 (1979), aff'd, 661 F.2d 76 (6th Cir. 1981) and Carroll v. Commissioner, 1978 T.C.M. (P-H) 178,173 (sustaining the validity of a sale and leaseback). See generally Rosenberg & Weinstein, supra note 16. See also Peck v. Commissioner, 43 T.C.M. (CCH) 291 (1982) (sustaining validity of sale and leaseback, but disallowing "excessive" rent deduction). Two sale versus lease cases specifically have attempted to follow Lyon, both finding in favor of the taxpayer. See Kansas City S. Ry. v. Commissioner, 76 T.C. 1067 (1981); Davis v. Commissioner, 37 T.C.M. (CCH) 1441 (1978). Kansas City S. Ry. and Davis illustrate the unworkability of the Lyon test. In both cases, the Tax Court placed greater emphasis on the Benton-Northwest Acceptance Corp.-Lockhart Leasing Co. subjective intent approach, despite any explicit approval of this approach by the Lyon court.

290. Id.
291. Id.
292. Id.
case. If the Court's logic in Lyon is extended, the presence of bargain renewal and purchase options would not negate the importance of the lessor's possession of the risk of depreciable loss. Where the evidence is otherwise inconclusive, the Court implied that the form of the transaction ought to govern. The Court concluded that "if the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties [ought to govern]."

Shifts of depreciable loss risk, residual value and residual value risk, however, operate independently; the shift to the lessee of any of the three changes the nature of the transaction. This is so because the shift of one element eliminates the relevance of the other two. Thus, shifting the depreciable loss risk to the lessee eliminates the need to consider residual value or residual value risk where the lessor will receive either a new or fully restored asset at the end of the lease term. The lessee possesses the right to the residual, and therefore bears the risk of residual value fluctuation. Likewise, the shift of residual value risk to the lessee renders the analysis of residual value and depreciable loss risk irrelevant. If the lessee possesses the asset's residual value through the use of the asset for nearly all of its useful life, the lessee bears the risk of residual value fluctuation. The lessor's risk of depreciable loss is irrelevant because he has closed out his investment in the asset by accepting lease payments in lieu of installment sale payments and has parted with equitable ownership of the property. The lessor retains only the risk of obsolescence, which may also be shifted by making the lease payments noncancellable.

The transfer of residual value risk, as in Lyon, eliminates the relevance of the quantum of residual value and allocation of risk of

293. Although the Lyon case involved a sale and leaseback transaction, the alternative characterization was a mortgage loan rather than a sale. The incidence of risk of depreciable loss is equally relevant in both settings. The underlying issue, however, is the identification of the true owner.
294. The lease agreement in Lyon contained eight successive five year renewal options following the 25 year primary term and a schedule of fixed price purchase options exercisable 11 years after the inception of the lease. If exercised, the purchase options would yield a steady six percent return on the lessor's investment. Lyon, 435 U.S. at 566-567, 570.
295. Id. at 584.
296. See supra text accompanying notes 224-72.
297. See supra note 261.
298. See supra notes 184-218 and accompanying text.
299. See supra note 188 and accompanying text.
300. See supra note 194.
depreciable loss. The lessee's interest in residual value appreciation makes it probable that the lessee will ultimately obtain ownership of the property. A substantial residual value at the end of the lease term, if in excess of the option price, cuts against the lessor because it practically assures the lessee's eventual exercise of the option. Risk of depreciable loss is irrelevant to the extent that the depreciated value exceeds the option price. The importance of the depreciation and obsolescence loss risk below the option price is subsumed by an analysis of the allocation of residual value risk.

The second factor considered by the Lyon Court was the lessee's risk of default or bankruptcy. The Lyon Court failed to recognize that sellers, lenders, and lessors alike face the risk of the default of their transaction partner. Further, parties frequently protect against these risks through various means. These risks should not be a distinguishing factor in analyzing a lease.

The third Lyon factor relevant to lease analysis is the absence of an understanding between the parties that the lessee will exercise the purchase option. One case noted that the presence of an informal agreement to exercise the purchase option supported the finding of a conditional sale. It is absurd to argue, however, that a negative implication arises from the absence of an informal agreement; this undermines the Lyon's Court emphasis on the reasonableness of the option price. Sensibly, no court after Lyon has emphasized the absence of an informal agreement to exercise the purchase option.

IV. TEFRA AND ITS EFFECT ON LEASE ANALYSIS

A. Finance Leases

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) overhauled the safe harbor leasing rules enacted in the Economic Recovery Tax Act of 1981 (ERTA). Section 208 of TEFRA repealed the 1981 safe harbor leasing provisions, which were to go into effect September 30, 1985, and section 209(a) of TEFRA introduced new Code section 168(f)(8), applying to leases

301. See supra notes 152-53 and accompanying text.
302. See supra note 290.
303. See generally Leary, supra note 77, at 1072-75.
304. See supra note 291.
305. See M. & W. Gear Co. v. Commissioner, 446 F.2d 841, 844 (7th Cir. 1971). See also Swift Dodge v. Commissioner, 692 F.2d 651 (9th Cir. 1982) (look to substantive provisions of agreement and to parties' conduct to determine economic realities of transaction).
entered into after December 31, 1983. The Tax Reform Act of 1984 postpones the effective date of the finance lease rules until 1988. Its legislative history offers three policies that support postponement: (1) deficit reduction; (2) that transactions treated as leases should have “meaningful economic substance”; and (3) that the tax system should not be used to freely transfer tax benefits. The Conference Committee believes that current IRS administrative guidelines support Congress’ latter two policies, and strongly urges the IRS not to relax those guidelines.

Section 168(f)(8)(A), the heart of the new rules, introduces substantive changes in the pre-ERTA law. In a “finance lease,” tax analysis of the lease will not consider the presence of either a fixed price purchase option of at least ten percent of the property’s original cost, or limited use property. In addition, the finance lease rules cover only “new section 38 property” and place several restrictions and qualifications on what constitutes finance lease property.

The most severe restrictions are the mandatory ratable spread of the investment credit over five years, and the limitation of finance leases to no more than forty percent of qualified property.

Congress went only half the distance towards returning to the

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308. New § 168(f)(8)(A) (Supp. I 1983) reads as follows:
(8) Special rules for finance leases—
(A) In general.—For purposes of this title, except as provided in subsection (i), in the case of any agreement with respect to any finance lease property, the fact that—
(i) a lessee has the right to purchase the property at a fixed price which is not less than 10 percent of the original cost of the property to the lessor, or
(ii) the property is of a type not readily usable by any person other than the lessee, shall not be taken into account in determining whether such agreement is a lease.


310. See supra note 308.

311. Id.


Another restriction set to expire in 1989 is found in § 168(i)(1) (West Supp. 1985). This subsection prohibits a finance lessor from reducing his tax liability by more than 50%; the restriction expires September 30, 1989. See I.R.C. § 168(i)(4)(A) (West Supp. 1985).
economic substance test as the guiding principle in lease analysis by failing to outline the key elements of "economic substance." This is bound to make judicial application of the finance lease rules haphazard.\footnote{317} Furthermore, the finance lease rules do not apply in many situations,\footnote{318} and there is uncertainty and disagreement as to whether they are elective.\footnote{319} Courts may scrutinize other lease provisions more carefully or may treat section 168(f)(8)(A) as an inviolable safe harbor; nevertheless, courts will be forced to develop more definitive working criteria for economic substance analysis.

B. The Need for Reform

The economic substance test in the tax analysis of leases has two functions: (1) to distinguish leases from sales, which require realization and recognition of gain under section 1001, and from

\footnote{317} The House Conference Report offers this synopsis of the state of the law to guide courts in applying the new finance leasing rules:

Finance leases must meet the requirements for lease treatment under nonsafe harbor rules, disregarding the fact that the lease contains a 10-percent fixed price purchase option or that the property is limited use property. Thus, the transaction must have economic substance independent of tax benefits and not merely be cast in the form of a lease for purposes of utilizing the lessor's tax base. The lessor must reasonably expect to derive a profit from the transaction independent of tax benefits. In addition to a profit, the transaction must not (without regard to the fact the agreement contains a fixed price option or that the property is limited use property) in substance be a financing arrangement or conditional sale in which the lessee has an investment in the property.

\footnote{318} Examples of situations in which the finance lease rules do not apply are: (1) leased property that does not meet the definition of "finance lease property," § 168(f)(8)(B) (West Supp. 1985); (2) leases that do not contain purchase options of at least 10% of the property's original cost and cover property other than limited use property, § 168(f)(8)(A) (Supp. I 1983); and (3) leases between nonqualifying individuals. See §§ 168(f)(8)(B)(iv)(IV), (V); 168(f)(8)(C)(i); 168(f)(8)(D) (West Supp. 1985); H. CON. REP. No. 760, 97th Cong., 2d Sess. 489-92, reprinted in 1982 U.S. CODE CONG. & AD. NEWS 1190, 1268.

The requirement that the lessor should reasonably expect to derive a profit, independent of tax benefits, is a sound proposition, but stricter than the current case law. The Joint Committee report cited Hilton v. Commissioner, 74 T.C. 305 (1980), aff'd per curiam, 671 F.2d 316 (9th Cir.), cert. denied, 459 U.S. 907 (1982), as authority on the question, but in Dunlap v. Commissioner, 74 T.C. 1377 (1980), the Tax Court found that a "realistic hope of material economic (nontax) gain from the investment" was sufficient, id. at 1437, thus retreating from the Hilton position.

\footnote{319} Compare Mount, The Tax Equity and Fiscal Responsibility Act of 1982 — Safe Harbor Lease Provisions Corralled, But Still Alive and Kicking, 60 TAXES 707, 718 (1982) (finance lease provisions are not elective) with Committee on Depreciation & Investment Credit, supra note 208 at 9-11. The Association's report states that although the Treasury is considering instituting a filing requirement to qualify under the finance lease rules, the Treasury is unwilling to state that the finance lease rules are elective. Id. at 10.
loans, where the principal transfers are not taxable events; and (2) to prevent taxpayer election of deductions under either section 162(a)(3) or section 167 by merely switching the label of the transaction. Present tax analysis often fails to accommodate these dual goals. Consistent results, however, may be achieved by application of the economic substance test.

1. Competitive Neutrality. — Safe harbor leasing was originally designed to achieve competitive neutrality. The goal of competitive neutrality — a phrase popularized by Professors Warren and Auerbach — is to spread the tax benefits generated by accelerated depreciation and the investment tax credit to corporations that lack sufficient taxable income to otherwise absorb those benefits. However, Congressional efforts under ERTA, and subsequently, TEFRA, to achieve competitive neutrality, and thus correct the distortive effects of ACRS and the ITC have failed because Congress has not fully articulated ACRS and ITC's underlying policy rationales. Therefore, Congress has been unable to identify the parties adversely affected by ACRS and the ITC. Furthermore, safe harbor leasing has allowed Congress to disguise its intended legislative agenda, whereas other methods of achieving competitive neutrality would force Congress to articulate its perception of the problem.

320. Safe harbor leasing was beset by problems from the outset. One of its chief problems was a funneling of nearly one quarter of the tax benefits made available by safe harbor leasing to the lessor and third parties and a lessening of taxpayer confidence in the tax system. See Staff of the Joint Comm. on Tax'n, supra note 15, at 23-27. At a 12% discount rate, the Committee reports that 76.5% of the tax benefits subject to safe harbor leasing went to the seller-lessee. Id. at 24 (Table 3). See also Lubick & Galper, The Defects of Safe Harbor Leasing and What to Do About Them, 14 Tax Notes 643, 647 (1982) (criticizing the leasing mechanism because it confuses the public about what is transpiring and involves high third-party costs).

321. See Warren & Auerbach, supra note 51, at 1762-74, 1785-86.


323. Professors Warren and Auerbach cite two possible rationales for ACRS and the ITC. One rationale is that Congress sought to exempt income taxation on capital income. Id. at 1756-57. Nevertheless, a corrective mechanism would only be necessary for "start-up" companies, since "loss" companies are already effectively exempt from income tax. Id. at 1759-61. Secondly, it is suggested that ACRS and the ITC are subsidies to encourage investment in capital assets by lowering the after-tax cost of recovery property. Under this rationale, a corrective mechanism is needed to neutralize the competitive advantage that wealthy taxpayers would obtain over loss and start-up companies. Id. at 1758-59.

In addition, Professors Warren and Auerbach cite two reasons for extending these subsidies to loss and start-up companies. First, they argue that economic welfare will suffer if the subsidies do not flow to companies engaged in the most socially desirable investment activity. Id. at 1761. Second, non-neutrality would lead to tax-induced mergers possibly disadvantageous to the economy. Id. at 1761.
Professors Warren and Auerbach describe three ways to achieve "competitive neutrality." Where the goal is to equalize the after-tax cost of capital of all corporate taxpayers investing in similar assets, competitive neutrality would have to be achieved by transferring the benefits of ACRS, the ITC, and related interest expenses so that loss companies could benefit to the same extent as profit companies. Professors Warren and Auerbach demonstrate that the tax benefits transferred under safe harbor leasing are inadequate to accomplish the desired result.

Alternatively, competitive neutrality can be viewed as a means of equalizing access to tax benefits, which are subsidies to investors in capital assets. One way to equalize the subsidy would be to transfer tax reductions from ACRS and the ITC in excess of true economic depreciation. The loss company beneficiary would thereby receive the same government subsidy for capital investment as profitable companies. Another way to equalize the subsidy would be to transfer the excess of ACRS deductions over the pre-1981 depreciation system known as Asset Depreciation Range (ADR). Some commentators who have adopted this position would also include the ITC as part of the subsidy element even though the ITC predates the 1981 legislation.

The timing of the introduction of safe harbor leasing implies that Congress adopted the latter approach. The absence of a designated mechanism to transfer the excess tax benefits created by ADR and the ITC over economic depreciation, offers some evidence, if only by negative implication, that Congress was concerned with the fair allocation of the additional benefits created by ACRS. If this is accurate, the subsequent enactment of I.R.C. § 48(q) has decreased the need for a tax benefit transfer mechanism by reducing the combined tax benefits of ACRS and the ITC.

If capital cost equalization is the congressional goal, Congress

324. Id. at 1768-72.
325. Id. at 1768-69.
326. Id. at 1768.
327. Id. at 1769.
328. Id. at 1769-71.
329. Id.
330. Id. at 1771. ADR was the primary method of asset depreciation before ACRS. See Treas. Reg. § 1.167(a)-11 (1977); Rev. Proc. 77-10, 1977-1 C.B. 548.
331. See Lubick & Galper, supra note 320, at 645-46.
332. Warren & Auerbach, supra note 52, at 1585. I.R.C. § 48(q) (West 1984 & Supp. 1985) usually lowers the ACRS asset basis by one-half of the ITC.
might be more effective by focusing on the net operating loss carryover rules.333 Under current law, a company with a net operating loss can carry excess deductions backward or forward to years of profitable operation.334 Tax law, however, fails to account for the loss due to the time value of money that occurs when a taxpayer must postpone a deduction several years into the future.335 Instead of cumbersome, inefficient leasing mechanisms, I.R.C. sections 46(b) and 172336 could be amended to provide that unused ITC, depreciation and interest deductions will grow at a compounded rate of interest until absorption.337 Companies incapable of utilizing the carryover before expiration due to perpetual unprofitability would not be entitled to capital cost equalization.

Either capital cost or subsidy equilization can also be achieved through refundability or transferability of tax benefits. Under a system of refundability, the government would issue a check in the amount of the subsidy directly to the qualifying corporation.338 An explicit transferability system would allow the corporation to sell the tax benefits to a buyer without transferring ownership in the underlying asset.339 In safe harbor leasing, by contrast, the parties enter into a fictitious sale and leaseback to transfer tax ownership to the tax benefit purchaser. The buyer-lessee's downpayment on the purchase price is usually the only cash to change hands, and constitutes the actual transfer of tax benefits.340 The lease and loan terms coincide and usually extend well beyond the recovery period of the asset. Rent and loan payments are set at the same amount, and the lessor ends up with a tax loss on the transaction equal to his downpayment.341

334. Under § 172(b) (West 1978 & Supp. 1985), the maximum carryback period is three years, and the maximum carryforward is 15 years. I.R.C. § 172(b)(1)(A), (B) (West Supp. 1985).
337. Deductions in a net operating loss year could be prorated between current absorption and the net operating loss amount. The identity of the depreciation and interest components of the net operating loss could be traced until absorbed in a future year's income.
338. See Lubick & Galper, supra note 320, at 645.
339. Id.
2. The Failure of the Finance Lease Rules. — The finance lease rules are a compromise between the goals of competitive neutrality and restoring economic substance as the guidepost for lease analysis; however, the compromise appears likely to fail on both fronts.

The goal of restoring economic substance as the standard governing leasing transactions will probably not be achieved by enactment of the finance lease rules. First, the new law affords lease status to a lease that contains a fixed price purchase option or involves limited use property, even though the lease more closely resembles a sale.\textsuperscript{342} Secondly, Congress was too vague in defining economic substance other than by general references to Service guidelines under Revenue Procedure 75-21.\textsuperscript{343} The guidelines, however, do not represent current law; technically, they are safe harbors for parties seeking the Service's acquiescence to their lease characterization. Moreover, strict adherence to the Service guidelines on aspects of the economic substance test not addressed by Congress will be impossible due to the Service's inconsistent criteria.\textsuperscript{344} The content and application of the economic substance test will be left to judicial imagination.

The value of finance leasing to the goal of competitive neutrality will depend upon which conception of competitive neutrality Congress desires to adopt, and upon the Service's willingness to revise its guidelines to incorporate the finance lease rules.\textsuperscript{345} The guidelines currently require the lessor to show a pretax profit on the lease transaction, by calculating the lessee's aggregate rental payments and the lessor's residual interest in the property, and subtracting the

\textsuperscript{342} See supra notes 308 & 312 and accompanying text. Curiously, the legislative history of TEFRA offers no explanation for the departure from the Service guidelines on fixed price purchase options and limited use property. See H. REP. No. 760, 97th Cong., 2d Sess. 489-92, reprinted in 1982 U.S. CODE CONG. & AD. NEWS 1190, 1268-70. Professors Warren and Auerbach note that finance leases were a creation of the Conference Committee, which explains the lack of a statement in the Senate Finance Committee report. See Warren & Auerbach, supra note 52, at 1583 & nn.31 & 32.


\textsuperscript{344} For example, the rule that the lessor must maintain at least a 20% at risk investment in the property, see Rev. Proc. 75-21, supra note 67, § 4(1)(A), at 715, is incompatible with a 10% purchase option. See Warren & Auerbach, supra note 52, at 1587.

\textsuperscript{345} See Warren & Auerbach, supra note 52, at 1587. They estimate that the tax benefit transfer potential of finance leases will be nearly equal to the original safe harbor leases; their conclusions, however, are optimistic and admittedly speculative. Id. at 1587-88. Further, the finance lease rules do not "effectively implement a coherent concept of competitive neutrality." Id. at 1589.
The lessee’s minimum rental payments will be smaller and the lessee’s benefit transfer larger if the Service looks to the residual interest when calculating the lessor’s profit, and ignores the option price. Conversely, if the Service only considers the option price when calculating the lessor’s profit, the lessee’s tax benefit transfer will decrease. The latter method is more accurate since the lessor has parted with his economic interest in the residual value in excess of the option price.

Congress can more effectively achieve the goals of competitive neutrality and restoration of the economic substance test. The finance lease rules should be repealed and replaced with either a direct tax benefit transfer system that does not intrude on the leasing rules, or a refundability system. Furthermore, Congress or the Treasury should define the criteria for lease status according to the transaction’s economic substance. The economic substance test, properly defined, will provide the most effective means for distinguishing a lease from a sale.

347. See Warren & Auerbach, supra note 51, at 1772-79.