Leasing—A Financial Option for States and Localities?

The Economic Recovery Tax Act of 1981 (ERTA) opens up some new and expanded opportunities to state and local governments for innovative financing of public projects. The possibilities include leasing under the new liberalized rules, leasing under the "old" rules but with the improved investment incentives, and contracting with private businesses to provide public services. While none of these options have been much used to date, fiscal pressures on states and localities due to cutbacks in Federal aid, lower tax revenues, and higher borrowing costs will spur more experimentation.

Leasing under the special new "safe harbor" rules[1]

The tax provisions governing leasing have been relaxed considerably under ERTA (Table 1) The special new leasing rules were designed primarily to help private companies which, because of insufficient taxable income, were unable to make full use of their investment tax credits and depreciation allowances Public institutions are also covered under these rules when investing in buses, subway cars, and other mass commuting vehicles, though investment tax credits are still not available for equipment leased to governmental units.

Even without the investment tax credit, the tax savings from the depreciation deductions alone can warrant leasing by the public sector One deal recently completed enabled the Metropolitan Transportation Authority (MTA) of New York to gain $15 million through the sale and leaseback of $102 million in equipment. Not all transit authorities, however, may be able to take full advantage of the new leasing laws, the United States Treasury Department has issued temporary regulations which preclude the use of the new rules for the portion of mass commuting vehicles bought with Federal money. Most transit authorities heretofore have received matching Federal grants for 80 percent of the cost of their rolling stock, so that the new leasing laws would apply only to the 20 percent of locally raised funds. Under these circumstances, probably only those transit systems in the larger cities would be able to put together leasing deals that were big enough to cover the legal and financial fees. Nonetheless, these circumstances could change. The Treasury's temporary regulations are still under review and subject to revision. Moreover, there could be cutbacks in the Federal capital grant program in coming years, necessitating larger contributions from localities—the larger these contributions, the greater the scope for leasing

The basic principles for transactions between private and public enterprises under the special new rules are relatively straightforward. Consider, for example, a transit authority which buys $100 million worth of equipment and enters a sale/leaseback arrangement with a private firm P. Under the typical arrangement,

[1] A lease complying with the new rules is called a "safe harbor" lease because special provisions preclude the Internal Revenue Service (IRS) from applying its preexisting regulations in determining what constitutes a bona fide lease These tests comprise the "old" rules referred to in the text

Table 1

Comparison of Main Features of "Old" and Special New Leasing Rules

"Old"	New
The lessor must have a positive cash flow and a profit from the lease independent of tax benefits	No such requirement
The lessee must not have an investment in the lease and must not lend any of the purchase cost to the owner	No such restriction
The lessee must not have a right to purchase the property at less than fair market value	No such restriction
The use of the property at the end of the term of the lease by a person other than the lessee must be commercially feasible	No such requirement
The lessor must have a minimum at-risk investment of 20 percent of the cost of the property throughout the lease term	The lessor must have a minimum at-risk investment of 10 percent of the adjusted basis of the property throughout the lease term

Table 2

Sale/Leaseback Example*

In millions of dollars

Year	Depreciation deductions		Total debt service	Debt service		Rental payments	Rent minus interest costs (taxable income)	
	Actual	Discounted		Interest	Principal		Actual	Discounted
0	15 0	15 0	—	—	—	—	—	—
1	22 0	19 1	15 4	13 5	1 9	15 4	1 9	1 6
2	21 0	15 9	15 4	13 2	2 2	15 4	2 2	1 6
3	21 0	13 8	15 4	12 9	2 5	15 4	2 5	1 6
4	21 0	12 0	15 4	12 5	2 9	15 4	2 9	1.6
5	—	—	15 4	12 1	3 3	15 4	3 3	1 6
6	—	—	15 4	11 6	3 8	15 4	3 8	1 6
7	—	—	15 4	11 0	4 4	15 4	4 4	1 6
8	—	—	15 4	10 4	5 0	15 4	5 0	1 6
9	—	—	15 4	9 6	5 8	15 4	5 8	1 6
10	—	—	15 4	8 7	6 7	15 4	6 7	1.6
11	—	—	15 4	7 7	7 7	15 4	7 7	1 6
12	—	—	15 4	6 6	8 8	15 4	8 8	1 6
13	—	—	15 4	5 3	10 1	15 4	10 1	1.6
14	—	—	15 4	3 8	11 6	15 4	11 6	1 6
15	—	—	15 4	2 0	13 4	15 4	13 4	1 6
Total†	100 0	75 8	230 9	140 9	90 0	230 9	90 0	24 7

* Assumptions Property worth $100 million and eligible for five-year ACRS treatment is sold by the lessee The buyer/lessor puts $10 million down and pays the remaining $90 million, plus interest at 15 percent, in fifteen equal annual instalments (The lease also runs for fifteen years) Future amounts are discounted at a 15 percent annual rate to yield present values as of year zero

† Columns may not add up to totals due to rounding

The Importance of the Terms Governing the Debt Service

The net tax savings possible with a sale/leaseback transaction involving a nontaxpaying lessee depends on the ability to delay paying taxes on the rental income. With rental payments set equal to the debt service and interest costs deductible, the additions to the lessor's taxable income equal the portion of the debt service which goes toward repayment of the principal (see example in the main text). The more this repayment is deferred, the less the present value of these additions to taxable income. Thus, with rental payments always set equal to debt service, the parties have no incentive to specify repayment of principal in any year of the lease but the last one. (Of course, if there were a possibility of future increases in the tax rate, the lessor might prefer to receive its taxable income at an earlier date.)

The Internal Revenue Service (IRS) is obviously not indifferent to the scheduling of the debt service and has issued regulations which limit the flexibility of the parties The net result of the restrictions is to favor a debt service that consists of equal payments over the course of the lease. The allocation of these payments between interest and repayment of principal is the same as that for a level payment mortgage. Thus, in the early years interest costs dominate, while repayment of principal becomes significant only in later years. The actual proportions depend on the interest rate and the number of years over which the loan is being paid off.

The sensitivity of the present value of the principal repayments to the interest rate and the length of the debt service can be seen by looking at the composition of the debt service for repaying a loan over five, fifteen, and thirty years at interest rates of 10, 15, and 20 percent. The higher the interest rate, the higher are the instalments and the larger the proportion in the early years going to cover interest costs. Thus, for example, the present value of a fifteen-year repayment schedule for a $90 million loan falls from $38.6 million for a debt service based on a 10 percent interest and discount rate to $15.6 million for the 20 percent case (Table 3).

Similarly, the longer the term of the loan, the lower the present value. As the repayment of principal is spread over more years, the size of each instalment becomes smaller. Thus, the present value of the repayment of principal falls from $58.0 million to $5.4 million as the debt service is stretched from five to thirty years (using a 15 percent discount rate in both cases). Therefore, the higher the interest rate and the longer the debt service, the smaller is the amount of principal repayment in the early years.

The IRS, however, regulates the amount of interest that can be charged and the maturity of the loan. The interest rate charged by the lessee cannot exceed that which is reasonable or determined at arm's length between the parties. The length of the period of debt service cannot exceed the term of the lease. The maximum possible term is thus limited to the greater of 90 percent of the useful life of the property or 150 percent of the midpoint of the applicable asset depreciation range as set by the IRS.

Table 3

Present Values of Rental Income Net of Interest Costs on $90 Million Debt

Pretax, in millions of dollars

Length of debt service	Alternative interest rates* 10 percent	15 percent	20 percent
Five years	67 0	58 0	50 4
Fifteen years	38 6	24 7	15 6
Thirty years	14 9	5 4	1 9

* The same percentage was used both for the interest rate on the loan and for discounting the taxable income stream back to year zero.

the transit authority keeps possession of the equipment and has an option to buy it back at the end of the lease for one dollar. Firm P makes a downpayment to the transit authority and agrees to pay the rest of the $100 million purchase price plus interest in equal-sized instalments over fifteen years—the life of the lease (See the discussion in the box for the restrictions governing the structuring of the debt service.) In return, firm P is allowed to apply the depreciation deductions for the equipment against its own taxable income. Although firm P charges the transit authority a rental fee, the amount is set equal to its debt service obligations.[2] Thus the rental fee and the debt-servicing payments exactly offset each other. No money actually changes hands after the initial downpayment—which, of course, the transit authority keeps.

For illustrative purposes, suppose the downpayment made by firm P is $10 million, the minimum nec-

[2] Although not a legal requirement, the matching of the rental payments to the debt service eliminates any risk of default between the lessor and the lessee The whole transaction can thereby be reduced to just one payment—the downpayment

essary to meet the at-risk requirement under the special rules The rest of the purchase price, $90 million, is then repaid by firm P, along with interest at 15 percent, in fifteen equal instalments of $15 4 million per year (Table 2) With these payments, firm P has "tax title" to the assets and can claim depreciation deductions equal to the full $100 million purchase price. Assuming that the equipment qualifies for the five-year write-off under the new accelerated cost recovery system (ACRS) of ERTA, firm P will be able to lower its taxable income by $15 million the first year, $22 million the second, and $21 million in each of the three following years. The total amount of tax savings, therefore, is $46 million, given a Federal tax rate of 46 percent.

The transaction, however, has other tax implications which offset part of the tax savings from the depreciation deductions. Although no cash changes hands, the IRS recognizes the rental payments as being received by firm P and the debt service payments as being made by firm P. The transit authority is unaffected since, being a public body, it pays no taxes But firm P must pay taxes on its rental receipts of $15.4 million per year less the tax-deductible interest charges on the debt to the transit authority. Thus, firm P's taxable income amounts to $1.9 million in the first year and then rises as interest costs fall with the repayments of principal. In effect, with the rental payments set equal to the debt service, firm P pays taxes on an amount equal to the portion of the debt service that goes toward the repayment of principal. Eventually, therefore, firm P will pay taxes on income equal to the $90 million that it borrowed. Thus, firm P gets to keep outright $4.6 million in Federal taxes saved on the $10 million excess of depreciation deductions over net taxable income Moreover, firm P has the use of the tax savings on the other $90 million in depreciation deductions for up to fifteen years. While all the depreciation deductions come in the first five years, less than 50 percent of the taxable rental payments are generated before the eleventh year.

A simple way to calculate the net value of these tax effects is to translate all the deductions and additions to taxable income into present-value terms as of the beginning of the lease The more delayed the receipt or loss of tax savings, the less is their present value. At an annual discount rate of 15 percent, the present value of the $100 million in depreciation deductions is equal to $75.8 million (Table 2). Discounting the net increases in taxable income yields a present value of $24 7 million. This present value calculation, therefore, shows a net, pretax gain from the transaction of $51.1 million; the aftertax benefit is about $23.5 million. Both parties have benefited: the transit authority has $10 million and firm P is left with a profit of $13.5 million. Under these assumptions of lease length and discount rate, the transit authority could negotiate for a higher downpayment In fact, firm P could pay as much as $25 5 million and still achieve a rate of return of 15 percent.[3]

Leasing under the "old" rules

Another option available to states and localities for structures and equipment other than mass commuting vehicles is to arrange a lease under the "old" rules.[4] The restrictiveness of these rules has tended in the past to impede public-sector leasing. But the new and much more liberal depreciation provisions of ERTA may help to make such leases more profitable. Moreover, in the case of dilapidated public buildings, the new tax laws include an additional incentive that may facilitate leasing: investment tax credits are now available for rehabilitation expenses even when the refurbished building is to be leased to a public entity [5] Accordingly, states and localities may now find it attractive to upgrade public structures by selling them to private companies which will renovate them and then lease them back to the government. In fact, Oakland, California, is exploring this alternative for one of the two buildings involved in recently announced sale/leaseback transactions

The restrictions imposed by the "old" rules are not inconsiderable. For example, the lessor must have a positive cash flow and a profit from the lease independent of tax benefits The net result of this rule is to lower the benefits to the lessee from leasing, as the rental charges must be set higher than they otherwise would have to be.

The lessee is also prohibited from lending money to the lessor. This rule creates two problems not existing with leases under the special new rules. First, it can raise the costs of financing the purchase of the asset. The lessee, because it is a public entity, has

[3] The $25 5 million exceeds the sum of the $10 million plus $13 5 million because the higher downpayment lowers the amount that must be borrowed from the transit authority and therefore the amount of rental income that is taxed

[4] Not all assets, however, can be leased under the "old" rules The IRS requires that the use of the asset by persons other than the lessee must be commercially feasible This regulation may make it difficult to lease special purpose buildings such as fire stations and custom designed equipment such as subway cars The effect of this restriction, however, need not be as limiting as it first appears Minor redesigns may suffice to accommodate this stricture Thus, for example, it may not be difficult to rebuild a school in such a way that it is easily convertible into commercial office space

[5] The investment tax credits are equal to 15 and 20 percent of the rehabilitation cost for nonresidential buildings more than thirty or forty years old, respectively By claiming the credits, however, the taxpayer must use depreciation rules less favorable than would otherwise be the case

direct access to tax-exempt funding; the lessor does not.[6] Second, the lessor as well as the third-party creditor must now be concerned about the financial condition of the lessee. With the addition of an outside lender to the leasing agreement, cash must actually change hands; the rental payments can no longer be used as a wash against debt service payments. Without the rental payments, the debt would not be retired nor would the lessor earn its full return on its equity investment which must equal at least 20 percent of the purchase price throughout the lease term.

The lessee must also accept additional risk if it plans to continue using the asset beyond the lease term. Under the "old" rules, the lessor cannot sell the asset to the lessee for less than its fair market value, an amount which cannot be known in advance. The lessor, therefore, will rely on a conservative—*i.e.*, low—estimate of the resale value when calculating the rental payments needed to earn an acceptable rate of return. The lower the estimated resale value, the higher the rental charges that the lessee must pay. If the asset turns out to be more valuable, as is likely in inflationary times, the lessor receives a windfall. The lessee, however, then has to re-lease or purchase the asset at a cost that offsets part or all of the savings realized on the lease itself.

Service contracts

An alternative to leasing that offers full use of ERTA's strengthened investment incentives is the service contract. Instead of leasing equipment (*e.g.*, garbage trucks), a public entity may contract with private-sector firms to provide a service (*e.g.*, garbage collection) with their own equipment. As long as equipment is not directly involved in a lease to a governmental unit, the firm can claim the regular depreciation allowances and investment tax credits or sell them under the special new leasing rules.

The problem with service contracts, however, lies in their definition. Simply designating an agreement as a service contract does not insure that the IRS will treat it as such. The distinction between service contracts and equipment leases is, indeed, problematic. For example, how does one measure the amount of "service" that must be provided in addition to the garbage trucks to transform an equipment lease into a contract for garbage service?

The courts have not developed a single test but rather a number of different ones to help determine a threshold[7] The distinction appears to hinge on the retention of control over the equipment as evidenced by such factors as who operates and maintains it. Thus, the substitution of a service contract for a current government activity requires more than a shift of ownership of assets to the private sector; it also means shifting employment. For instance, a firm supplying garbage collection services would presumably have its own work force to operate and maintain its trucks. Thus, a city switching from providing this service itself to contracting with an outside vendor would no longer need employees to do those jobs. To realize the full savings, therefore, total employment in the public sector would have to be reduced.

Conclusion

The ultimate usefulness of leasing for states and localities remains a matter of conjecture. Few transactions have been completed since the passage of ERTA. There are many technical details that need to be worked out for each of the alternatives—leasing under the special new rules, leasing under the "old" rules, and contracting for public services.

[6] Some lessors, however, may be able to use industrial development bond financing which offers tax-exempt financing to private-sector firms for certain types of investments

[7] See Xerox v United States, 1980-2 U S T C , ¶9530 (Ct Cl Trial Div) which allowed investment tax credits for copying machines placed on government premises under service contracts

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