Rev. Proc. 2001-28, 2001-1 CB 1156, 5/07/2001, IRC Sec(s). 167

Leveraged leases.

1. Purpose

This revenue procedure provides guidelines that the Internal Revenue Service will use for advance ruling purposes in determining whether certain transactions purporting to be leases of property are, in fact, leases for federal income tax purposes. This revenue procedure modifies and supersedes Rev. Proc. 75-21, 1975-1 C.B. 715. Rev. Proc. 2001-29, 2001-19 I.R.B. 1160, sets forth the information and representations required to be furnished by taxpayers in requests for advance rulings on leveraged lease transactions within the meaning of this revenue procedure.

2. Background

Section 4.01 of Rev. Rul. 55-540, 1955-2 C.B. 39, sets forth certain conditions that, in the absence of compelling factors of contrary implication, would warrant treatment of a transaction for federal income tax purposes as a conditional sales contract rather than a lease of equipment. See Rev. Rul. 55-541, 1955-2 C.B. 19; Rev. Rul. 55-542, 1955-2 C.B. 59; and Rev. Rul. 57-371, 1957-2 C.B. 214, for examples of transactions determined to be sales rather than leases. See Rev. Rul. 60-122, 1960-1 C.B. 56, for two transactions, one considered a lease and the other considered a sale. See also Rev. Rul. 72-408, 1972-2 C.B. 86, concerning the federal income tax consequences of a transaction cast in the form of a lease subsequently determined to be a sale.

3. Scope

This revenue procedure applies in the case of transactions commonly called “leveraged leases.” Such leases generally involve three parties: a lessor, a lessee and a lender to the lessor. In general, these leases are net leases, the lease term covers a substantial part of the useful life of the leased property, and the lessee's payments to the lessor are sufficient to discharge the lessor's payments to the lender.

The guidelines set forth in this revenue procedure clarify the circumstances in which an advance ruling recognizing the existence of a lease ordinarily will be issued solely to assist taxpayers in preparing ruling requests and the Service in issuing advance ruling letters as promptly as practicable. These guidelines do not define, as a matter of law, whether a transaction is or is not a lease for federal income tax purposes and are not intended to be used for audit purposes.

4. Guidelines

Unless other facts and circumstances indicate a contrary intent, for advance ruling purposes only, the Service will consider the lessor in a leveraged lease transaction to be the owner of the property and the transaction a valid lease if all the guidelines described below are met. If all of these guidelines are not met, the Service nevertheless will consider ruling in appropriate cases on the basis of all the facts and circumstances.

.01. Minimum unconditional “at risk” investment

.01. The lessor must have made a minimum unconditional “at risk” investment in the property (the “Minimum Investment”) when the lease begins, must maintain such Minimum Investment throughout the entire lease term, and such Minimum Investment must remain at the end of the lease term. The Minimum Investment must be an equity investment (the “Equity Investment”) that, for purposes of this revenue procedure, includes only consideration paid, and personal liability incurred, by the lessor to purchase the property. The net worth of the lessor must be sufficient to satisfy any such personal liability. In determining the lessor's Minimum Investment, the following rules will be applied:

(1) Initial Minimum Investment. When the property is first placed in service or use by the lessee, the Minimum Investment must be equal to at least 20 percent of the cost of the property. The Minimum Investment must be unconditional. That is, after the property is first placed in service or use by the lessee, the lessor must not be entitled to a return of any portion of the Minimum Investment through any arrangement, directly or indirectly, with the lessee, a shareholder of the lessee, or any party related to the lessee (within the meaning of section 318 of the Internal Revenue Code) (the “Lessee Group”). The lease transaction may include an arrangement with someone other than the foregoing parties that provides for such a return to the lessor if the property fails to satisfy written specifications for the supply, construction, or manufacture of the property.

(2) Maintenance of Minimum Investment. The Minimum Investment must remain equal to at least 20 percent of the cost of the property at all times throughout the entire lease term. That is, the excess of the cumulative payments required to have been paid by the lessee to or for the lessor over the cumulative disbursements required to have been paid by or for the lessor in connection with the ownership of the property must never exceed the sum of (i) any excess of the lessor's initial Equity Investment over 20 percent of the cost of the property plus (ii) the cumulative pro rata portion of the projected profit from the transaction (exclusive of tax benefits).

(3) Residual Investment. The lessor must represent and demonstrate that an amount equal to at least 20 percent of the original cost of the property is a reasonable estimate of what the fair market value of the property will be at the end of the lease term. For this purpose, fair market value must be determined (i) without including in such value any increase or decrease for inflation or deflation during the lease term, and (ii) after subtracting from such value any cost to the lessor for removal and delivery of possession of the property to the lessor at the end of the lease term. In addition, the lessor must represent and demonstrate that a remaining useful life of the longer of one year or 20 percent of the originally estimated useful life of the property is a reasonable estimate of what the remaining useful life of the property will be at the end of the lease term.

.02. Lease Term and Renewal Options

.02. For purposes of this revenue procedure, the lease term includes all renewal or extension periods except renewals or extensions at the option of the lessee at fair rental value at the time of such renewal or extension.

.03. Purchase and Sale Rights

.03. No member of the Lessee Group may have a contractual right to purchase the property from the lessor at a price less than its fair market value at the time the right is exercised. When the property is first placed in service or use by the lessee, the lessor may not have a contractual right (except as provided in section 4.01(1) above) to cause any party to purchase the property. The lessor must also represent that it does not have any present intention to acquire such a contractual right. The effect of any such right acquired at a subsequent time will be determined at that time based on all the facts and circumstances. A provision that permits the lessor to abandon the property to any party will be treated as a contractual right of the lessor to cause such party to purchase the property.

.04. Investment by Lessee

.04. (1) Permitted Investments. Except as otherwise specifically provided in paragraphs (2) and (3) below, no part of the cost of the property or the cost of improvements, modifications, or additions to the property ("Improvements"), may be furnished by any member of the Lessee Group. Property that could itself be separately leased in a transaction eligible for an advance ruling under this revenue procedure does not constitute an Improvement. For example, assume X leases a chemical plant from Y. Assume further, that after the plant is placed in service, X wishes to erect and own additional tanks that will be used to store the output of the plant. Although the tanks will be used in conjunction with X's plant, they constitute separate items of property that could be used in conjunction with other facilities and therefore do not constitute limited use property under section 5.02 of this revenue procedure. If a third party owned the tanks, it could lease them to X in a transaction eligible for an advance ruling. Thus, the tanks do not constitute an Improvement.

(2) Severable Improvements. A member of the Lessee Group may furnish amounts to pay for the cost of an Improvement that is owned by a member of the Lessee Group, and is readily removable without causing material damage to the leased property ("Severable Improvement"), provided that such Improvement is not subject to a contract or option for purchase or sale between the lessor and any member of the Lessee Group at a price other than fair market value at the time of such purchase or sale. At the commencement of the term of the lease, a Severable Improvement to the leased property must not be required in order to render the leased property complete for its intended use by the lessee. However, property will be considered to be complete even though the lessee may add as Severable Improvements ancillary items of equipment of a kind that customarily are selected and furnished by purchasers or lessees of property of the kind subject to the lease. Thus, for example, to the extent an item of equipment such as the boiler for a leased, steam powered vessel otherwise constituted a Severable Improvement, the vessel would not, for purposes of this section, be considered complete without the boiler. On the other hand, a leased airplane would be considered complete without items of equipment such as aviation electronics and a leased vessel would be considered complete without such ancillary items such as radar, lines, or readily removable fittings, and will be eligible for an advance ruling even though such items of equipment are to be added by the lessee.

(3) Nonseverable Improvements. A member of the Lessee Group may furnish amounts to pay for the cost of Improvements that are not readily removable without causing material damage to the property ("Nonseverable Improvements") if they are described in subparagraph (a) below and the conditions of subparagraph (b) are met.

(a) A Nonseverable Improvement is described in this subparagraph if either:

(i) it is furnished in order to comply with health, safety, or environmental standards of any government or governmental authority having relevant jurisdiction (or any industry-wide standard recognized by such government or governmental authority);
(ii) it does not increase the productivity (or capacity) of the leased property to more than 125 percent of its productivity (or capacity) when first placed in service, or modify the leased property for a materially different use. For this purpose, separate units that are subject to one lease (e.g., ten boxcars subject to one lease) are each considered "the leased property;" or
(iii) the cost of the Nonseverable Improvement, when added to the cost of Nonseverable Improvements that previously have been made to the property (other than those described in subparagraph (i) above) does not exceed 10 percent of the cost of the property. For purposes of this subparagraph, the cost of a Nonseverable Improvement will be considered to be the actual cost multiplied by a fraction, the numerator of which is the Implicit Price Deflator for Fixed Nonresidential Investment (published by the Department of Commerce in the Survey of Current Business) for the year in which the property was placed in service, and the denominator of which is the Implicit Price Deflator for Fixed Nonresidential Investment for the year in which the Improvement is made. As indicated in section 4.04(5) of this revenue procedure, ordinary maintenance and repair does not constitute an Improvement.

(b) the following conditions must be satisfied:

(i) At the commencement of the term of the lease, a Nonseverable Improvement must not be required in order to complete the property for its intended use by the lessee;
(ii) The Nonseverable Improvement must not cause the leased property to become limited use property within the meaning of section 5.02 of this revenue procedure; and
(iii) The furnishing of the cost of the Nonseverable Improvement must not constitute an equity investment by a member of the Lessee Group in the property. For this purpose, the lessee's right to use the Improvement during the lease term in which such improvement is made does not constitute an equity investment in the property. The furnishing of such cost will be considered an equity investment in the property if a member of the Lessee Group may receive compensation, directly or indirectly, for its interest in such Nonseverable Improvement. A member of the

Lessee Group will be regarded as having made an equity investment in the property if, for example:

- the lessor is obligated to purchase the Nonseverable Improvement or reimburse a member of the Lessee Group for the cost or the fair market value of the Nonseverable Improvement;
- any option price or renewal rental rate to a member of the Lessee Group is adjusted downward to reflect any portion of the cost or fair market value of the Nonseverable Improvement; or
- the lessor is obligated to share with a member of the Lessee Group a portion of the proceeds of any sale or lease of the property to a third party.

(4) Cost Overruns and Modifications. If the cost of property exceeds the estimate on which the lease was based, the lease may provide for adjustments of rent to compensate the lessor for such additional cost.

(5) Maintenance and Repair. If the lease requires the lessee to maintain and keep the property in good repair during the term of the lease, ordinary maintenance and repairs performed by a member of the Lessee Group will not constitute an Improvement.

.05. No Lessee Loans or Guarantees

.05. No member of the Lessee Group may lend to the lessor any of the funds necessary to acquire the property, or guarantee any indebtedness created in connection with the acquisition of the property by the lessor. A guarantee by any member of the Lessee Group of the lessee's obligation to pay rent, properly maintain the property, or pay insurance premiums or other similar conventional obligations of a net lease does not constitute a guarantee of the indebtedness of the lessor.

.06. Profit Requirement

.06. The lessor must represent and demonstrate that it expects to receive a profit from the transaction, apart from the value of or benefits obtained from the tax deductions, allowances, credits, and other tax attributes arising from such transaction. This requirement is met if—

(1) Overall Profit. The aggregate amount required to be paid by the lessee to or for the lessor over the lease term plus the value of the residual investment referred to in section 4.01(3) of this revenue procedure exceed an amount equal to the sum of the aggregate disbursements required to be paid by or for the lessor in connection with the ownership of the property and the lessor's Equity Investment in the property, including any direct costs to finance the Equity Investment; and

(2) Positive Cash Flow. The aggregate amount required to be paid to or for the lessor over the lease term exceeds by a reasonable amount the aggregate disbursements required to be paid by or for the lessor in connection with the ownership of the property.

5. Other Considerations

.01. Uneven Rent Test.

.01. Leveraged lease transactions that satisfy the guidelines set forth in section 4 of this revenue procedure and that contain uneven rent payments may be subject to section 467 and the regulations thereunder relating to the accounting treatment for certain leases with prepaid or deferred rent. In addition, section 1.467-3(c)(4) of the Income Tax Regulations provides an uneven rent test. A lease meeting this uneven rent test will not be treated as a disqualified leaseback or long-term agreement for purposes of section 467. How the lease is treated under section 467, including whether or not the uneven rent test of section 1.467-3(c)(4) is met, will not affect the ability of a taxpayer to obtain an advance ruling under this revenue procedure.

.02. Limited Use Property.

.02. (1) In General. Section 4.01(3) of this revenue procedure requires the lessor to represent and demonstrate certain facts relating to the estimated fair market value and estimated remaining useful life of the property at the end of the lease term. This requirement is intended, in part, to assure that the purported lessor has not transferred the use of the property to the purported lessee for substantially its entire useful life. In the case of such "limited use" property, at the end of the lease term there will probably be no potential lessees or buyers other than members of the Lessee Group. As a result, the lessor of limited use property will probably sell or rent the property to a member of the Lessee Group, thus enabling the Lessee Group to enjoy the benefits of the use or ownership of the property for substantially its entire useful life. See Rev. Rul. 55-541, 1955-2 C.B. 19, for an example of a transaction in which property was determined to be leased for substantially its entire useful life and the conclusion that such a transaction transfers equitable ownership. Accordingly, the Service will not issue advance rulings concerning whether certain transactions purporting to be leases of property are, in fact, leases for federal income tax purposes when the property is limited use property.

(2) Examples. The following examples illustrate the types of property the Service considers to be limited use property, and the types of property the Service does not consider to be limited use property.

(a) X builds a masonry smokestack attached to a masonry warehouse building owned by Y, and leases the smokestack to Y for use as an addition to the heating system of the warehouse. The lease term is 15 years; the smokestack has a useful life of 25 years, and the warehouse has a remaining useful life of 25 years. It would not be commercially feasible to disassemble the smokestack at the end of the lease term and reconstruct it at a new location. The smokestack is considered to be limited use property.

(b) X builds a complete chemical production facility on land owned by Y and leases the facility to Y, a manufacturer of chemicals. The lease term is 24 years, and the facility has a useful life of 30 years. The land is leased to X pursuant to a ground lease for a term of 30 years. The technical "know-how" and trade secrets Y possesses are necessary elements in the commercial operation of the facility. At the time the lease is entered into, no person who is not a member of the lessee group possesses the technical "know-how" and trade secrets necessary for the commercial operation of the facility. The taxpayers submit to the Service the written opinion of a qualified expert stating it is probable that

by the expiration of the lease term of the facility third parties who are potential purchasers or lessees of the facility will have independently developed such “know- how” and trade secrets. The facility is considered to be limited use property. In reaching this conclusion, the Service will not take into account such expert opinion because such opinions are too speculative for advance ruling purposes.

(c) The facts are the same as in example (b) except X has an option, exercisable at the end of the lease term of the facility, to purchase from Y the “know-how” and trade secrets necessary for the commercial operation of the facility, and it would be commercially feasible at the end of such lease term for X to exercise the option and operate the facility itself. The facility is not considered to be limited use property.

(d) The facts are the same as in example (b) except it would be commercially feasible for the lessor at the end of the lease term to make certain structural modifications of the facility that would make the facility capable of being used by persons not possessing any special technical “know-how” or trade secrets. Furthermore, if such modifications were made, it would be commercially feasible, at the end of the lease term, for a person who is not a member of the lessee group to purchase or lease the facility from X. The facility is not considered to be limited use property.

(e) X builds an electrical generating plant on land owned by Y and leases the plant to Y. The lease term is 40 years, and the plant has an estimated useful life of 50 years. The land is leased to X pursuant to a ground lease for a term of 50 years. The plant is adjacent to a fuel source that it is estimated will last for at least 50 years. Access to this fuel source is necessary for the commercial operation of the plant, and Y has recently obtained the contractual right to acquire all fuel produced from the source for 50 years. Y will use the plant to produce and generate electrical power for sale to a city located 500 miles away. The plant is synchronized into a power grid that makes the sale of electrical power to a number of potential markets commercially feasible. It would not be commercially feasible to disassemble the plant and reconstruct it at a new location. The electrical generating plant is considered to be limited use property because access to the fuel source held exclusively by Y is necessary for the commercial operation of the plant.

(f) The facts are the same as in example (e) except X has an option, exercisable at the end of the lease term of the plant, to acquire from Y the contractual right to acquire all fuel produced from the fuel source for the 10-year period commencing at the end of such lease term. It would be commercially feasible at the end of such lease term for X to exercise this option. Furthermore, it would be commercially feasible, at the end of such lease term, for a person who is not a member of the lessee group to purchase the contractual right to the fuel from X for an amount equal to the option price and purchase or lease the plant from X. The plant is not considered to be limited use property.

6. Effect On Other Documents

Rev. Proc. 75-21, 1975-1 C.B. 715, Rev. Proc. 76-30, 1976- 2 C.B. 647, and Rev. Proc. 79-48, 1979-2 C.B. 529, are modified and, as modified, are superseded.

7. Effective Date
This revenue procedure is effective May 7, 2001.

8. Drafting Information
The principal author of this revenue procedure is Edward Schwartz of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Mr. Schwartz at (202) 622-4960 (not a toll-free call).