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The Impact of Tax Reform: What Equipment Leasing Companies Need to Know

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January 19, 2018 - The equipment leasing and finance industry faces a new tax landscape following the enactment of H.R. 1 (known as the Tax Cuts and Jobs Act) at the end of 2017 ("Tax Reform"). The headline accomplishment of Tax Reform is decreasing the federal corporate tax rate from 35 percent to 21 percent; however, that is a mixed blessing for the leasing industry depending on the term and tax intensity of particular leases.

Tax Reform added limitations on interest deductions, which could affect the industry's ability to rely on existing securitization structures for economical capital funding. In addition, tax deferral using like-kind exchanges is no longer available for equipment. But, the news is not all bad. The ability to expense 100 percent of the cost of equipment purchases presents other opportunities and Tax Reform has introduced new motivations for equipment users to lease.

I. 100 PERCENT EXPENSING

For the first time, Tax Reform enacted broad 100 percent expensing (also known as 100 percent bonus depreciation) for equipment. The new provision is particularly groundbreaking in that it applies to "used" equipment.[1]

The expensing rules have many technical nuances. Here are some of the key ones for equipment leasing:

1. **Temporary Provision: "**Expensing" is not a *permanent* provision of the Code.[2] For property placed in service on or after January 1, 2023,[3] the deduction declines by 20 percent each year (i.e., 80 percent in 2023, 60 percent in 2024, etc.) until reaching zero.[4]

2. **"New to You":** The property either must (i) never have been placed in service by any party, or (ii) it must not have been used previously by the taxpayer or acquired by the taxpayer from a related party that previously used the property.[5] For example, if a manufacturer sells new automobiles to its corporate subsidiary for lease by the corporate subsidiary to customers, the corporate financing subsidiary could claim expensing because the automobiles were not placed in service prior to their acquisition by the subsidiary.

   In contrast, if the manufacturer used the automobiles as company cars and then sold them to the finance subsidiary, the finance subsidiary could not claim expensing because the automobiles were previously used and were acquired from a related party.[6] In this instance, the finance subsidiary would step into the remaining basis, if any, in the hands of the manufacturer.[7] That basis would be zero if the manufacturer had claimed the expensing benefit.

3. **No Expensing for Certain Lessees:** As was previously the case with respect to accelerated depreciation and bonus depreciation, expensing is not available for property leased to governmental entities, non-profit entities or foreign individual or entities. It is also not available for property located outside of the United States.

4. **Regulated Utilities Should Lease:** There is a new rule that denies expensing to property owned by regulated utilities.[8] Because the rule only applies to property "owned" by regulated utilities (as opposed to property "used" by them), a lessor that leases property to a regulated utility could claim expensing (even though the regulated utility itself could not).[9] This is different than the rules that apply to tax-exempt use property, which would preclude a lessor from claiming expensing on property leased to a tax-exempt entity.[10] This rule may make leasing the preferable equipment financing option for regulated utilities.

5. **Sale-Leasebacks:** There is no prohibition on a lessor in a sale-leaseback claiming expensing of used equipment where the lessee/user of the equipment remains the same. For example, an airline could have purchased ten aircraft in 2015 for its own use. After depreciating and using the aircraft, the airline would still be able to enter into a sale-leaseback with a third party and continue to use the aircraft. The purchaser/lessor could claim expensing on the purchase price it pays for the aircraft (assuming the aircraft are used in U.S. routes), even though there was no change in the "user" of the aircraft. This could be a particularly attractive option to the airline if it uses the sale proceeds to retire debt that was creating interest limitation issues under Section 163(j), which are discussed below.

6. **Binding Contract:** Expensing is not available if the lessor had a binding contract to acquire the property before September 28, 2017.[11] Therefore, lessors will need to carefully review their acquisition agreements.

   It appears that a lessee's binding contract to acquire equipment before September 28, 2017 would not preclude a lessor from claiming 100 percent expensing on such equipment. Thus, a lessee could purchase the equipment, then execute a sale-leaseback with a lessor, and the lessor could claim 100 percent expensing.

7. **Confusing Lease Syndication Provision:** There is a taxpayer-friendly leasing exception to the previous bonus rules that appears to have inadvertently been carried over into Tax Reform.[12] This apparent drafting mistake at best causes confusion and at worst could potentially be interpreted in an inappropriately harsh manner.

   Under prior law, "used" property was not eligible for bonus depreciation. However, there was a limited exception for sales of recently leased property from one lessor to another (i.e., lease syndications) that permitted bonus depreciation if the lease syndication occurred within three months of the original lessor's acquisition of the leased property. Following Tax Reform, this exception is not needed, as all "used" property is eligible for expensing. Moreover, the previous limited exception to allow lease syndications was only for a very short period of time – three months; whereas the expensing rules have no time limit.

Therein lies the problem. The exception is no longer needed. But, by carrying it over into a regime with no time limit on syndications, the taxpayer-friendly three-month exception could possibly be viewed to translate into an "unfriendly" three-month *limitation* on the availability of expensing for used property that *only* applies to lease syndications because each word in a statute (much less a whole clause) is presumed to have been included for a reason. [13]

The following examples demonstrate the inequitable result if the three-month leasing exception rule were to continue to apply to sales of leased equipment:

Example 1: Lessor A acquires equipment on February 1, 2018 and leases it to user X. On June 1, 2018 (i.e., more than three months after it was acquired by lessor A), lessor A sells the equipment subject to the lease to lessor B. Lessor B is not entitled to expense that equipment if the lease syndication rule in fact operates as described above.

Example 2: In contrast, user X acquires equipment on February 1, 2018 and directly uses it in its operating business. Then on June 1, 2018, user X sells the equipment to lessor B and leases it back. Lessor B is entitled to expense that equipment.

It is difficult to imagine that the Tax Reform retained the three-month lease syndication provision in order to affirmatively impose a restriction on lease syndications. There is no indication that Congress did not intend for the "used" property expansion of the bonus depreciation rules to apply across the board. Moreover, it is difficult to fathom that Congress would target lease syndications for harsher treatment given that the provision was first enacted by Congress in 2004 to facilitate lease syndications by creating a three-month exception that was not available for other *used* equipment. We hope that Treasury confirms that the lease syndication rule was not retained to impose a more stringent standard for expensing eligibility in the case of a purchase of leased equipment than is imposed in the case of purchases of other types of "used" equipment.

II. REPEAL OF LIKE KIND EXCHANGE FOR EQUIPMENT

The quid pro quo for expensing is that Congress repealed like kind exchanges for equipment. (Real estate like kind exchanges are still available.) There is still a small window for equipment like kind exchanges if the acquired "equipment" is replacing equipment that was "disposed of" on or before December 31, 2017.[14] So if, for instance, a lessor sold vehicles on Friday, December 29, 2017, it would be able to acquire "replacement" vehicles through its qualified intermediary until the earlier of (a) six months from the sale date and (b) the date for filing its 2017 tax return. Few states are likely to adopt expensing, so companies would be well served to continue their like kind exchange programs during this limited window in order to capture the benefit of deferred state tax.

As discussed above, the expensing percentage will start to ratchet down in 2023; while like kind exchanges for equipment are gone forever (unless, Congress enacts it again). Therefore, in the long run, the equipment leasing industry may have preferred to have retained like kind exchanges than been provided with an expensing benefit that will lapse.

III. NET OPERATING LOSS - 80 PERCENT ANNUAL LIMITATION

When planning for expensing, companies must be cognizant of the new limitation Tax Reform placed on the use of net operating losses (NOLs). Under Tax Reform, only 80 percent (as opposed to 100 percent under prior law) of NOLs can be used in any particular year they are carried forward to, with the balance carried forward as long as necessary until there is sufficient taxable income to use them (taking into account the annual 80 percent limitation).[15] Here is an example: in 2018, the lessor has $200 of deductions and only $100 of gross income, which results in a $100 NOL. Then in 2019, the lessor has $200 of gross income and only $100 of current deductions. Even though in 2019 the lessor has sufficient gross income to use the full $100 NOL, the lessor can only use $80 of it in that year. The remaining $20 is carried forward. Then in 2020, the lessor again has $200 of gross income and only $100 of current deductions. Therefore, the lessor can use 80 percent of the $20 remaining NOL (with $4 of NOL carried forward).

A. Using Depreciation Elections to Avoid NOLs

The foregoing NOL problem could have been avoided if in 2018 the lessor had managed its depreciation elections to avoid the NOL (i.e., electing less accelerated depreciation). Then assuming it had sufficient gross income, it could claim the depreciation deferred to subsequent years under a less accelerated method of depreciation without triggering the 80 percent NOL limitation.

Each partnership or corporation (including members of consolidated groups) can make its own depreciation election for property it places in service in each year by each asset class.[16] However, disregarded entities and grantor trusts are not able to make separate elections. The elections for assets owned by these entities are made by the parent entity that is recognized for tax purposes.

Depreciation elections apply to all assets in a depreciation class. Thus, if a corporation makes an election for rolling stock, that election would also apply to commercial aircraft, as both are in the same depreciation class. This rule applies separately by corporation even if they are members of the same consolidated group. Thus, if corporation A and corporation B are members of the same consolidated group, and the rolling stock is acquired by corporation A and the aircraft are acquired by corporation B, then corporations A and B can make different elections. Similarly, if corporation A acquires rolling stock and automobiles, then corporation A can make one election for all of the rolling stock and a different election for all of the automobiles because rolling stock and automobiles are in different depreciation classes.

IV. TAX REFORM AND FUNDING STRUCTURES

Tax Reform has changed the economics of securitization – a leading source of funding for equipment leasing companies. The securitization structure where leasing companies fund themselves by issuing notes backed by the payment streams from their leases is a tried and true capital funding model, and is especially prevalent in the auto leasing industry. In the most common structure, the leasing business's operating entity (the "Leasing Company") owns a special purpose entity that is disregarded for tax purposes (a "DRE"), and the DRE owns the leased assets (the "Assets") and issues the securitization notes.[17]

A. Section 163(j) Interest Limitation Planning

Tax Reform changed lease securitization economics by amending Section 163(j) to include a potential limit on the current deductibility of interest expense on debt incurred by the Leasing Company. Section 163(j) applies when a taxpayer's interest deductions exceed its interest income in a given tax year ("Net Interest Expense"). Section 163(j) limits the deduction for Net Interest Expense to 30 percent (the "30 percent limitation") of the taxpayer's tax "EBIT" (starting in 2018)[18] or tax "EBITDA" starting in 2022.[19] The disallowed amount can be carried forward indefinitely.

The enactment of Section 163(j) is an aspect of Tax Reform that the equipment leasing industry should be aware of and understand, as the possibility that it could apply and thus preclude a current deduction 100 percent of interest costs translates into higher costs in the capital funding model. Section 163(j) affects equipment leasing companies using securitization funding more than equipment lenders because in a lending business the securitized payment stream is "interest" (as opposed to "rent"), which offsets the interest expense in the funding (i.e., the interest income eliminates the potential for there to be Net Interest Expense related to the securitized assets).

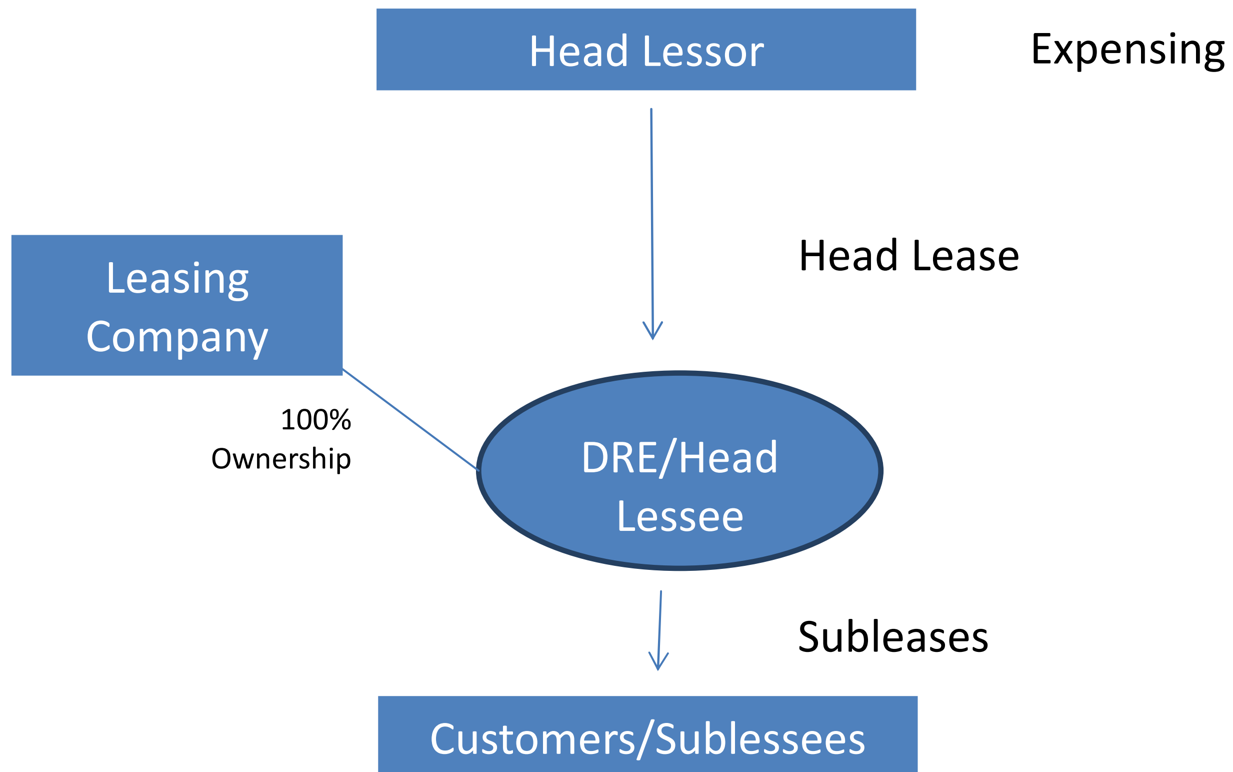
To give a simple example, let's assume in 2018 a Leasing Company has $100 of rental income from leases of the Assets and $100 of interest expense on its notes. Section 163(j) would limit the interest deduction in 2018 to $30; the remaining $70 of interest expense would be treated as an interest carry forward. In contrast, if the securitized payment stream were $100 from a portfolio of equipment loans, there would have been no Net Interest Expense; all $100 of interest would be deductible in 2018. It is important to note that these rules are applied based on the federal income tax characterization of the income. Thus, the fact that GAAP deems lease payments to have an interest element does not change this result.

The good news is that there two planning opportunities available to a Leasing Company that originates leases to mitigate the impact of Section 163(j) on its capital funding. First, rather than issuing debt, the Leasing Company could enter into a sale-leaseback or a leveraged lease using a securitization structure for the leverage. Second, the Leasing Company could employ rent structuring techniques using Section 467 to create deemed interest income for tax purposes and thereby avoid the potential hit of the 30 percent limitation for an equal amount of interest expense.

B. Sale-Leasebacks in Lieu of Debt Financing

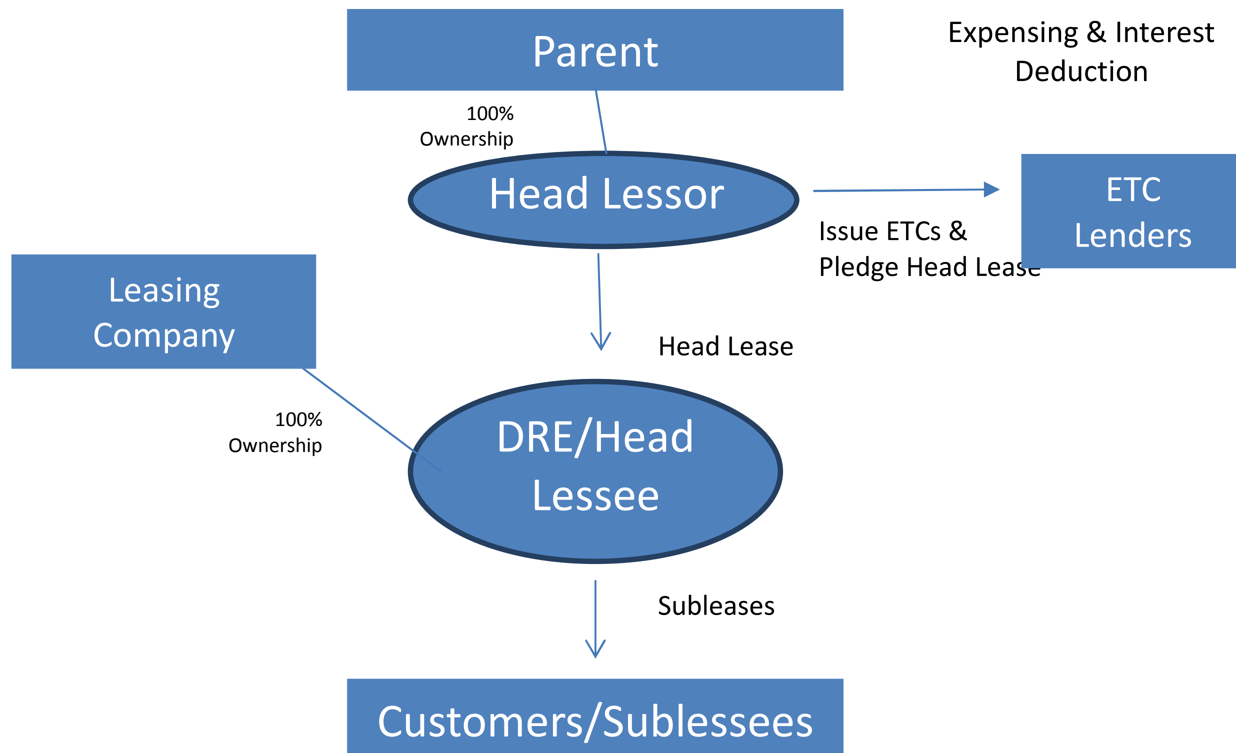
In a sale-leaseback, the Leasing Company obtains the financing for the Assets by selling the portfolio to a third-party financier (the "Head Lessor") and forming a DRE (the "Head Lessee") to lease the Assets back (the "Head Lease"). The Head Lessee subleases the Assets to its various customers. Assuming the leases at the head lease and sublease levels are true leases for income tax purposes, the Leasing Company is, for income tax purposes, paying rent (not interest) to the Head Lessor. The benefit of the sale-leaseback structure for financing the Leasing Company's portfolio is that it avoids the 163(j) problem that arises when securitization is the funding source. In addition, the Head Lessor would get the benefit of 100 percent expensing or accelerated depreciation, and this benefit should translate into lower rental payments due from the DRE under

the Head Lease, leaving the DRE with more cash to distribute to its owner (the Leasing Company). Here is a diagram of the sale-leaseback structure:



C. Leveraged Lease with Securitization Debt

The sale-leaseback structure can be further adapted to include leverage, and securitization technology can be utilized to provide that leverage. Commercially, this transaction would be a "leveraged lease"; albeit a structure that is no longer afforded favorable treatment under GAAP. For the leverage component, the Head Lessor could be a trust that issues equipment trust certificates ("ETCs") in a securitization. It need not, however, be a trust for tax reasons. The Head Lessor would use the proceeds of the ETCs, along with equity from its parent, to acquire the Assets from the Leasing Company. As in the simple sale-leaseback, the Head Lessee would be leasing the Assets from the Head Lessor and subleasing the Assets to customers. The cash rent due under the subleases would generally exceed the cash rent due to the Head Lessor, and excess cash would be distributed to the Leasing Company as the owner of the DRE. The Head Lessor, in turn, would use the rent received from the Head Lessee to service the ETCs, with the payments received by the Head Lessor generally exceeding the debt service on the ETCs, and this excess cash would be distributed to the Head Lessor's parent. Here's a leveraged lease diagram:



The likely candidate to be the Head Lessor's parent would be a bank. For income tax purposes, the bank would be considered the borrower under the ETCs. Therefore, the bank would need to be comfortable that its overall operations would generate sufficient interest income such that its interest expense on its customer deposits (i.e., its normal source of funding), plus the interest expense for the ETCs, would not be more in any year than its interest income from its lending operations (i.e., no Net Interest Expense), or at least not enough more so as to trigger the 30 percent limitation.

Banks will likely find themselves with few competitors to be the Head Lessor's parent in a leveraged sale-leaseback using this ETC financing structure. This is due to the low cost of financing to banks and the potential application of the 30 percent limitation under Section 163(j). There are not many financiers that pay as little for their funding as banks do and have as large a book of loans generating interest income (i.e., banks would generally be able to avoid having Net Interest Expense).

D. Using Section 467 to Create Interest Income

If Section 163(j) is causing the Leasing Company's interest deductions to be deferred, the Leasing Company could use Section 467 to (a) create interest income to absorb interest deductions that would otherwise be deferred by Section 163(j) and (b) provide the counterparty to the lease with a tax benefit in the form of an interest deduction, thereby improving the lease economics of the counterparty. This planning technique is available regardless of whether the Leasing Company is the lessor or the lessee.

Section 467 enables parties to leases to divorce the payment of rent from accrual of rent by permitting the lease to include two different rent schedules: one schedule for rent payments and one schedule for rental accrual. To the extent the difference between the "rent" under the two schedules exceeds certain limits, Section 467 deems there to be a loan that accrues interest for tax purposes.[20]

1. Section 467: Leasing Company as Lessee

In a sale-leaseback where the Leasing Company is using a Head Lease to provide financing for the Assets (i.e., the Leasing Company (or its DRE) is the Head Lessee), if the Leasing Company were suffering from a Section 163(j) interest limitation, it would want to negotiate a Head Lease rental structure where the deemed loan runs from the Head Lessee to the Head Lessor; in such case, the deemed loan generates interest income for the Leasing Company.

The conceptual idea is to structure the schedules so that the Leasing Company's (or its DRE's) rent payments in the early years of the Head Lease exceed the rental accrual amounts (i.e., the Head Lessee's *prepayments* of rent are deemed a loan to the Head Lessor). The economics benefit the Head Lessor because it receives a tax benefit from being able to take interest deductions on the deemed loan (as opposed to current income recognition on the full amount of cash rent received), which theoretically should make the Head Lessor willing to accept lower rents under the Head Lease (i.e., better financing terms for the Leasing Company). At the same time, the Leasing Company is not negatively impacted by having to report interest income from the deemed loan, as the Leasing Company offsets this interest income with interest expense that would have otherwise been deferred by Section 163(j).

Without going into all of the details, here is an example of how the schedules could work: assume a ten-year Head Lease with $10 million per year average annual allocated rental accrual. The Leasing Company in this case might negotiate for the annual allocated rental accrual in the first half of the Head Lease to be 90 percent of the average (e.g., $9 million) and the annual allocated rental accrual in the second half to be 110 percent of the average (e.g., $11 million). If we assume the Head Lessor pays $200 million for the Assets, the Head Lessee could agree to make a $40 million payment of rent at the start of the Head Lease in exchange for no cash payments of rent during the first four years.[21] At the end of the first year, there would be a $31 million deemed loan (i.e., $40 million prepayment less $9 million of allocated rent). For tax purposes, the deemed loan would be deemed to accrue interest at 110 percent of the applicable federal rate,[22] which would be 2.83 percent, with semi-annual compounding, for a ten-year Head Lease entered into in January 2018. As a result of this structure, the Leasing Company would have $877,300 of deemed interest income for tax purposes and could use this interest income to offset the same amount of interest expense from the Leasing Company's prior debt issuances, thereby creating a tax benefit for the Leasing Company (i.e., the ability to take current deductions for interest expense that would otherwise have been deferred under Section 163(j)).

The structure has the opposite consequences to the Head Lessor; generating $877,300 of interest expense for the Head Lessor in the first year. The interest expense would be a tax benefit to the parent of the Head Lessor; provided the parent has sufficient interest income from its other operations to avoid application of the Section 163(j) limitation.

2. Section 467: Leasing Company as Lessor

To further address its Section 163(j) position, the Leasing Company could also use Section 467 to create deemed interest income from the customer leases. The application, though, is somewhat limited because Section 467 only applies to leases where the total rental payments are more than $250,000. Therefore, the customer would need to be relatively sizable for this planning opportunity to be available.

An example of this structure might be the Leasing Company (or its DRE) leasing a fleet of rolling stock to a railroad for ten years. In this case, the concept would be to generate interest income to the Leasing Company (or its DRE) under the sublease (i.e., create a deemed loan that runs to the railroad). To accomplish this, the railroad's rent payments in the early years need to be less than accrued rent (i.e., the railroad's *deferral* of rent payments is deemed a loan from the Head Lessor). Using the numbers from the previous example, under the customer lease schedules, the annual allocated rental accrual in the first half of the lease would be 110 percent of the average (e.g., $11 million) and the annual allocated rental accrual in the second half would be 90 percent of the average (e.g., $11 million). Further, the Leasing Company (or its DRE) could negotiate with the railroad that no rent would be due until the third year, in which case, the Leasing Company would be deemed to have loaned $11 million to the railroad. Again assuming a ten year lease entered into in January 2018, the deemed $11 million loan would accrue interest at 2.83 percent, with semiannual compounding; thus generating $311,300 of interest income for the Leasing Company in just the first year. There would be a corresponding interest deduction for the railroad. Accordingly, assuming the railroad can use the interest deduction, the railroad in theory would pay higher rents (or select the Leasing Company's bid over other bids) due the tax benefit it would receive under the lease. Further, the Leasing Company is not negatively affected by the deemed interest income, as the interest income is offset with a corresponding amount of interest deductions that would have otherwise been deferred by Section 163(j).

The equipment leasing industry has travelled the road of tax changes many times before and that experience positions it well to adapt its business model to allow it to thrive following the enactment of Tax Reform.

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[1] I.R.C. § 168(k)(1)(A), -(6)(A)(i).
2 References herein to the "Code" are to the Internal Revenue Code of 1986, as amended by Tax Reform, and capitalized references to "Sections" are to sections of the Code.
[3] Certain types of property are provided an extra year to be placed in service. I.R.C. § 168(k)(2)(B).
[4] I.R.C. § 168(k)(6).

[5] I.R.C. § 168(k)(2)(A)(ii), - (E)(ii).
[6] This prohibition on expensing if the taxpayer or its related party previously used the property arguably could be interpreted as precluding a lessee from expensing the cost of property the lessee acquired pursuant to a lease purchase option. In that case, the lessee was using the property during the term of the lease. However, there was no previous ownership by the lessee or its related party, and the lessee would get expensing if it were to make a comparable purchase of leased property that had been used by a different lessee. We are optimistic that Treasury will clarify that this situation is not viewed as "previous use" by the taxpayer for purposes of expensing.
[7] *See* I.R.C. § 168(i)(7).
[8] I.R.C. §§ 163 (j)(7)(A)(iv), 168(k)(9)(A).
[9] There are Treasury Regulations under Sections 46 and 167 that include provisions characterizing leased property as public utility property based on the activities of the lessor or the lessee. *See* Treas. Reg. § 1.46-3(g)(3) (property leased by a non-utility lessor to a to a utility is subject to the same restrictions in the lessor's hands as in the utility's hands); Treas. Reg. § 1.167(l)-3(b)(1) (property leased by a non-utility lessor to a to a utility is considered public utility property, but not subject to the same restrictions in the lessor's hands as in the utility's hands). Neither of these Treasury Regulations is directly applicable to the expensing provisions enacted under Tax Reform. In the case of Treasury Regulation § 1.46-3(g)(3), the provision relates to an investment tax credit statute, not a depreciation statute.
[10] I.R.C. § 168 (k)(2)(D), -(g)(1)(B), -(h).
[11] P.L. 115-97, § 13201(h)(1)(B) (2017).
[12] I.R.C. § 168(k)(2)(A)(ii), - (E)(iii).
[13] "The Supreme Court has applied in tax cases the maxim of construction that every part of the statute be given meaning or function, and the courts should not interpret one provision in a way that would render another provision superfluous." JASPER L. CUMMINGS, JR., THE SUP. CT.'S FED. TAX JURISPRUDENCE 286 (2010) (citing Atl. Mut. Ins. Co. v. Comm'r, 523 U.S. 382 (1982)). However, this maxim of construction has its limits. *See* Chickasaw Nation v. United States, 534 U.S. 84, 85 (2001) ("common sense suggests that [the reference] is simply a bad example that Congress included inadvertently, a drafting mistake.") The lease syndication provision appears to be in that category.
[14] P.L. 115-97, § 13303(c)(2)(A) (2017).
[15] I.R.C. § 172(a)(2).
[16] I.R.C. §§ 168(g)(7), (k)(7).
[17] This discussion is to generally explain the potential impact of Tax Reform on securitization as a method of capital funding and, accordingly, is limited to basic securitization structure.
[18] I.R.C. §163(j)(1), -(8)(A)(i)-(iv).
[19] I.R.C. §163(j)(1); -(8)(A)(v).
[20] *See* Treas. Reg. § 1.467-4. A simplified explanation of the concept is that the Code treats the schedule of rent accrual as akin to the "actual" rent due for each period and the rent payment schedule as setting forth how the rent obligation is paid from time to time. See § 467(a), (b); Treas. Reg. §§ 1.467-1, -2, -4.
[21] The prepayment of $40 million in our example is the maximum amount that tax practitioners would generally be comfortable with based on rules under Section 470, which applies to limit deductions where the lessee is tax-exempt. *See* I.R.C. §470(d)(1)(C)(i). While this provision is not applicable in our example, it is the only guidance available regarding the permitted size of a rent pre-payment. Accordingly, some practitioners use it as a guidepost to be comfortable that a large prepayment will be not be too large to be respected as rent.
[22] I.R.C.§ 467(e)(4); Treas. Reg. § 1.467-2(e).