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Tax Characterization of International Leases: The Contours of Ownership

William W. Park
Boston University School of Law

TAX CHARACTERIZATION OF INTERNATIONAL LEASES: THE CONTOURS OF OWNERSHIP

William W. Park†

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† Associate Professor of Law, Boston University; Visiting Associate Professor of International Law, The Fletcher School of Law and Diplomacy. The author wishes to thank David R. Tillinghast for help in thinking about tax law.

Wealth as a whole consists in using things rather than in owning them . . . .
—Aristotle[1]

INTRODUCTION

Pondering the human tendency to pay dearly for short-lived adornments, Shakespeare asks a question of interest to lawyers as well as poets: "Why so large cost, having so short a lease . . .?"[2] The lawyer's analysis of the issue might begin with a scenario set in an imaginary world in which the tax effects of business transactions are determined by their legal form rather than their economic substance. In such a world, each of two companies decides to build a new factory. One acquires the land outright, paying in several installments. The other enters into a short-term lease at a very high rent with the option to purchase the land for a penny at the end of the lease term. Not surprisingly, the second company eventually exercises this option.

Although the economic substance of the two land acquisitions is remarkably similar, their tax consequences would differ significantly. The lessee would deduct the rentals as a business expense,[3] whereas the installment purchaser would deduct nothing.[4] Thus, the "large cost" for

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1 ARISTOTLE, *Rhetoric*, bk. 1, ch. 5, 1361a, 23-24, in ARISTOTLE: RHETORIC AND POETICS 39 (1954).

2 Poore soule the center of my sinfull earth,
Foil'd by these rebbell powers that thee array,
Why dost thou pine within and suffer dearth,
Painting thy outward walls so costlie gay?
Why so large cost having so short a lease,
Dost thou upon thy fading mansion spend?

W. SHAKESPEARE, *Sonnet 146*, in SONNETS (The Scolar Press Ltd. ed. 1968).

3 I.R.C. § 162(a)(3) states:

> There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred . . . in carrying on any trade or business, including . . . 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.

4 No deduction is permitted for the depreciation of land. Treas. Reg. § 1.167(a)-2 provides that the depreciation deduction applies only "to that part of the property which is

"so short a lease"—to return to the Bard's query—is revealed as part of a scheme to create tax benefits.

If equipment rather than land is acquired, however, there may be greater tax benefits from purchasing than from leasing. The tax advantage of ownership lies in the possibility of depreciating the equipment at an accelerated rate[5] or obtaining an investment tax credit,[6] which may reduce the company's tax bill more than would the deduction of rental expenses.

When the lessor and lessee of an asset reside in different countries, the tax consequences of characterization are multiplied. Tax characterization may affect the tax rate on the lease payments under either domestic law[7] or applicable income tax treaties,[8] the credit for foreign taxes paid,[9] and national jurisdiction to impose a tax at all.[10]

To protect the integrity of their tax systems, many nations have rejected the imaginary world in which labels are legally determinative. Instead, these countries frequently allocate tax consequences in accordance with the economic substance of a transaction. Specific rules determine whether a transaction denominated a "lease" should be treated as such, or should be characterized as the equivalent of an installment sale. These rules vary with the circumstances of the lease and the type of property involved.

One might describe a true lease as the provision of a service, whereby the lessor furnishes relatively short-term use of property to the lessee. In contrast, the purchase of property generally involves the transfer of the right to use the property for all or most of its useful life. Characterization is often difficult when the transaction appears to be a hybrid between a true lease and a purchase. Of particular importance is the financial impact of the characterization process. It affects billions of dollars of goods,[11] ranging from aircraft to factories. Although the im-

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subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence."

5 *See* I.R.C. §§ 167, 168.

6 *See id.* § 38.

7 *See id.* § 871.

8 *See* Appendix; text accompanying note 226 *infra*.

9 *See* I.R.C. §§ 901-904; text accompanying notes 240-52 *infra*.

10 For example, a claim of sovereign immunity may depend on whether income is termed "interest" or "rental." *See* Treas. Reg. § 1.892-1(g), example 1, T.D. 7707, 45 Fed. Reg. 48,884 (1980); text accompanying notes 279-80 *infra*.

11 In 1976, the U.S. Department of Commerce estimated that American leases covered $100 billion of equipment. BUREAU OF DOMESTIC COMMERCE, U.S. DEP'T OF COMMERCE, LEASING AND RENTAL INDUSTRIES: TRENDS AND PROSPECTS 1-3 (1976). Other estimates of the inventory of leased assets in the United States have run as high as $150 billion. *See* FROST & SULLIVAN, THE EQUIPMENT LEASING MARKET, Report No. 382 (Apr. 1976) at 1. In 1973, the Value Line Investment Survey reported the value of goods then on lease at over $10 billion. VALUE LINE INVESTMENT SURVEY, Oct. 12, 1973, at 227. Leased equipment in the

pact is most significant on the income tax system, characterization may also affect other fiscal regimes, including consumption taxes[12] and property taxes.[13]

The lease characterization process may provide useful insight into the concept of economic ownership in situations in which property rights have been divided among different persons. Moreover, it raises the issue of whether divergent national rules may distort patterns of international trade and finance by encouraging leases under which both lessor and lessee obtain the tax benefits of depreciation. One well publicized example of such an arrangement is the so-called "double dip" lease entered into between British banks and American equipment users, structured so that each party is considered the equipment owner—and thus entitled to depreciation deductions—under its own national tax law.[14]

This Article considers the fiscal policies relevant to the characterization of domestic and international leases and compares these policies with analogies in such non-tax disciplines as accounting, banking, civil jurisdiction, products liability, and security interests. After a survey of the economic structure of leasing, the Article describes the characterization standards of several capital exporting nations, and then examines the special characterization issues incident to trans-border leases, including the effect of income tax treaties. Finally, the Article explores the impact of characterization on patterns of transnational trade and the potential harmonization of divergent characterization standards.

I

Leasing As a Mode of Finance[15]

A. *Finance Leases and Operating Leases*

An enterprise in need of a building or equipment can finance it

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United Kingdom in 1977 was valued at 2.4 billion pounds by the British Equipment Leasing Association. *See* T. Clark, Leasing 25 (1978).

Mr. Peter Nevit, the President of Bank of America's leasing subsidiary (Bank Amerilease Group), recently predicted that the enactment of the safe harbor for finance leases contained in the Economic Recovery Tax Act of 1981 would cause an increase of up to 300% in the volume of tax-induced leasing, which he estimated currently at between $10 billion and $15 billion per year. Wall St. J., Aug. 27, 1981, at 1, col. 6.

12 Value added tax generally will be charged on the supply of goods or services through sale or lease, but not on loan interest. *See, e.g.,* U.K. Finance Act, 1972, c. 41, §§ 1(1), 5(2).

13 Property taxes normally would fall on the owner, whether lessor or purchaser, but not on a lessee or lender.

14 *See* N.Y. Times, Apr. 7, 1981, § D 1, col. 3. "Double dip" leases are discussed in section IV *infra*.

15 For recently published general surveys of the finance leasing industry, see E. Bey, De La Symbiotique Dans Les Leasing et Crédit-Bail Mobiliers (1970); T. Clark, *supra* note 11, at 14-77; Equipment Leasing-Leveraged Leasing (B. Fritch & A. Reisman eds.

through a variety of alternatives. A firm might pay cash for a building in which to conduct its business or, instead, it might just rent a hotel suite. Between these extremes lies a continuum of options: it may purchase with funds obtained by unsecured borrowing; it may purchase with a loan secured by a mortgage on the acquired property; or it may agree to a long-term noncancelable rental for substantially the entire life of the building.

The last alternative and its variants[16] frequently are referred to as finance leases. Developed by nineteenth century capitalists who supplied railway wagons to move coal and other minerals, leasing has expanded to include manufacturers and dealers in sophisticated machinery as well as finance institutions established specifically to lease such goods.[17]

In theory, leasing differs from other forms of credit in that the equipment itself, rather than money, is the thing borrowed. In economic substance, however, a lease and a loan may be functionally the same transaction.[18] A noncancelable rental period may cover all or most of the equipment's useful life, or relatively high rentals may be coupled with an option to purchase or to renew the lease at a bargain price which ensures that the option will be exercised. The lessee's payments enable the financier or dealer to recover the cost of the equipment plus a profit.

If the cost of the equipment plus an implicit interest charge is fully recovered over the lease term, the arrangement is called a full payout lease.[19] The full payout lease may be a multiparty agreement in which a bank or finance company purchases capital goods ordered to the specifications of the enterprise that will actually use them. This triangular symbiosis fulfills each party's needs; the manufacturer sells its goods, the

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1977); M. GIOVANOLI, LE CRÉDIT-BAIL EN EUROPE (1980); R. PRITCHARD & T. HINDELANG, THE LEASE/BUY DECISION 11-47 (1980).

16 *E.g.*, a short-term lease with an option to purchase at a bargain price.

17 For the history of leasing, see T. CLARK, *supra* note 11, at 3-10; Fritch, *Leveraged Leasing*, in EQUIPMENT LEASING-LEVERAGED LEASING, *supra* note 15, at 98-101; Peden, *The Treatment of Equipment Leases as Security Agreements Under the Uniform Commercial Code*, 13 WM. & MARY L. REV. 110 (1971).

In 1955, the Internal Revenue Service issued guidelines on lease characterization for purposes of determining the deductibility of rental payments. Rev. Rul. 55-54, 1955-2 C.B. 39, discussed in text accompanying notes 125-30 *infra*. Twenty years later, the IRS promulgated additional guidelines to take account of the "leverage" phenomenon: borrowing money to purchase an asset that carries with it tax benefits. Rev. Proc. 75-21, 1975-1 C.B. 715 and Rev. Proc. 75-28, 1975-1 C.B. 752, discussed in text accompanying notes 131-40 *infra*.

18 *See* T. CLARK, *supra* note 11, at 15-38; R. PRITCHARD & T. HINDELANG, *supra* note 15, at 20-21; Clark, *Equipment Leasing—Some Tax Thoughts*, 1977 BRIT. TAX REV. 282, 288-89 ("[P]rospective lessees will no doubt continue to regard leasing as only one of a large range of possible financing methods."); Foster, *More Use of Leasing*, Financial Times, Sept. 17, 1975, at 28, col. 3.

19 *See, e.g.*, R. PRITCHARD & T. HINDELANG, *supra* note 15, at 2021.

entrepreneur or consumer obtains equipment, and the financier extracts interest.[20] Because equipment and plant do not last forever, the lease payments are normally calculated according to the useful life of the goods, taking into account any residual value that the lessor expects to recover at the end of the lease.

In contrast, the lessor's profit from an operating lease depends on the subsequent lease of the equipment, or perhaps its sale to another user, at the end of the lease term. Operating lease terms are relatively short compared to the useful life of the leased property; weekend car or hotel room rentals are common examples.

Assume, with respect to a full payout lease, that a bank finances a machine with a cost of $10,000 and wants to receive a yield on its money of 13.4%. If the financier estimates a useful equipment life of five years, it will offer a lease with a $227 monthly rental. Over the five-year lease term, this will yield cost recovery plus $3,600 income, each rental representing a payment of both principal and interest. If the term is reduced to three years, the transaction begins to resemble an operating lease. The bank recovers only $8,172 in total rental payments. Accelerated depreciation under the double declining balance method[21] would yield a tax deduction of $7,850 over three years,[22] however, to which is added the benefit of the investment tax credit. Assuming the equipment is not obsolete, there also may be proceeds from a sale of the equipment at its residual value.[23] Thus, the lessor, in effect, will be paid twice: once by the equipment user, and again by the government in the form of tax credits and accelerated depreciation. The tax benefit might be split with the lessee, in the form of reduced payments, as an inducement to finance by lease rather than by outright loan.[24]

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20 Secondary lenders may leverage the lease. *See* Bole & Ahlstrom, *Economics of Leveraged Leasing*, in EQUIPMENT LEASING-LEVERAGED LEASING, *supra* note 15, at 365-98.

21 For an explanation and illustrations of the application of the double declining balance method of depreciation, see Treas. Reg. § 1.167(b)-2 (1956), *as amended by* T.D. 6712, 1964-1 C.B. 109.

22 For simplicity this illustration ignores the Accelerated Cost Recovery System, discussed in note 118 *infra*.

40% of	$100 =	$40.00
40% of	60 =	24.00
40% of	36 =	14.40
Total deductions		$78.40

23 For simplicity, this hypothetical set of figures ignores the time value of money.

24 The vocabulary of the leasing industry is complicated by language differences, particularly within the tongue allegedly shared by Americans and the British. "Renting" generally refers to a relatively short-term lease. In the United Kingdom, a contract with an option to buy the equipment at a nominal price is a "hire-purchase" contract. Accountants refer to a long-term lease as a "capital lease," dividing these into "sales-type," entered into by manufacturers or dealers, and "direct-financing," entered into by banking institutions. *See* FINANCIAL

B. *Legal and Accounting Incentives for Finance Leasing*

Originally, the tax incentive for leasing rather than outright purchase was the deduction of rentals from income.[25] Although depreciation of most capital assets was permitted, depreciation schedules were less favorable than the rental deduction.[26] To encourage investment in income-producing assets, depreciation schedules were modified. Consequently, substantial tax advantages now attach to equipment ownership.[27] The United States allows accelerated depreciation[28] and an investment tax credit for new equipment.[29] If the equipment user's profits are not sufficient to absorb the accelerated depreciation deductions and credits, the user may wish to sell these benefits to the financier

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ACCOUNTING STANDARDS BOARD, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 13: ACCOUNTING FOR LEASES (1976).

In French-speaking countries, the terms "leasing" and "*crédit-bail*" describe finance transactions. These are distinguished from short-term rentals, which are called "*location*." Loi No. 66-455, July 2, 1966 (France); Arrêté Royal No. 55, Nov. 10, 1967 (Belgium).

"Sale/leaseback" financing involves transferring the assets to the lender, in exchange for the loan proceeds of the sale or loan, while the borrower continues to use the assets pursuant to a lease agreement. For recent examples of sale/leaseback transactions, see Woods-Tucker Leasing Corp. v. Hutcheson-Ingram Dev. Co., 626 F.2d 401 (5th Cir. 1980), *vacated on other grounds*, 642 F.2d 744 (5th Cir. 1981) (citrus farming equipment sold and then rented back to farmer); Hilton v. Commissioner, 74 T.C. 305 (1980) (newly constructed department store sold to finance corporation and rented back under a net lease).

Bankers distinguish between "open end" leases, in which the lessee assumes the risk of residual value fluctuation, and "closed end" leases, where that risk falls on the bank. *See* M & M Leasing Corp. v. Seattle First Nat'l Bank, 563 F.2d 1377, 1381 (9th Cir. 1977), *cert. denied*, 436 U.S. 956 (1978).

25 *See* Note, *Leases: Security Interests: Uniform Commercial Code*, 49 CORNELL L.Q. 672, 674 (1964) ("The primary tax consideration [of leases] is whether the rental payments are fully deductible by the lessee as business expenses.").

26 *See* Estate of Starr v. Commissioner, 274 F.2d 294 (9th Cir. 1959) (attempt to accelerate deductions for lease of sprinkler system); note 160 *infra*.

27 The relationship of depreciation to equipment profitability is illustrated as follows. Assume a taxpayer in the 50% bracket. In the first year, the capital allowance results in a reduction in equipment cost by half. When compared to its cost, the equipment provides twice its normal yield, and more businesses should find the investment profitable. For example, a machine that costs $100 need only produce $5 per year to provide a 10% annual yield, because the real expenditure for the machine, taking into account the $50 tax saving, is only $50.

28 I.R.C. §§ 167, 168. Section 168 was added by § 201 of the Economic Recovery Tax Act of 1981. By shifting tax from early to later years, the taxpayer in effect obtains from the government an interest free loan on the deferred tax; the accelerated deductions "shelter" the income from tax. For a discussion of recent legislation in the tax shelter area, see Graetz, *The Evolution of the Tax Shelter Provisions of the Tax Reform Act of 1976; Fewer than Fifty Ways to Limit Your Losses*, 29 U.C.L.A. TAX INST. 1 (1977). Readings that provide a general survey of the policies relevant to business preferences are collected in P. POSTLEWAITE, POLICY READINGS IN INDIVIDUAL TAXATION 309-54 (1980).

29 I.R.C. §§ 38, 46, 48. Section 38 authorizes a credit against the tax liability of a taxpayer who acquires and places in service depreciable tangible personalty with a useful life of at least three years. Special rules and prohibitions apply to aircraft, vessels, railroad rolling stock, and property used predominantly outside the United States. For legislative history of the investment tax credit, see S. REP. NO. 1881, 87th Cong., 2d Sess. 10 (1962).

in return for a lower interest rate. Because the economic advantage of any lease depends in part on the relative income tax status of financier and user, taxpayers can be expected to attempt to shift tax benefits to the party that can make best use of them.

From the viewpoint of the tax collector, recharacterization shifts depreciation deductions and investment credits among the parties, but items of income and deductions are neither lost nor created. Either the equipment user or the financier, but not both, can claim them; rent deducted by the lessee will constitute gross income to the lessor.[30]

Fiscal authorities nevertheless may be expected to resist lease characterizations that shift credits or deductions among taxpayers with different effective tax rates or different amounts of income against which to offset the credits or deductions.[31] For example, a credit that would reduce the lessor's tax might have no effect if taken by a lessee that has no tax liability during the year in question. Or, the lessor's effective tax rate could be 50%, while the lessee's effective rate is only 10%. Thus, while a $100 deduction taken by the lessor would reduce the tax payment by $50, the same deduction would reduce the tax payment by only $10 if allocated to the user.[32]

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30 For example, if a piece of equipment costs $100, and periodic payments of $22 per year are made by the user over the equipment's five year useful life, alternate characterizations of the transaction as lease, sale, or loan will result in the following net deductions:

Lease			
(a)	Lessor gross income	$ 110	
	Lessor depreciation	−(100)	
	Lessor net income		10
(b)	Lessee deduction		110
(c)	Net deductions		$100
Installment Sale			
(a)	Seller income	$ 10*	
(b)	Purchaser depeciation	+ 100**	
(c)	Net deductions		$100
Loan			
(a)	Lender interest income	$ 10***	
(b)	Borrower interest deductions	10	
(c)	Borrower depreciation	100	
(d)	Net deductions		$100

*Amount realized less basis.
**Total purchase price deemed to be 22 x 5 = 110; alternatively, $100 price plus $2 per year deemed interest, deductible by the purchaser under § 163.
***Repayment of loan principal creates no income to lender, who merely recoups capital.

For simplicity, this example ignores the income generated by the leased asset.

31 At least one commentator has proposed that parties should be permitted to bargain among themselves for tax benefits. Kronovet, *Characterization of Real Estate Leases: An Analysis and Proposal*, 32 TAX LAW. 757, 773-74 (1979).

32 In addition, timing of deductions and credits will affect revenue even if both taxpayers are subject to the same tax rate. If a deduction or credit must be carried over to a future

The taxpayer and the tax collector may thus have conflicting interests in determining ownership because the tax attributes of ownership—depreciation and investment credits—affect tax benefits. Free bargaining for tax status tends to shift deductions to the higher bracket taxpayer, away from the party with little or no tax liability.[33]

A trans-border lease presents additional revenue considerations. Shifting deductions from one taxpayer to another may push income outside the tax jurisdiction of one country into another. If a foreigner leases to an American, for example, the United States withholds tax on the rentals paid,[34] which are considered United States source income. If the foreigner sells the equipment, however, the United States has no jurisdiction over the seller's income (assuming the place of sale is outside

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year, the tax is collected now rather than later. Slowing down or speeding up the collection of tax creates a gain or loss equal to the interest on the amount of tax deferred. See, *e.g.,* Estate of Starr v. Commissioner, 274 F.2d 294 (9th Cir. 1949) (transaction cast as lease so that rental deductions would benefit equipment user), and comment thereon by M. CHIRELSTEIN, FEDERAL INCOME TAXATION 108-10 (2d ed. 1979).

For example, Anaconda decided to build a $138 million new plant in the same year that the Allende government expropriated Anaconda property worth $356 million. The magnitude of the loss, which could be carried forward for 10 years (I.R.C. § 1212(a)(i)(c)), foreclosed benefit to Anaconda from the investment tax credit for the cost of the new plant. Therefore, Anaconda leased the plant from financial institutions that could use the investment credit, thus obtaining lower finance costs than would have been available on direct borrowing. *See* Vanderwicken, *Powerful Logic of the Leasing Boom*, 88 FORTUNE 132 (Nov. 1973).

33 To illustrate, assume that a lessor takes depreciation under the double declining balance method for a machine that costs $100, has a ten year useful life, and rents for $12 per year.

Lessor income	$12
Lessor depreciation (DDB)	20
Lessor net loss	(8)
Lessee deduction	$12

Even if the taxpayers are in the same tax bracket, the revenue authorities may resist lease treatment. The lessor's depreciation deduction offsets $8 of other income, which at a 50% rate saves $4 of tax. In fact, this is a postponement of tax because the lessor will have fewer deductions in later years than if the straight line method had been used to spread deductions over the life of the equipment. But the lessor has obtained the use of this money for several years. Moreover, an increase in the amount of other equipment leased or inflation effectively may postpone the tax indefinitely.

On the other hand, if the transaction is characterized as a sale, the lessee benefits from the depreciation, but only if it has income to absorb the depreciation deductions. Interest normally would produce tax symmetry: the borrower's interest expense equals the lender's interest income. Because there is always an interest element built into any credit transaction, the revenue effects are unlikely to change whether the arrangement is characterized as a loan or an installment credit sale. If a purchaser borrows $100 to buy equipment and pays interest at 20%, it will have a $20 deduction during the first year and the financier will have $20 income. Changing the characterization from loan to installment sale will not matter, if the financier is also the vendor, because the installment seller also collects interest.

34 I.R.C. § 871(a)(1)(A). The statutory rate of 30% is frequently reduced under income tax treaty provisions. *See* note 226 *infra*.

the United States) except to the extent of interest,[35] which in any event is offset by the deductions taken by the purchaser-borrower.[36] Under certain circumstances, a foreigner might avoid United States tax liability on a sale of capital assets even if title passes in the United States.[37]

Leasing also has been a preferred form of borrowing because it permits the equipment user to maintain a more attractive balance sheet if certain accounting standards can be met.[38] The equipment user's goal is to avoid reflecting the equipment purchase debt as an obligation on its balance sheet and debt/equity ratios, which would otherwise reduce the credit available from other sources.[39] If the transaction can be characterized as an operating lease, rentals are treated as a current expense, and the rental obligation is not recorded as a liability on the balance sheet.

Traditionally, leasing also afforded a creditor the opportunity to secure repayment of a loan on a priority basis. In cases of user bankruptcy, an owner-lessor could repossess his equipment, rather than letting it fall into the hands of the bankruptcy trustee or other creditors and allow the user an equity of redemption upon sale of the equipment.[40] The availability of such priority thus provided another incentive for leasing as a mode of finance. The similarity between a lease and a security interest, however, led many courts to deny the financier the right to repossess the equipment except in the case of a true lease.[41] Moreover, the new Bankruptcy Code empowers the trustee in bankruptcy to stay repossession of property that is subject even to a true lease.[42]

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35 Interest received by a nonresident alien generally is taxable as U.S. source income. A special exception is made for interest on bank deposits. I.R.C. §§ 861(a)(1)(A), 861(c).

36 *See id.* § 163.

37 *Id.* § 871(a)(2). The Foreign Investment in Real Property Tax Act of 1980, Pub. L. No. 96-499, § 1122(a), 94 Stat. 2682 (1980), modified the exemption. The Act adds § 897 to the Internal Revenue Code, providing a 20% minimum tax on U.S. real estate gains realized by nonresident aliens.

38 *See* FINANCIAL ACCOUNTING STANDARDS BOARD, *Accounting for Leases*, in FINANCIAL ACCOUNTING STANDARDS 850-909 (1977); text accompanying notes 448-63 *infra*.

39 *See, e.g.,* T. CLARK, *supra* note 11, at 180-82.

40 *See* text accompanying notes 395-97 *infra*.

41 The criteria for distinguishing between a lease and security interest under Article Nine of the Uniform Commercial Code are discussed in Part VI, section C. *See generally* J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE 877-83 (2d ed. 1980); Coogan, *Leases of Equipment and Some Other Unconventional Security Devices: An Analysis of UCC Section 1-201(37) and Article 9*, 1973 DUKE L.J. 909.

42 The bankruptcy trustee may assume any unexpired lease notwithstanding a clause terminating the lease upon lessee bankruptcy. 11 U.S.C. § 365(e)(1) (1976). As a practical matter, the lessor is denied repossession of the equipment. The trustee has until court confirmation of its plan to cure any lessee default.

The property itself, as distingnished from the leasehold interest, does not become part of the bankrupt's estate. *Id.* § 541(a)(1). This distinction may be of little significance, however, Notwithstanding the incentives for leasing, commercial law may attach disadvantages to equipment ownership, such as liability for personal injuries or property damage caused by the leased property. The financier's choice of a leasing arrangement to achieve one end thus may carry with it other less desirable consequences.

C. *Leverage*

Leverage is a technique used to obtain tax benefits from equipment acquired with borrowed money. Depreciation of the full purchase price is taken into account in calculating taxable income, even if the taxpayer borrows the purchase money and is not liable itself to repay the loan.[43] Leverage adds to the lease transaction a lender from whom the lessor, or "equity participant," borrows money.[44] The lessor benefits from depreciation deductions and investment tax credit on the entire cost of the leased asset, with only a *de minimis* investment of its own capital. Funds borrowed to purchase the equipment normally are secured only by a charge on the equipment, with no personal liability on the borrower. The total tax savings achieved by sheltering income from this or other investments may amount to many times the initial investment.[45]

Until the Economic Recovery Tax Act of 1981[46] established a "safe harbor" for some lessors, the tax benefits of leverage in the United States were limited to corporate entities[47] bearing at least 20% of the risk in

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in the ease of a long-term lease, for although title to the equipment remains with the lessor, the right to repossess cannot be exercised until very late in the equipment's useful life.

43 In 1947, the Supreme Court laid the foundation for leverage in Crane v. Commissioner, 331 U.S. 1 (1947). The *Crane* Court assumed that the amount realized in any property transaction is the gross price of the asset sold, rather than the net proceeds after deduction of a nonrecourse mortgage. 331 U.S. at 11. The corollary of this doctrine is that the property's value forms the taxpayer's basis in the property, permitting full depreciation of the asset cost. *Crane* was amplified in Parker v. Delaney, 186 F.2d 455 (1st Cir. 1950), *cert. denied*, 341 U.S. 926 (1951), in which Judge Magruder's concurrence questioned the depreciation benefits of leverage. 186 F.2d at 459. For a recent note on the *Crane* doctrine, see Weis, *The Crane Rule Updated*, 32 TAX LAW. 289 (1979).

44 Descriptions of leveraged leasing have listed as many as six parties. *See* Fritch, *Leveraged Leasing*, in EQUIPMENT LEASING-LEVERAGED LEASING, *supra* note 15, at 105. There is always one additional party, the government, which contributes through the indirect subsidy of tax credits and accelerated depreciation.

45 For example, assume that equipment costing $100 with a five year useful life generates $40 of depreciation deductions on a double declining balance, plus a $10 investment tax credit. The tax benefit to a lessor in the 50% bracket would be $30 during the year of initial investment. The lessor may have invested only $120 of its own money. Useful illustrations of leveraged leases are provided in D. KIESO & J. WEIGANDT, INTERMEDIATE ACCOUNTING 945-49 (1977), parts of which are reprinted in J. COX, FINANCIAL INFORMATION ACCOUNTING AND THE LAW 673-74 (1980).

46 Pub. L. No. 93-34.

47 I.R.C. § 465, discussed at note 140 *infra*, disallows individuals and small closely-held companies from taking depreciation deductions on equipment financed by unsecured borrowing. Generally, a Subchapter S corporation is unsuitable as a lessor because of the passive

equipment[48] that at the end of the lease term had a residual value of 20% of the equipment's original cost and a remaining useful life of at least one year or 20% of the originally estimated useful life.[49] The 1981 Act created an exception to these standards, making it easier for a leveraged party to obtain the status of a lessor.[50]

D. *Leasing and the Banks*

Although the National Bank Act[51] does not specifically authorize leasing, it empowers banks to exercise "all such incidental powers as shall be necessary to carry on the business of banking . . . ."[52] In 1963, the Comptroller of the Currency issued regulations enabling national banks to enter into finance lease transactions.[53] Likewise, many states have authorized leasing by state-chartered banks.[54] The Federal Reserve Board, under its authority to determine what activities are "closely related to banking,"[55] also has authorized bankholding company affiliates to engage in "leasing personal property."[56] By retaining an equity interest in the equipment financed, the bank qualifies for the tax benefits described above, which may be passed on to the lessee in the form of lower interest rates. Thus, the tax benefits associated with direct ownership of equipment can be obtained, at least in part, through a lease.

Attempts by independent leasing companies to invalidate the Comptroller's regulations permitting bank leasing have failed, and finance leases have been held to be "functionally interchangeable" with secured loans under certain circumstances.[57] Similar reasoning, how-

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income restriction imposed by I.R.C. § 1372(e)(5). *See* Sawyer, *When Will Rental Income Terminate the Subchapter S Election? An Argument in Favor of Abolishing the Passive Income Restriction*, 34 Sw. L.J. 899 (1980).

48 Rev. Proc. 75-21, 1975-1 C.B. 715.

49 *Id.*

50 *See* text accompanying notes 166-72 *infra*.

51 National Bank Act of 1864, ch. 106, 13 Stat. 99 (codified in scattered sections of 12 U.S.C.).

52 12 U.S.C. § 24 (1976).

53 12 C.F.R. § 7.3400 (1981), discussed further at notes 378-83 *infra*. *See also id.* § 7.7376 (permitting subsidiaries of national banks to lease property).

54 *E.g.*, HAWAII REV. STAT. § 403-47.1 (1976); MARYLAND CODE ANNOT. § 3-605(b) (1980); N.Y. BANKING LAW § 98 (McKinney 1971 & Supp. 1980).

55 12 U.S.C. § 1843(c)(8) (1976).

56 12 C.F.R. § 225.4(a)(6) (1981), discussed further at notes 384-87 *infra*.

57 *See* M & M Leasing Corp. v. Seattle First Nat'l Bank, 563 F.2d 1377 (9th Cir. 1977), *cert. denied*, 436 U.S. 956 (1978). The district court had upheld the regulation only as to "open end" leases—those containing a lessee guarantee of a specified residual value at the end of the lease term. 563 F.2d at 1379-80. The Ninth Circuit concluded that any lease might be the equivalent of a loan, depending on the risk associated with the residual value. *Id.* at 1380-81. *See* text accompanying notes 390-91 *infra*.

ever, also has led to the application of usury limits to leases.[58] Banks are thus between Scylla and Charybdis; they must structure leases as the functional equivalent of loans so as to comply with banking regulations, while maintaining their character as true lessors for purposes of tax and usury legislation.[59]

II

NATIONAL STANDARDS FOR LEASE CHARACTERIZATION

To protect the integrity of their tax systems, many industrialized nations have established standards for determining which party to a lease has the economic ownership of the rented property. These standards affect the deductibility of lease payments in calculating the net business income of the equipment user and the availability of depreciation deductions and investment incentives intended to stimulate the purchase of new plant and machinery. Characterization of lease transactions generally follows one of two approaches. The first accepts legal form as determinative of ownership, with special rules covering specific abuses. The second approach looks to a transaction's economic substance, allocating the tax benefits of ownership to the party that bears the risks and rewards of fluctuation in the residual value of the leased asset. Many national systems, including that of the United States, contain elements of both approaches.

A. *Legal Form*

1. Crédit-Bail[60]

In France, a special legal regime governs the tripartite equipment finance lease. *Crédit-bail*, literally translated as "loan-lease," is the statutorily defined term for a tripartite lease in which the financier purchases the equipment from the manufacturer according to the lessee's specifications and grants the lessee an option to acquire the property at a price that takes into account the rentals paid.[61] A 1966 statute designates the

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58 *See, e.g.,* Woods-Tucker Leasing Corp. v. Hutcheson-Ingram Dev. Co., 626 F.2d 401 (5th Cir. 1980), *vacated on other grounds*, 642 F.2d 744 (5th Cir. 1981).

59 *See generally* P. HELLER, HANDBOOK OF FEDERAL BANK HOLDING COMPANY LAW 239-421 (1976); 91 HARV. L. REV. 1347 (1978).

60 The author received helpful comments on the tax aspects of *crédit-bail* from Professor Yves Blaisse of the University of Paris.

61 Law No. 66-455, July 2, 1966. Only licensed financial institutions may engage in *crédit-bail*. These institutions must have their statutory seat (*siège*) in France. Because "inbound" trans-border leasing is not possible, strictly speaking, a foreign financier either must establish a French subsidiary and meet special requirements or conclude an arrangement with a French institution.

The legal and tax aspects of *crédit-bail* are summarized in Gavalda, *Crédit-bail Mobilier: Operation et domaine, Régime juridique, financier et fiscal*, JURISCLASSEUR BANQUE, Fascicule 58 E-financial institution as owner of the leased equipment,[62] a position accepted by tax authorities.[63] Thus, the *crédit-bail* financier depreciates the financed equipment, and may do so on an accelerated basis (*amortissement disgressif*)[64] if the equipment is new. The lessee may deduct rentals even though it acquires an equity in the equipment.[65] Deduction of rentals is thus the same for *crédit-bail* finance agreements and operating leases without purchase options.[66] Real estate *crédit-bail* follows similar rules.[67] Nonstatutory finance leases are referred to as "leasing"; true operating leases are called "*location*."

Although French commercial law has long struggled with the distinction between lease and sale,[68] tax authorities have dealt with artificial leases not by recharacterizing them, but by employing the doctrine of *abus de droit* or "abuse of right."[69] The lessee has abused its right to a deduction when a lease term is abnormally short compared to the length of the equipment's useful life, or when an option price is clearly lower than the residual fair market value. Both circumstances are considered evidence of an attempt to disguise the true nature of the transaction.[70]

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1. On *crédit-bail* generally, *see* E. BEY, *supra* note 15.

Finance leasing that is not *crédit-bail* may be carried on by French and non-French institutions, but without the statutory guarantees as to characterization.

62 Art. 1-1.

63 Doc. Adm. 4, D. 252 [1960 & Supp. 1970] CODE GEN. IMPÔTS arts. 39-1(2), 39(c) (Fr.); *see* Gavalda, *supra* note 61, at 22.

64 *See* D. CREMIEUX-ISRAEL, LEASING ET CRÉDIT-BAIL MOBILIERS: ASPECTS JURIDIQUES COMPTABLES ET FISCAUX 234-35 (1975).

65 [1960 & Supp. 1970] CODE GEN. IMPÔTS arts. 38 & 39-A-1 (Fr.); CREMIEUX-ISRAEL, *supra* note 64, at 220.

66 [1960 & Supp. 1970] CODE GEN. IMPÔTS art. 38 (Fr.); *see* Gavalda, *supra* note 61, at 22.

67 Law of Dec. 24, 1969, art. 64 (Law N. 69.1161).

68 Before 1980, French law did not recoguize the validity of a seller's retained security interest as against third parties. Thus, French commercial law is rich with eases distinguishing between a sale and a lease to determine priority in repayment of claims. See cases collected in V. DALLOZ, RÉPERTOIRE DE DROIT CIVIL (P. Raynaud ed. 1976), Section "Location-Vente."

The law of May 12, 1980, Law No. 80-355, J.O. May 13, 1980, at 1202, amended the bankruptcy law of July 13, 1967, and made a seller's retained security interest enforceable against third parties in case of purchaser's bankruptcy. *See* [1980] RECUEIL DALLOZ SIREY 200; Ohl, *La Clause de Réserve de Propriété Mobilierè Et Son Opposabilité a la Masse En Droit Francais*, [1980] DROIT ET PRATIQUE DU COMMERCE INTERNATIONAL 587; Derrida, *La Clause De Réserve De Propriété et le Droit Des Procédures Collectives*, [1980] RECUEIL DALLOZ SIREY 293.

On the distinction between a lease coupled with a purchase option and an installment sale disguised as a lease, see J. MAZEUD, LECONS DE DROIT CIVIL 200-03, Tome III, Vol. 2, § 923 (5th ed. 1979).

69 CODE GEN. IMPÔTS art. 1649 quinquies B. "Les actes dissumulant la portee veritable d'un contrat ou d'une convention . . . ou deguisant soit une realisation, soit un transfert de beneficies ou de revenue, ou permettant d'eviter soit en totalite, soit en partie, le paiement des taxes . . . ne sont pas opposables a l'administration." *See* Gavalda, *supra* note 61, at 23.

70 The abuse of right doctrine has developed ministerial pronouncement in parliament.

The lessee in such circumstances otherwise would gain tax advantages not permitted to an equipment owner, who is allowed only normal depreciation.[71] Although the authorities might treat such rentals as installments of the sale price,[72] an abuse of right is more likely to result in a fine[73] or loss of deductions in excess of the straight line depreciation allowed the lessor.[74] Tax treatment of the lessor is generally symmetrical with that of the lessee. Depreciation may be taken over the period of the equipment's normal use,[75] which is determined by the trade custom of the lessee;[76] it may not, however, exceed the rent collected.[77] Real estate leasing is subject to a similar abuse of right principle.[78]

Numerous other countries, most notably Belgium, have adopted the French model of a *sui generis* finance lease.[79] *Location-financement*, lit-

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See, e.g., Senate Debates, Oct. 3, 1970, *reprinted in Journal Officiel*, Oct. 3, 1970, at 1425. Other ministerial responses include those made during debates in the National Assembly on Apr. 30, 1965, *reprinted in Journal Officiel*, at 1018, and on Jan. 17, 1970, *reprinted in Journal Officiel*, Q.E. No. 8. 670.

71 D. CREMIEUX-ISRAEL, *supra* note 64, at 21.

72 Ministerial response from debates in the National Assembly on June 8, 1979, *reprinted in Journal Officiel*, at 9386.

73 [1960 & Supp. 1970] CODE GEN. IMPÔTS. For a brief discussion of an accountant's perspective of the abuse of right principle, see Power, *International Leasing*, 6 TAX PLANNING INT'L 41, 43 (1979).

74 *See* Power, *supra* note 73, at 43.

75 [1960 & Supp. 1970] CODE GEN. IMPÔTS, art. 39C & Annex II, art. 30.

76 Judgment of Mar. 21, 1980, Conseil d'Etat, Paris, [1980] Recueil (Décision No. 13,896).

77 [1960 & Supp. 1970] CODE GEN. IMPÔTS, Annex II, art. 31.

78 [1960 & Supp. 1970] CODE GEN. IMPÔTS. Special entities referred to as S.I.C.O.M.I. (Sociétés immobilières pour le commerce et l'industrie), authorized by the Ordinance of Sept. 28, 1967, conduct finance leasing of real estate. *See generally* R. WALTER, *Qu'est-ce que le Leasing?* 41-57 (1973).

When the purchase option price is less than the residual value of the building on the lessor's books, the user is presumed to have taken rapid depreciation in the guise of rental deductions. When the purchase option is exercised, such excess depreciation is "reintegrated" in the lessee's taxable income, normally in an amount by which the present market value exceeds the option price (Loi No. 69. 1161, Dec. 24, 1969). The tax collector scrutinizes short-term leases, which offer the greatest potential for abuse. In French real estate circles, short-term means 15 years. Administrative guidelines are found in the Bull. Off. 4H, April 1970 (B.O.4.H.4.70).

Courts also have had to deal with lease characterization in the context of the transfer tax (*droit de mutation*) imposed on any assigument of business goodwill (*fonds de commerce*). CODE GENERAL DES IMPÔTS, Art. 719. The tax currently is imposed at a rate of 13%. In a case where railroad car leases were assigned by a finance company to a management company, the French tax authorities argued that the leases represented a clientele whose assignment was subject to the transfer tax. Société d'Exploitation Technique de Transports (SETT), decided Nov. 21, 1977, *Cour de cassation*, Case No. 271, 1977 Bulletin des Arrets de La Cour de cassation Civile, section Chambre Commerciale et Financiere, Vol. 2, at 229-30. Holding for the taxpayer the *Cour de cassation* found that the finance company did not have sufficient activity to create business goodwill. One may speculate that the court would have held differently if the contracts had been operating leases rather than passive investment.

79 Brazil is also prominent among those countries that have followed the French model.

erally translated "rental finance," is the Belgian equivalent of *crédit-bail*. A royal decree requires that (1) the equipment must be purchased to the lessee's specifications; (2) the rental term must cover the useful life of the equipment; (3) rentals must be fixed as a function of the equipment's depreciation; and (4) the lessee must have an option to purchase at the equipment's estimated residual value.[80]

In 1976, a royal decree fixed the Belgian accounting treatment for finance leases contracted after January 1, 1980.[81] For purposes of corporate reporting, finance leases are capitalized on the lessee's balance sheet so that the leased property is treated as an asset and the total rental obligation is reported as a long-term liability.[82] Consequently, the balance sheet of the financial institution no longer carries the leased equipment as an asset. The official commentary accompanying the 1976 Belgian accounting decree suggests that finance leases should be capitalized for determination of taxable income as well as for accounting purposes.[83] Although a subsequent circular of the Belgian revenue authorities supports this position,[84] neither legislation nor administrative decree has yet implemented these reforms. In practice, the tax characterization of Belgian finance leasing remains where it was before 1980—lessors depreciate the equipment, and lessees deduct rentals.[85]

2. *Legal Title in the United Kingdom*[86]

In the United Kingdom, the legal form of a lease generally determines which party is entitled to the generous depreciation deductions for capital equipment allowed under British law. If the lessor maintains legal title to the equipment, it retains the tax benefits incident to ownership, even if the lease term spans the equipment's useful life. The existence of a purchase option, however, shifts the depreciation benefits to the lessee.

British tax law provides large depreciation deductions, or "capital

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See Ministerio Das Financas E Do Plano, Decreto-Lei No. 171/79, De 6 Junho 1979, *Boletin de Ministerio de Justica*, Legislaeo 1979 Junho, Suplemento No. 288.

80 Arrêté Royal No. 55, Nov. 10, 1967, Art. 1. *See generally* S. ROBIN, LE LEASING: NOUVELLE TECHNIQUE DE FINANCEMENT (1970).

81 Arrêté Royal, Oct. 8, 1976; CODE DE COMMERCE, livre I, titre X.

82 *Id.* Art. 26. This comment took the form of a "Pre-Decree Report to the King" (*Rapport au Roi Precedent l'Arrêté du 8 Octobre 1976*).

83 "[L]es règles [du present arrêté] seront acceptées par l'administration fiscale pour la détermination de l'assiette taxable . . . ." *Rapport au Roi Precédent l'Arrêté du Octobre 1976*.

84 Administration des Contributions Directes Circulaire du 31 Mars 1978 (Ci. R 17 421/290.379).

85 *See* letter from Maître Hélena DeBacker to William Park (June 23, 1981) (on file at *Cornell Law Review*). Maître DeBacker, a member of the Brussels Bar, specializes in Belgian tax law.

86 The author received helpful comments on the tax aspects of finance leasing in the United Kingdom from Mr. Andrew Curran who practices tax law in London.

allowances," to stimulate investment in new plant and machinery. The lessor may deduct the entire cost of capital goods leased to a British user as "first year allowances."[87] Leases to a non-British user provide "writing down" allowances of 25% of the equipment cost, calculated on a declining balance.[88] If an equipment user does not have sufficient taxable income to benefit fully from these capital allowances, it may arrange to lease the equipment from a lessor that does have sufficient income, with the tax benefit reflected in an implicit finance cost that is lower than that available in a straight loan.[89]

Thus, the United Kingdom allocates depreciation benefits relating to plant and machinery according to a simple rule: Capital allowances go to the lessor in the absence of a purchase option. Although intended originally for hire-purchase contracts with a nominal purchase option price, the rule now has wide application. The Finance Act of 1971 permits a person "carrying on a trade" to claim capital allowances for any equipment supplied under a contract that provides that the user shall or may become the owner.[90] In essence, a purchase option, although not a renewal option, creates an irrebuttable presumption that the lessee will acquire an equity in the property. Ownership by both the lessor and lessee generally are considered incompatible; thus, the lessor cannot depreciate equipment that is subject to a purchase option.[91] Nor is the lessor entitled to any capital allowances if it loses title to the equipment, as when the equipment becomes affixed to realty.

British law contains an anti-abuse provision aimed at sham transactions that are motivated solely by tax considerations. The statute withholds the 100% "first-year allowance" when "it appears . . . with respect to transactions . . . that the sole or main benefit which, but for this sub-paragraph, might have been expected to accrue to the parties or any of them was the obtaining of [accelerated depreciation]."[92] Application of this provision is limited to the assignment of vessels and the sale and leaseback of equipment used in the lessee's business prior to the lease. There is, however, a statutory "first use" exception[93] and a prac-

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87 Finance Act, 1971, c. 68, § 42.

88 *Id.* § 44.

89 The British leasing industry has shown great imagination, British businessmen having even leased their suits. *See* FINANCIAL WEEKLY, June 1, 1979, at 17. The customer's preferred Savile Row tailor makes a suit that is rented to its wearer; sale to the executive eventually may be made at fair market value, which would be minimal for a second-hand suit. In the United States, the IRS recently has held such clothing transactions to be sales. Rev. Rul. 80-322, 1980-2 I.R.B. 36.

90 Finance Act, 1971, c. 68, § 45(1).

91 *See* Clark, *supra* note 18.

92 Finance Act, 1971, c. 68, § 49, sched. 8(3).

93 Finance Act, 1972, c. 41, § 68(5) & (7).

tice of administrative indulgence.[94]

Leases of equipment manufactured and used outside the United Kingdom—the so-called "foreign to foreign" leases—are subject to special scrutiny and normally do not receive the full 100% first year allowance, but only the 25% "writing-down" allowance.[95] Because the mechanism for recognizing "foreign to foreign" leases recently has undergone several changes, some history may help in understanding existing provisions.

Until the abolition of exchange controls in 1979, the Bank of England cooperated with the Inland Revenue to police the export of 100% first year allowances to non-U.K. residents. To acquire equipment from a foreign manufacturer, a British lessor usually had to pay the cost in foreign currency, necessitating specific exchange control approval.[96] The Bank of England normally referred these leases to Inland Revenue, which required the lessor to renounce part of the depreciation allowance. Only upon the lessor's disclaimer of the 100% first year allowance would the Bank of England approve the sending of payments abroad by a British resident. This denial of 100% first year allowances applied only to finance leases. To distinguish between true leases and loans, the Bank of England compared the lease term to the equipment's useful life. The lease was deemed merely a finance device if it extended beyond two-thirds of the equipment's estimated useful life or if there was an option to extend the lease other than at a fair market rate. If service or maintenance was the lessor's responsibility, the transaction was deemed a true lease.[97]

Abolition of exchange controls by the Thatcher government created the need for a new mechanism to prevent tax incentives from benefiting "foreign to foreign" finance leasing.[98] From October 1979 through May 1980, a transitional statute restricted capital allowances to 25% in the case of finance leases of foreign-manufactured equipment to non-British residents without a trade or business in the United King-

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94 *See* Clark, *supra* note 18, at 286.

95 Finance Act, 1971, c. 68, § 44; Finance Act, 1980, c. 48, § 72, sched. 12. For example, a British financier may purchase computer equipment from a French manufacturer for lease to a French user. Such a "foreign to foreign" lease provides neither jobs nor increased productivity for British industry. This practice has been particularly prevalent in shipping, with members of an affiliated group using tax allowances of other members. *See* A. PARKER, EXCHANGE CONTROL 250 (3d ed. 1978).

96 *See* A. PARKER, *supra* note 95, at 250-55. The United Kingdom abolished its exchange controls as of Oct. 23, 1979.

97 *Id.*

98 For a summary of the early 1980 legislative proposals, see *International Bureau of Fiscal Documentation*, 20 EUROPEAN TAX. 33-35 (1980); Ring, *Finance Bill Notes: Capital Allowances*, 1980 BRITISH TAX REV. 133, 151-56.

dom.[99] This restriction applied only to equipment supplied under a "finance lease," which was defined as a lease (1) with a term of at least 75% of the asset's useful life; (2) that provided that the equipment's residual resale value would accrue to the lessee; or (3) that contained a renewal option at less than a fair market rental. This definition focuses on whether any residual value will return to the lessor at the end of the lease term. These transitional measures are thus of particular significance to any study of leasing, in view of their attempt to link economic ownership with residual value.

As ultimately enacted, the British anti-abuse measure[100] permits a capital allowance for only short-term rentals or for leases to British businesses. The statute provides 100% first year allowances only for plant or machinery used for a "qualifying purpose"[101]—where "circumstances are such that a first-year allowance could have been made to the lessee if he had bought the machinery or plant,"[102] or the equipment is used for "short-term leasing."[103] Short-term generally means less than thirty consecutive days to the same person.[104] To prevent relief from the rule by brief "off lease" periods, the Act excludes from short-term leasing any use that would normally total ninety days or more per year to the same person.[105] If, during any two of the first four years of its useful life, the equipment will be leased by taxpayers who would themselves have claimed first year allowances, then leases of up to a year will still qualify for full allowances.[106] The 25% "writing down" allowance is still permitted for finance leasing, thereby increasing London's attractiveness as a center for banking and finance.

B. *Economic Substance*

National tax systems that distinguish between leases and installment sales or loans according to the economic substance of a transaction generally focus on the allocation of risks and benefits associated with the parties' interests in the residual value of the leased assets. Property, whether real or personal, is viewed as a bundle of legal rights attached to an asset.[107] In a classic lease, these rights are transferred from one

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99 Finance Act, 1980, c. 48, § 72, sched. 12.
100 Finance Act, 1980, c. 48, § 64.
101 *Id.* § 64(1).
102 *Id.* § 64(2)(a).
103 *Id.* § 64(2)(b). The short-term leasing may be carried on by either the lessor or lessee. *Id.* § 64(2)(c).
104 *Id.* § 64(3)(a).
105 *Id.*
106 *Id.* §§ 64(3)(b), 64(8).
107 The Supreme Court has discussed the concept of property ownership as a bundle of legally protected interests. *See, e.g.,* United States v. Willow River Power Co., 324 U.S. 499, 502-03 (1945) (owner of dam denied compensation under fifth amendment for reduction in

party to another for a limited period. In a sale, however, they are transferred forever. In some cases, the parties may label a transaction a lease although it has the economic substance of a sale. For instance, the parties may agree to a transfer for a period of time equal to the useful life of the asset. Similarly, at the outset of the transaction, they may fix a purchase option at a price so low that no reasonable businessman would fail to exercise it at the end of the lease term. In both instances, the user will possess all of the rights worth having; the owner will have little economic interest in an asset that will be either worthless or purchased by the lessee for a nominal sum.

Economic ownership implies retention of an interest in an asset that may provide a significant gain or loss at the end of the lease. When equipment is leased to one user for its entire useful life, or is certain to be acquired by the user, the lessor has neither the benefits nor the risks attendant to fluctuations in the equipment's residual market value. Therefore, at the heart of the complex characterization standards applied in nations such as West Germany and the United States is a preoccupation with identifying the party with an interest in the asset at the end of the lease term.

1. *West Germany*[108]

In 1970, shortly before the issuance of the Finance Ministry leasing rulings discussed below, the Supreme Tax Court of West Germany (*Bundesfinanzhof*) held that ownership for tax purposes could be imputed to a lessee when leasing is merely a means of financing the acquisition of capital goods.[109] The decision concerned a five year lease of supermarket fixtures that were ordered according to the lessee's specifications. During the lease term, the lessee agreed to pay total rental equal to the lessor's cost plus interest. At the end of the lease term, the lessee would have an option to renew the lease indefinitely. The user would thereby deduct the cost of the fixtures over five years, rather than over their useful life. Because the lessee could force an extension of the lease, it could retain possession of the assets for the duration of their useful life. The court therefore concluded that the transaction was a sale rather than a lease.

hydroelectric capacity resulting from navigation improvement); Penn Cent. Transp. Co. v. New York City, 438 U.S. 104 (1978) (designation of Grand Central Terminal as city landmark, thus preventing lease of airspace, not a taking of property). For a brief survey of the relationship between legal rights and the institution of property, see J. CRIBBET, PRINCIPLES OF THE LAW OF PROPERTY 4-7 (2d ed. 1975).

108 The author received helpful comments on the tax aspects of finance leasing in West Germany from Dr. Volker Fuchs and Dr. Bodo Schlosshan, both practicing law in Frankfurt.

109 Judgment of Jan. 26, 1970, BFHG, IVR 144/66, [1970] Bundessteuerblatt, Teil II, 264.

Following this decision, the Federal Finance Ministry released its basic ruling concerning the tax consequences of finance leasing.[110] The ruling applies only to full payout leases in which the rental amount paid over a noncancelable term enables the lessor to recover the cost of acquiring or producing the goods plus a finance charge. Under the ruling, such an agreement is deemed a true lease only if the base term is from 40% to 90% of the equipment's useful life, and if any option to purehase the equipment or renew the lease is at a fair market price.[111]

The logic of the 90% upper limit on the lease term is obvious; relinquishment of dominion over equipment for more than nine-tenths of its life effectively eliminates the lessor's interest in its residual value. The rationale of the 40% lower limit is perhaps less evident.[112] As noted above, the ruling applies only to full payout leases, where rentals cover all of the lessor's costs plus a finance charge. A reasonable lessee will be unwilling to cover all costs plus interest in exchange for use of the equipment for a period less than 40% of the asset's life. According to the German view of human nature, the lessee will conclude such a deal only if it expects to acquire the property at the end of the lease term pursuant to a tacit understanding with the lessor.[113]

Even if the base term of the lease lies between the permissible limits, West German law will not characterize the transaction as a lease unless the option to purchase or renew the rental is at a price at least equal to the fair market value or book value of the equipment.[114] Because it will have little value in the hands of another lessee, equipment made to a lessee's specifications is deemed to be owned by the lessee.[115] The financier is assumed to have closed out any interest in the residual value of such equipment.[116]

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110 April 19, 1971, [1971] BGB 1, at 264.

111 *Id.* Real estate leases are subject to a similar 40-90 test by a subsequent ruling that is applicable specifically to transactions involving immovables (*unbewegliche Wirtschaftsgüter*). March 21, 1972, [1972] Bundessteuerblatt, Teil I, 188.

112 For an Austrian comment on the questionable rationale underlying the 40% requirement, see C. STOLL, LEASING: STEUERRECHTLICHE BEURTEILUNGSGRUNDSÄTZE 46 n.72 (Vienna 1973).

113 See comment by George Vorbrugg in 19 EUROPEAN TAX. 98 (1979).

114 Book value is determined by straight line depreciation (*lineare Absetzung für Abnutzung*).

115 April 19, 1971, [1971] BGB 1, Articles III(2) and III(3).

116 A 1975 German ruling dcaling with leases in which the lessee bcars the loss resulting from a decline in the equipment's residual value, but in which the financier benefits from any increase in the equipment's value, presents an interesting aspect of West German lease characterization. Ruling of Dec. 22, 1975, BFM—Schrieben—IV B 25 2170—161/75—Der Betrieb, Jan. 30, 1976, at 172. Three hypothetical leases are presented all of which are "part payout" in that total rentals are less than the acquisition and finance cost of the equipment.

In the first seenario, the lessee has an obligation to purchase the equipment at the end of the lease term at a predetermined price, but no purchase option exists. The lessor's right to force purchase places the risk of a decrease in the equipment's value on the lessee, because the

2. *United States*

The present panoply of tax incentives to investment in plant and machinery gives owner status significant advantages in the United States,[117] particularly since the adoption of the "Accelerated Cost Recovery System."[118] Equipment users may be unable to take full advantage of these incentives, however, because their deductions and credits may exceed their income or their tax liability. If the equipment financier is in a better position than the equipment user to take advantage of these incentives, parties to an equipment financing may be tempted to recast the transaction as a lease, thus allocating the investment incentives to the financier and sharing the benefit in the form of lower finance costs for the user. The gains to the financier and equipment user, of course, represent corresponding losses to the government.

The IRS and the courts have struggled to preserve the integrity of the tax system by recharacterizing many purported leases as loans or installment sales. Generally, the judicial standards exhibit greater flexibility and subjectivity than is reflected in the administrative tests.[119]

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lessor will undoubtedly exercise the put. The lessor may reap the increase in market value, however, by selling the equipment itself.

The second scenario assumes that when the lessor sells the equipment to a third party at the end of the lease, the lessee must reimburse any deficiency between the sale price and the financier's costs. Any sales profit realized if the sales price exceeds the amortized residual value is split between the financier and user, with the financier receiving 25% and the user the remaining 75% of the profit.

In the third scenario, the lessee may cancel the lease after a base term of at least 40% of the equipment's life, but must pay a termination fee equal to the difference between the equipment's cost and the rents already paid. Credit is given for 90% of any proceeds realized on sale. The lessee pays any deficiency between the sales proceeds and the amount necessary (when added to rentals) to meet the lessor's acquisition and finance cost. A decline in residual value thus is borne by the lessee, and any increase accrues to the financier.

In each situation, the lessee guarantees that the lessor will bear no greater risk than in a full payout lease. Although bearing no risk of downward fluctuation, the lessor in all three situations could reap part of any appreciation. This potential benefit is considered sufficient interest in the property to justify a finding of ownership. The ruling provides assurance that transactions similar to any of the three scenarios will be considered trne leases, thus allowing the lessor to claim depreciation.

117 Without investment incentives, an equipment user with a choice between being an owner or a renter generally would obtain a greater tax advantage from lessee status, because deduction of rentals from gross income would provide more benefit than would depreciation.

As late as 1964, one commentator concluded that the "primary tax consideration [in leasing] is whether the rental payments are fully deductible by the lessee as business expenses." Note, *Leases: Security Interests: Uniform Commercial Code*, 49 CORNELL L.Q. 672, 674 (1964). Lessee status also would be advantageous if the asset were nondepreciable property like land. *See* Rev. Rul. 55-540, 1955-2 C.B. 39, § 3.02.

118 The "Accelerated Cost Recovery System" (ACRS) permits depreciation of equipment placed in service after 1980 over a period of three, five, ten, or fifteen years, depending on the type of property. Under ACRS, statutory percentages are applied to the unadjusted basis of the property in order to determine the annual depreciation deduction. *See* Economic Recovery Tax Act, Pub. L. No. 97-34, § 201(a), signed Aug. 13, 1981 (adding I.R.C. § 168).

119 Both judicial and administrative standards for lease characterization are interpreta-

To facilitate the use of tax incentives for investment in new equipment, the Economic Recovery Tax Act of 1981 provides a "safe harbor" that permits parties to an equipment financing a limited right to characterize a transaction as a lease for tax purposes. The safe harbor, applicable only to corporate lessors of a limited class of property,[120] requires that the lease term not exceed 90% of the equipment's useful life,[121] and that the lessor's investment in the equipment be at least 10% of its adjusted basis.[122]

Although the 1981 Act moves the United States characterization standards closer to the approach that accepts legal form as determinative of ownership, the economic substance of a transaction remains a significant element of the lease characterization process. The safe harbor standards themselves reflect a certain measure of economic substance by requiring a limited lease term with respect to the equipment's life and a 10% minimum investment. Moreover, the administrative guidelines and judicial decisions heretofore applicable still will apply if the parties do not or cannot elect the safe harbor. Therefore, both a foreign financier and an American equipment user still may depreciate

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tions of I.R.C. §§ 162(a) and 167, which respectively allow deduction of rentals for, and depreciation of, property used in a trade or business.

120 "Section 38 property" includes, *inter alia*:

> (A) tangible personal property (other than an air conditioning or heating unit), or
>
> (B) other tangible property (not including a building and its structural components) but only if such property—
>
> > (i) is used as an integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services, or
> >
> > (ii) constitutes a research facility used in connection with any of the activities referred to in clause (i), or
> >
> > (iii) constitutes a facility used in connection with any of the activities referred to in clause (i) for the bulk storage of fungible commodities (including commodities in a liquid or gaseous state).

I.R.C. § 48(a)(1).

121 The lease may extend to 150% of the ADR Class Life if this is longer. I.R.C. §§ 167(m), 168(f)(8)(B)(iii)(II).

122 For a fuller discussion of the safe harbor provision, see text accompanying notes 166-74 *infra*. The special lease rules apply to transactions entered into after Dec. 31, 1980.

The new Treasury regulations give the example of a company that normally would pay $1 million for equipment but decides to lease instead of buy. The prospective lessor purchases the equipment for $200,000 eash and an $800,000 nonrecourse note payable over nine years in equal installments of principal and interest equal to $168,000. The rentals payable by the equipment user are $168,000, exactly equal to the lessor's installments on the loan. The equipment user benefits from such a transaction by obtaining the equipment at a discount. The lessor, during the first year alone, obtains tax benefits that far exceed the cash payment for the equipment. Treas. Reg. § 5c, 168(f)(8)-1(e), Example No. 1. Even if the lease provides an option to purchase the equipment for $1 at the end of the lease term, the transaction still would qualify as a lease if the parties so elected. *Id.*, Example No. 3.

the equipment in a "double dip" lease[123] as long as the parties do not invoke the safe harbor rules. In addition, the safe harbor provisions apply only to so-called "new section 38 property,"[124] cannot be elected if the lessor is an individual, and are not available if the lessee is a foreign person not using the leased property in a trade or business.

a. *The Administrative Standards*. In 1955, the IRS moved to prevent the artificial shift of deductions by issuing a Revenue Ruling characterizing five categories of leases.[125] The Ruling states that characterization is a function of the parties' intent, which is evidenced by the circumstances of each case.[126] The relevant factors in determining intent fall into three general categories:[127] first, whether the lessee overtly acquires an equity interest in the equipment, either immediately or upon payment of a stated amount of rentals;[128] second, whether the rentals are extraordinarily high when compared with fair market rental, evidencing the user's expectation of covertly deducting the equipment's purchase price as rentals;[129] and finally, if part of the rental is explicitly designated as "interest" or is readily recognizable as such.[130]

In a Revenue Procedure issued twenty years after the Ruling, the IRS set out the guidelines that it will use for advance rulings to determine whether leveraged transactions are true leases.[131] The gnidelines, albeit complicated, are intended to ensure that technicalities do not determine tax consequences and that the tax consequences of an agreement fiow from its substance rather than from its label.

The rule of thumb contained in the guidelines is similar to that followed by lessors prior to 1975[132] and is based on the premise that the

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123 *See* text accompanying notes 282-85 *infra* (description of U.K.-U.S. "double dip"). If the lease term covers all of the equipment's useful life, for example, or contains renewal options at a nominal rental, the U.S. equipment user still should be able to claim the tax incidents of ownership of the equipment even though the U.K. lessor does so as well.

124 *See* note 120 *supra*.

125 Rev. Rul. 55-540, 1955-2 C.B. 39.

126 *Id.* § 4.01.

127 In fact, six overlapping factors are listed, but a tripartite classification is more useful.

128 Rev. Rul. 55-540, 1955-2 C.B. 39, § 4.01(a), (b).

129 *Id.* § 4.01(c), (d), (e). Payments that cover the total cost of the equipment plus interest, or that are combined with a purchase option at less than the fair market value, indicate artificially high rentals.

130 *Id.* § 4.01(f).

131 Rev. Proc. 75-21, 1975-1 C.B. 715, as modified by Rev. Proc. 81-71 (Dec. 28, 1981) (takes into account I.R.C. § 168(f)(8) elections).

132 *See* Coogan, *supra* note 41, at 967. The emphasis on risk of fluctuation in residual value has led practitioners to advise that at least two years or 20% of the equipment's useful life and 15% of its original cost remain at the end of the lease term. *Id.*

Several practitioners' checklists of factors that distinguish a true lease from a conditional sale are summarized in R. PRITCHARD & T. HINDELANG, *supra* note 15, at 13-14; Wilson, *Federal Income Tax Considerations In Long-Term Equipment Leasing*, 1 WHITTIER L. REV. 129, 140-46 (1979). Practitioncrs generally advise financiers and equipment users that the following circumstances are indicia of an installment sale: (1) user guarantees to pay rent regardless of future performance of the equipment—the so-called "hell or high water clause"; (2) user incidents of ownership include the risks and benefits of fluctuations in residual value. In other words, one does not possess ownership rights in property if it will be used exclusively by another, either because of the length of the lease or because there are options that as a practical matter are certain to be exercised. The guidelines require that the lessor have a minimum unconditional "at risk investment" from the beginning to the end of the lease term.[133] At least 20% of the equipment's cost must be financed by the lessor's own money,[134] and the lessor's investment must "remain equal to at least 20 percent of the cost of the property at all times throughout the entire lease term."[135] In addition, at the end of the lease term the equipment must retain the longer of one year or 20% of its useful life, and at least 20% of its original cost.[136] In other words, the lease term may never exceed the equipment's useful life, and the lessor's equity in the equipment's residual value must be at least one-fifth of the equipment's cost. The lessee may not invest in the property through loans or guarantees.[137] Furthermore, the transaction must result in a profit for the lessor that is independent of tax benefits;[138] if the only benefit to the lessor is a tax deduction or credit, the IRS will assume that the transaction is a sham[139] for purposes of advance rulings.[140]

b. *The Judicial Approach*. Judicial standards for lease characterization generally have been more subjective and beneficial to the taxpayer than those of the IRS. Although courts consider objective criteria in determining the true nature of the transaction,[141] they have stretched the judicial imagination to look beyond mathematical ratios of cost to rentals and lease term to useful life. Courts will attempt to ascertain the

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payment of rentals equal to a relatively high portion of the equipment cost for a relatively short period; (3) user right to purchase equipment or renew the lease at less than fair market value. *Id.*

133 Rev. Proc. 75-21, 1975-1 C.B. 715, § 4(1)(A).

134 Borrowings on which the lessor is personally liable are included in the lessor's equity. *Id.* § 4.

135 *Id.* § 4(1)(B).

136 *Id.* § 4(1)(C).

137 *Id.* § 4(5).

138 *Id.* § 4(6).

139 *Id.* § 4. *See* Knetsch v. United States, 364 U.S. 361 (1960).

140 The at risk provisions of the guidelines comport with the statutory prohibition against individuals and closely held corporations taking depreciation deductions in excess of their own investments, in either costs or borrowings on which the lessor is personally liable. *See* I.R.C. § 465. These statutory requirements do not apply to "personal holding companies" (defined in I.R.C. § 542) that are "actively engaged in equipment leasing." *Id.* § 465(c)(4). Thus, leverage leasing by some corporate lessors still may yield accelerated depreciation deductions that include unsecured borrowing.

141 For a recent case that surveys judicial decisions distinguishing "sale" from "lease" for tax purposes, see Calbom v. Commissioner, 41 T.C.M. (CCH) 1009, 1013-15 (Feb. 26, 1981).

intent of the parties at the time of the execution of the contract.[142] Judicial decisions emphasize that a valid business purpose will cover a multitude of sins; thus, courts will conclude that a transaction is a lease if the business bargain is not patently inconsistent with traditional arrangements between lessors and lessees.[143]

The recent Supreme Court case of *Frank Lyon Co. v. United States*[144] illustrates the emphasis that courts place on business purpose in their approach to lease characterization. An Arkansas bank built, sold, and leased back its office building because federal and state regulations prohibited it from carrying the long-term mortgage on the building on its balance sheet.[145] The ground was leased to the Frank Lyon Company for a term of seventy-five years.[146] Frank Lyon Company purchased the building as it was being built and leased it back to the bank with quarterly rentals exactly equal to Lyon's mortgage payments.[147] The bank leased the building for twenty-five years with options to renew for forty more years; it could also repurchase the building after eleven years.[148] The building leaseback thus potentially covered sixty-five of the seventy-five years of the ground lease, leaving ten years during which the building could be used by a lessee other than the bank. Denying the lessor's depreciation deductions, the IRS considered the lessor merely a conduit between the bank and the project's ultimate financier, a life insurance company.[149]

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142 *See* Breece Veneer & Panel Co. v. Commissioner, 232 F.2d 319, 323 (7th Cir. 1956), *rev'g* 22 T.C. 1386 (1954) (payments for use of buildings, grounds, and equipment by plywood manufacturer for five years at $20,000 per year, with various purchase options held to be deductible as rental payments).

Several kinds of "intent" may be relevant. If parties stand to increase their profit by entering into a lease rather than a sale, then a lease clearly is intended on one level of language. The substantive terms of the transaction, however, may appear inconsistent with the traditional business bargains struck between owners and users of land or equipment. It is this objective intent that is determinative for characterization. *See, e.g., id.* at 323.

143 *Cf.* Rev. Proc. 75-21, 1975-1 C.B. 715 (discussed in text accompanying notes 131-40 *supra*).

144 435 U.S. 561 (1978). For a critieal analysis of the *Frank Lyon* case, see Wolfman, *The Supreme Court in the* Lyon*'s Den: A Failure of Judicial Process*, 66 CORNELL L. REV. 1075 (1981).

145 Federal and state statutes required the bank to obtain permission from both the Federal Reserve System and the Arkansas State Banking Department for any investment in banking premises if the cost exceeded the bank's eapital stock or 40% of stock and surplus. 12 U.S.C. § 371d (1976); 12 C.F.R. § 265.2(f)(7) (1981); ARK. STAT. ANN. § 67-547.1 (Supp. 1977). The Federal Reserve had advised the bank that it would not authorize such an investment.

146 The actual length of the ground lease was 76 years and 7 months. The first 19 months covered the estimated construction period. 435 U.S. at 565.

147 The cost of the building was approximately $7,640,000, all but $500,000 of which Frank Lyon Company borrowed from New York Life Insurance Company. *Id.*

148 It was only upon exercise of the repurchase option that Lyon would get its $500,000 plus interest returned. *Id.* at 565-68.

149 The IRS also denied the deduction for the interest paid to New York Life. *Id.* at 568-69.

The Supreme Court disagreed, holding that the lessor was indeed the building's owner for tax purposes. Writing for the majority, Justice Blackmun stressed the not insubstantial period during which Lyon had full use of the building, as well as the non-tax reasons—the banking regulations—that influenced the transaction's complex structure. The penultimate paragraph of Justice Blackmun's opinion states:

> [W]here, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.[150]

The elements that may influence courts[151] include the estimated useful-life/rental-term ratio,[152] residual value,[153] the value of purchase and renewal options,[154] insurance and maintenance obligations,[155] and guarantees protecting the lessor against a downward fluctuation in the equipment's value.[156] Cases that characterize transactions as purchases have focused on the existence of nominal purchase options,[157] options at

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150 *Id.* at 583-84. In Hilton v. Commissioner, 74 T.C. 305, 346 (1980), the court stated, "[I]mplicit in the [*Lyon*] Court's opinion is the acceptance of the proposition . . . that the seller-lessee's financing requirements may be a valid business purpose to support a sale-leaseback transaction for tax purposes."

151 For a survey of recent cases dealing with tax characterization of leveraged leases, see P.L.I., EQUIPMENT LEASING 287-304 (1979); Wilson, *supra* note 132; Comment, *Leveraged Leasing: I.R.S. Versus the Courts*, 12 CREIGHTON L. REV. 1133 (1979).

152 *See* Home News Publishing Co. v. Commissioner, 28 T.C.M. (CCH) 834 (1969) (lease term of 39 months with a 5 year renewal option; court deemed useful life "longer than" 39 months and held the transaction a sale); Judson Mills v. Commissioner, 11 T.C. 25 (1948) (lease terms of 7, 5, and 4½ years, with useful lives of 12-15, 12-16, and 12-16 years respectively; court held each a sale).

153 *See* Mt. Mansfield Television, Inc. v. United States, 239 F. Supp. 539 (D. Vt. 1964), *aff'd*, 342 F.2d 994 (2d Cir.), *cert. denied*, 382 U.S. 818 (1965); Home News Publishing Co. v. Commissioner, 28 T.C.M. (CCH) 834 (1969).

154 *See* M & W Gear Co. v. Commissioner, 446 F.2d 841 (7th Cir. 1971); Estate of Starr v. Commissioner, 274 F.2d 294 (9th Cir. 1959); Beus v. Commissioner, 261 F.2d 176 (9th Cir. 1958); Home News Publishing Co. v. Commissioner, 28 T.C.M. (CCH) 834 (1969); Judson Mills v. Commissioner, 11 T.C. 25 (1948).

155 The following cases consider maintenance and insurance obligations as relevant, although not determinative, factors: Sun Oil Co. v. Commissioner, 562 F.2d 258 (3d Cir. 1977), *cert. denied*, 436 U.S. 944 (1978); M & W Gear Co. v. Commissioner, 446 F.2d 841 (7th Cir. 1971); Home News Publishing Co. v. Commissioner, 28 T.C.M. (CCH) 834 (1969); Judson Mills v. Commissioner, 11 T.C. 25 (1948).

156 If the sum of the rental payments and option price is equivalent to the fair market value of the leasehold, the transaction is essentially identieal to an installment sale. *See* M & W Gear Co. v. Commissioner, 446 F.2d 841 (7th Cir. 1971); 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). *Cf.* Estate of Stundon v. Commissioner, 29 T.C.M. (CCH) 62 (1970); Home News Publishing Co. v. Commissioner, 28 T.C.M. (CCH) 834 (1969); WBSR, Inc. v. Commissioner, 30 T.C. 747 (1958).

157 See, *e.g.*, Oesterreich v. Commissioner, 226 F.2d 798 (9th Cir. 1955), which involved a

less than fair market value,[158] or options taking into account rents paid.[159] Also relevant to finding a sale is the relation of the rental period to the property's useful life.[160] Courts occasionally labor through the mathematics of adding rents and purchase options to find that they equal equipment cost,[161] but such results are not always fatal to a claim that the transaction is a lease.[162] Non-arithmetic factors, such as the

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lease agreement for three adjoining plots of land with a total rental of $679,380 for a period of 67 years and 8 months beginning September 1, 1929. The rental schedule provided for annual rents of $7,500 for the first 10 years, $12,000 per year for the next 18 years, and then progressively smaller rents for the next 10 years leveling off at $7,500 in the 68th year. At the end of the lease term, the lessee could exercise an option to purchase for only $10. The Ninth Circuit reversed the Tax Court and held the transaction a sale because the substance of the agreement determined the true intent of the parties, which was to pass title to the lessees. There was no question that the option would be exercised.

158 *See, e.g.,* Home News Publishing Co. v. Commissioner, 28 T.C.M. (CCH) 834 (1969). Home News entered into a 39 month agreement with Equilease in the form of a lease of recording equipment, with $835.68 as pre-paid rent for the final three months of the term. The monthly rent was $278.56. A rider attached to the lease provided an option for renewing the agreement for 5 years at a rental of $180.30 per year as well as an option to purchase the equipment for $901.50 less 50% of the renewal rentals paid at the time the option was exercised. The lessee assumed the risk of loss and taxes. *Id.* at 837. The Commissioner and Tax Court, agreeing that the terms of the lease provided for the taxpayer to have clear title to the equipment at the end of the 39 months, concluded that the transaction was a sale.

In M & W Gear Co. v. Commissioner, 446 F.2d 841 (7th Cir. 1971), M & W Gear leased a farm for a five-year period for an annual rental of $50,660. At the end of the five-year period, the lessee could exercise an option to purchase for $342,700 less any monies paid under the lease. The lessee did in fact exercise the purchase option. The Tax Court determined that the transaction was a sale and therefore disallowed rental deductions for the years 1964 and 1965. The Seventh Circuit affirmed, relying upon the convenient and coincidental matching of rental payments plus option with the original intended sale price of $342,700.

159 See, *e.g.,* Sun Oil Co. v. Commissioner, 562 F.2d 258 (3d Cir. 1977), *cert. denied,* 436 U.S. 944 (1978) which involved a sale/leaseback with a tax-exempt pension trust covering about 320 service station sites. All leases contained options to repurchase the sites. Simultaneous with the sale, Sun agreed to lease the properties for a primary term of 25 years with rentals sufficient to enable the pension trust to amortize its investment and receive interest. The leases also contained an option exercisable by the lessee to renew the lease for additional terms up to an aggregate of 65 years at annual rentals based on percentages of the purchase price of the land. The Third Circuit, concluding that the transaction was a sale, found that the rentals were a return of the pension trust's advances plus interest. The rentals did not reflect the market values of the property. Sun Oil retained benefits, binders, and risks that were similar to ownership, and the leases bore marked similarities to debt financing. Furthermore, rents had no connection with the economic value of the property; rather, they were related to a fixed interest return on the pension trust's advances.

160 See, *e.g.,* Estate of Starr v. Commissioner, 274 F.2d 294 (1959), in which the taxpayer leased a sprinkler system for its plant. Normal selling price was $4,960; rentals were $1,240 per year for five years, renewable for an annual rental of $32, which was essentially a maintenance and upkeep cost. The $1,240 was held a capital expenditure and not deductible rent.

161 *See, e.g.,* Haggard v. Commissioner, 241 F.2d 288 (9th Cir. 1956). Haggard leased a farm. His rentals were $10,000 in 1948, $12,000 in 1949, and $2,000 for an option to purchase the farm for $24,000. This adds up to $48,000, the price at which the lessor had previously negotiated a sale that had fallen through.

162 See, *e.g.,* WBSR, Inc. v. Commissioner, 30 T.C. 747 (1958), which involved a lease of a radio station for one year for $4,000 with an option to purchase for $44,000 less any rents paid. In July 1950, the lessee paid $2,000 in rent, and in April 1951 after operating condi-

parties' prior attempt to negotiate an outright sale, may also cast doubt on the genuineness of the lease.[163] On the other hand, lack of certainty that the users ultimately will purchase the leased property may be relevant in determining that a true lease exists,[164] especially when the IRS challenges entire portfolios of leasing companies.[165]

c. *The Economic Recovery Tax Act.*[166] The Economic Recovery Tax Act of 1981 reduces the rigors of the administrative and judicial characterization standards outlined above. Recognizing that the Accelerated Cost Recovery System,[167] which is intended to stimulate investment in capital equipment, might be of limited advantage to an equipment user that is unable to absorb the available deductions and credits,[168] Congress created statutory exceptions to the normal lease characterization standards. To render the capital recovery allowances more widely usable by companies with greater potential tax burdens, Congress facilitated the transfer of these allowances by making lease characterization more flexible.

Under certain circumstances, an equipment finance lease may be treated as a lease for income tax purposes even if it fails to meet the conventional characterization standards. This "safe harbor" applies to the financing of so-called "new section 38 property," which includes facilities such as plant, machinery, and new tangible personalty.[169] The

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tions improved, the lessee exercised the purchase option. The court held that the parties had intended a lease, and the $2,000 originally paid as rent was properly deductible as such.

163 In Beus v. Commissioner, 261 F.2d 176 (9th Cir. 1958), the lessee leased a farm for two years for $15,000, with an option to purchase for $31,000. The property's sale price had been listed as $47,500. On several occasions while making out loan applications, the lessee stated that he had purchased the property, even before exercising the option. The court found that the farm had been originally for sale and that the seller had indicated that he did not want to lease, that the original agreement was altered in form but not in substance, and that the lessees intended to acquire an equity interest in the property.

164 *See, e.g.,* Cal-Maine Foods, Inc. v. Commissioner, 36 T.C.M. (CCH) 383 (1977); WBSR, Inc. v. Commissioner, 30 T.C. 747 (1958); Calcasieu Paper Co. v. Commissioner, 12 T.C.M. (CCH) 74 (1953). See also instruction to jury in Tomlinson v. United States, 60-2 U.S. Tax Cas. (CCH) ¶ 9578 (E.D. Ark. 1960).

165 Judicial willingness to find reasons why a lessee might not purchase is particularly evident in two recent cases in which the IRS challenged the entire lease portfolios of finance companies. In Lockhart Leasing Co. v. United States, 446 F.2d 269 (10th Cir. 1971), the leases contained purchase options at 10% of the original cost. In Northwest Acceptance Corp. v. Commissioner, 500 F.2d 1222 (9th Cir. 1974), the options varied from 10% to 50% of the equipment's original cost. Both challenges failed despite the existence of some transactions that would clearly be termed sales, including contracts that contained an equipment dealer's guarantee to repurchase the equipment. Although acknowledging these guarantees, the Ninth Circuit in *Northwest* concluded that the clearly erroneous standard of review precluded it from reversing the Tax Court.

166 Pub. L. No. 97-34 (1981). Serious proposals have been made for repeal of I.R.C. § 168(f)(8). *See* N.Y. Times, Feb. 20, 1982, at A1, col. 4.

167 *See* note 118 *supra*; I.R.C. § 168.

168 *See* SENATE FINANCE COMM., S. REP. NO. 144, 97th Cong., 1st Sess. 61-63 (1981). *See also* H.R. CONF. REP. NO. 215, 97th Cong., 1st Sess. 217-18 (1981).

169 The leasing provisions apply to "qualified lease property," which is defined to include

lessor must have a minimum investment of at least 10% of the property's adjusted basis, and the lease must have a term of no more than 90% of the property's useful life.[170] The parties to a lease must elect to invoke the safe harbor provisions; however, the election is available only if the lessor is a corporation.[171] Thus, allowances may not be assigned to wealthy individuals.[172] The property must be leased within three months after being placed in service by the lessee,[173] thereby preventing the lessee from claiming additional cost recovery and investment credits on the same property.[174]

The safe harbor essentially permits the sale of the tax incidents of ownership, including depreciation allowances and investment tax credits. Equipment users can trade these tax benefits either for cash at the time of purchase, or for the reduction of percentage points in financing costs.[175] Some commentators have hailed this development as a "business bonanza,"[176] giving "a financial lift to ailing industries."[177] Others, however, lament it as a subsidy to chronically unprofitable industries unable to obtain market support.[178] Sale of deductions and credits under the Act may of course benefit healthy, as well as ailing, businesses.[179]

new "Section 38 property." "Section 38 property," in turn, includes tangible personalty as well as other tangible property if used as an integral part of manufacturing, extraction, transportation, or research. I.R.C. § 48(a).

170 The lease may also extend to 150% of the ADR "Class Life," provided by I.R.C. § 167(m) and Treasury Regulations, if this is longer. I.R.C. § 168(f)(8)(B)(iii)(II).

171 The concept of corporate lessor includes partnerships composed of corporations or grantor trusts whose grantor and beneficiaries are corporations. *Id.* § 168(f)(8).

172 Subchapter S "small business corporations" and "personal holding companies" do not qualify as corporate lessors. *Id.* § 168(f)(8).

173 *Id.* § 168(f)(8)(D).

174 If the lessee-user later acquires the property outright and subsequently disposes of it, the accelerated depreciation and investment credit may be subject to "recapture" under I.R.C. § 1245. *See id.* § 168(f)(8)(H).

175 To illustrate how the sale of tax benefits may operate, assume that a manufacturer wishes to purchase new machinery at a cost of $1 million. A corporation with a potentially large tax bill might purchase and lease the machinery to the manufacturer, investing $100,000 of its own funds and borrowing the rest on a "nonrecourse" basis, secured by rentals from the lessee. The intitial investment of 10% would be recouped immediately as investment tax credit, thus washing out any real financial risk. In addition, the lessor would take the generous cost recovery allowances. The manufacturer's rentals would equal principal and interest on the machinery acquisition calculated on the basis of a machinery cost of $900,000 rather than $1 million, beeause the investment tax credit reduces the net cost to the lessor by 10%. Both parties have benefited; the equipment user obtains the asset at a lower cost, and the lessor receives capital recovery allowances on an investment never really made. The tax collector is the only loser.

176 Wall St. J., Aug. 27, 1981, at 1, col. 6.

177 N.Y. Times, July 28, 1981, at D1, reporting on the Senate Finance Committee Bill.

178 Alan Greenspan, Chairman of the Ford Administration's Council of Economic Advisers, reportedly called the Act "sort of the equivalent of food stamps for undernourished corporations." Wall St. J., Aug. 27, 1981, at 1, col. 6.

179 For example, Occidental Petroleum reportedly sold the tax incidents of ownership on

The most questionable aspect of the safe harbors is their application to property acquired before the enactment of the new rules. Assets placed in service during 1981, but prior to the Act, may qualify for the safe harbor if their sale and leaseback was completed three months after cnactment.[180] It is difficult to imagine how an investment incentive operates retroactively, to stimulate purchases of capital equipment that have already been made. Safe harbor coverage of property already in service can only be viewed as an element in the phase-out of the corporate income tax. In any event, the safe harbor may be expected to engender a new class of brokers, similar to those in the United Kingdom, who pair companies in need of equipment with those in need of tax deductions.[181]

The Temporary Treasury Regulations for leases under the Act[182] describe circumstances under which, notwithstanding an election to the contrary, leases still will be characterized according to their economic substance. For example, the creditability of in-house research expenses that include payments for property used in research[183] must be made without regard to the characterization election of the Act.[184] Property will not be considered qualified for the election if leased to a foreign person for use not effectively connected with a United States trade or business.[185] This latter rule, a cognate of the British requirement of a "qualifying purpose," may be expected to inhibit the development of double dip leases from American financiers to foreign users.[186]

3. *Canada*

The Canadian Department of National Revenue has issued one set of principles to determine when a lease will be treated as a sale, and another set to distinguish a sale/leaseback from a loan.[187] Three conditions indicate a sale: (1) lessee acquisition of title upon payment of a specified amount of rentals; (2) a requirement that the lessee buy the

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$95 million of equipment that was purchased in 1981. *See* Wall St. J., Nov. 18, 1981, at 1, col. 5.

180 I.R.C. § 168(f)(8)(D). This deadline was Nov. 13, 1981.

181 In July 1981, the author visited a London lease-broker that has developed a computer program to match potential equipment users, suppliers, and financiers, as well as to calculate the implicit finance cost savings from such a lease as eompared with an outright purchase. For this privilege the author would like to thank David Castley, Anthony Covill, and Gerald Hollamby.

182 Temp. Treas. Reg. § 5c.168(f)(8) (issued Oct. 23, 1981).

183 I.R.C. § 44F(b)(2)(A)(iii).

184 Temp. Treas. Reg. § 5c.168(f)(8)-1.

185 *Id.* § 5c.168(f)(8)-6(b)(4).

186 Assets used predominantly outside the United States are subject to different cost recovery schedules from those available for domestic assets. I.R.C. § 168(f)(2).

187 Interpretation Bulletin IT-233, *reprinted in* 7 CAN. INCOME TAX REVISED (BUTTERWORTHS) 7514-17 (1975). Banks may lease in Canada only through a Canadian subsidiary. Banks and Banking Law Revision Act of 1980, 29 Eliz. II, ch. 40, art. 173(1)(j).

property upon termination of the lease; and (3) a purchase option established at the inception of the lease at substantially below the property's fair market value, or under terms such that no reasonable person would fail to exercise that option. The assumption by the lessee of insurance and maintenance obligations may also be indicative of a sale, but is not conclusive.[188]

A sale/leaseback may be recharacterized as a loan, and the lessor and lessee considered lender and borrower, when there is evidence of an intent to borrow on the security of the property.[189] Such an intent will be inferred when the sale price substantially differs from the property's fair market value, as determined by cost in the case of new equipment or by an independent appraisal for used property.[190] When a lease is recharacterized, the lessee may be allowed a deduction for payments that constitute finance costs.[191]

III

THE TRANS-BORDER LEASE

Trans-border leases raise additional characterization issues distinct from the dichotomy between true leases and credit sales. These issues include the tax status of the foreign lessor, the availability of benefits under tax treaties, the application of anti-avoidance legislation, and the allowance of a credit for foreign taxes paid. Alternative characterizations of a transaction between a lessor and lessee resident in different countries may do more than shift fiscal benefits among taxpayers. The international aspects of the arrangement may divert income from a nation's fiscal jurisdiction or, more significantly, create multiple depreciation deductions.

A. *The Tax Status of the Foreign Lessor*

The United States taxes foreign[192] business entities and nonresident aliens in accordance with the nature and source of their profit-making activity. For example, a foreign enterprise doing business in the United

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188 Interpretation Bulletin IT-233, *supra* note 187, §§ 3, 5.

189 *Id.* § 13.

190 *Id.* §§ 10-11. Even if the sale is at fair market value, the subsequent leaseback may be recharacterized if it is deficient under the criteria set out in text accompanying notes 151-65 *supra*. *Id.* § 12.

191 *Id.* §§ 8-9.

192 The United States considers as "foreign" any association that is not created or organized under federal or state law. I.R.C. § 7701(a)(5). For a discussion of other concepts of corporate nationality such as "management and control" and "*siège*," see Park, *Fiscal Jurisdiction and Accrual Basis Taxation: Lifting the Corporate Veil to Tax Foreign Country Profits*, 78 COLUM. L. REV. 1609, 1638-40 (1978).

States is subject to a progressive tax on net income.[193] On the other hand, "passive" income such as interest or dividends from a foreigner's investments is subject to a flat rate of tax imposed on gross receipts.[194] An isolated sale by a foreigner may escape taxation altogether.[195] Under bilateral income tax treaties, tax treatment may vary for different kinds of income, such as royalties, interest, and "business profits." Additionally, tax treatment may depend on whether the foreigner operates through a "permanent establishment" in the country in which the income originates.

Determination of the geographic source of income also may depend on the characterization of the lease. Rental income is deemed to have its source in the country in which the property is located.[196] Sales income, however, has its source in the place of "title passage,"[197] which is determined by how the risk of loss is allocated.[198] If the equipment supplier merely is extending credit, rather than truly leasing or marketing equipment, only the interest element of each payment constitutes United States source income.[199]

Fitting the trans-border lease into the matrix of rules applied to international transactions thus presents special characterization problems which, in turn, may be affected by the basic lease/sale distinction. For example, the characterization of a transaction as a true lease may result in full taxation of all rental payments as domestic source income, rather than taxation of only an interest element.[200] If a transaction is determined to be a sale, the income may be treated as a tax-exempt capital gain[201] or may fall completely outside the statutory cat-

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193 I.R.C. §§ 871(a)(2), 882.

194 *Id.* §§ 871(a)(1), 881.

195 An occasional sale would not fall within any of the categories of income taxed under I.R.C. §§ 871, 881, and 882. *See* Treas. Reg. §§ 1.864-4(b) (ex. 3) (1972), 1.871-7(a)(4) (1974), 1.882-3(b) (1960). *See generally* D. TILLINGHAST, TAX ASPECTS OF INTERNATIONAL TRANSACTIONS 278 (1978).

196 I.R.C. § 861(a)(4).

197 *See* United States v. Balanovski, 236 F.2d 298, 304-07 (2d Cir.), *cert. denied*, 352 U.S. 968 (1956).

198 For example, the IRS probably would deem as United States source income a sale "f.o.b. New York," whereas it would likely deem as foreign source income a sale "c.i.f. London." S. ROBERTS & W. WARREN, U.S. INCOME TAXATION OF FOREIGN CORPORATIONS AND NONRESIDENT ALIENS VI-57 to VI-58 (1966). *See generally id.* at VI-54 to VI-66.

199 Section 5.02 of Rev. Rul. 55-540, 1955-2 C.B. 39, 43, discussed in text accompanying notes 125-30 *supra*, indicates that a transaction recharacterized as a credit sale may be broken into its components, including "interest or other charges." The debtor's location generally represents the "source" of interest payments. I.R.C. § 861(a)(1).

200 See discussion of Australian law in text accompanying notes 212-17 *infra*.

201 The United States taxes nonresident alien individuals if they remain in the United States for more than half the taxable year. Conversely, nonresident business entities are always exempt. I.R.C. §§ 871(a)(2), 882. *See generally* S. ROBERTS & W. WARREN, *supra* note 198, at II-1 to II-36. The United States taxes capital gains from real estate owned by foreign-

egories of income that are relevant to the taxation of foreign entities.[202]

The United States, like most nations, taxes foreign individuals and entities on net gain "effectively connected with the conduct of [United States] trade or business."[203] The United States imposes tax at a graduated rate after allowance of appropriate business deductions.[204] Most income tax treaties to which the United States is a party,[205] as well as the Model Double Taxation Convention on Income and Capital developed by the Organization of Economic Cooperation and Development,[206] restrict the host country's right to tax active business income. Under the OECD Model Treaty, the source country may tax the foreign entity only if it conducts business through a "permanent establishment," a concept that implies a greater degree of economic penetration than merely "doing business."[207] Although the mere leasing of property

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ers under I.R.C. § 897, which was added to the Code in December 1980. Omnibus Reconciliation Act of 1980, Pub. L. No. 96-499, § 1121(a), 94 Stat. 2599.

202 *See* D. TILLINGHAST, *supra* note 195, at 274-80.

203 I.R.C. §§ 864(c), 871(b), 882. *See* D. TILLINGHAST, *supra* note 195, at 274.

204 I.R.C. §§ 1, 11, 871(b), 882. State taxation of foreign corporations doing intrastate business generally parallels federal law, although it is limited by federal statute (see 15 U.S.C. § 381(a) (1976), prohibiting state imposition of net income tax on foreign corporations merely soliciting intrastate orders), and case law, (see, *e.g.*, Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450 (1959) (net income from exclusively interstate operations of foreign corporation may be subjected to state taxation only if levy is nondiscriminatory and properly apportioned to local activities within the state); and line of cases discussed in Park, *supra* note 192, at 1651-54). For a comparison of state statutes that tax business activities of foreign corporations, see C.T. SYSTEM, WHAT CONSTITUTES DOING BUSINESS (1976). *See also* Fritch, *supra* note 17, at 171-72.

205 The 36 income tax treaties signed by the United States are set forth in the chart accompanying note 226 *infra*. The United States Treasury Department's Model Income Tax Treaty provides that "business profits" are not taxable in the source country unless the foreign enterprise carries on its business through a permanent establishment located in the source country. Art. 7(1), [1981] 1 TAX TREATIES (CCH) ¶ 153, at 226, *reprinted in* D. TILLINGHAST, *supra* note 195, at 562-88.

206 In 1977, the Organization for Economic Cooperation and Development published a Model Double Taxation Convention on Income and Capital. On the OECD's prior draft treaty, see generally H. LAZEROW, THE OECD DRAFT INFLUENCE ON U.S. INCOME TAX TREATIES (1976). *See also* Klock, *The Role of U.S. Income Tax Treaties: Two Spheres of Negotiation*, 13 TEXAS INT'L L.J. 387 (1978).

207 *See generally* H. LAZEROW, *supra* note 206, at 31-40; S. ROBERTS & W. WARREN, *supra* note 198, at IX-127 to IX-183; Williams, *Permanent Establishments in the U.S.*, 29 TAX LAW. 277 (1976). *See also* Samann v. Commissioner, 313 F.2d 461 (4th Cir. 1963) (permanent establishment of Swiss residence during first two and one-half months of taxable year affects entire year during which royalties were received); Donroy, Ltd. v. United States, 301 F.2d 200 (9th Cir. 1962) (California limited partnership is permanent establishment for Canadian limited partner); Commissioner v. Consolidated Premium Iron Ltd., 265 F.2d 320 (6th Cir. 1959) (nonfunctional office that was never more than a United States address on stationery letterhead not permanent establishment for Canadian company); Simenon v. Commissioner, 44 T.C. 820 (1965) (Connecticut home where foreign author wrote novels is permanent establishment under French treaty); Johnston v. Commissioner, 24 T.C. 920 (1955) (permanent establishment for Canadian partner); Handfield v. Commissioner, 23 T.C. 633 (1955) (agent American news company with stock of merchandise from which orders were regularly filled is

may constitute doing business, additional economic activity is required before a permanent establishment will be found.[208]

Many treaties specifically designate equipment rentals as a form of business profit. The United States Treasury Model Income Tax Treaty states that " 'business profits' means income derived from . . . the rental of tangible personal (movable) property . . . ."[209] Other treaties classify equipment rentals differently. For example, the OECD Model Treaty defines royalties to include "payments of any kind . . . [to the extent to which they are paid as] consideration for the use of, or the

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permanent establishment for Canadian postcard manufacturer); Lewenhaupt v. Commissioner, 20 T.C. 151 (1953) (agent managing California realty with power of attorney is permanent establishment for Swedish resident), *aff'd*, 221 F.2d 227 (9th Cir. 1955) (per curiam); Rev. Rul. 80-15, 1980-2 C.B. 365 (domestic trust formed by Italian resident to conduct litigation not permanent establishment); Rev. Rul. 77-45, 1977-1 C.B. 413 (Canadian engineers rendering services at construction site not permanent establishment); Rev. Rul. 76-322, 1976-2 C.B. 487 (Australian company sold to United States subsidiary on consignment not permanent establishment); Rev. Rul. 72-418, 1972-2 C.B. 661 (advertising by German bank through United States representative not permanent establishment); Rev. Rul. 67-322, 1967-2 C.B. 469 (Danish restaurant at World's Fair in New York is permanent establishment); Rev. Rul. 67-321, 1967-2 C.B. 470 (French floorshow in New York hotel not permanent establishment); Rev. Rul. 65-263, 1965-2 C.B. 561 (Canadian corporation maintaining New York office to solicit business for services to be performed by corporation in Canada is permanent establishment); Rev. Rul. 63-113, 1963-1 C.B. 410 (Canadian shipment of goods to United States consignee not permanent establishment); Rev. Rul. 62-31, 1962-1 C.B. 367 (New York showroom is permanent establishment regardless of salesmen's inability to contract for British corporation); Rev. Rul. 60-249, 1960-2 C.B. 264 (entering horse in more than one race in United States is permanent establishment for French resident), *modified*, Rev. Rul. 70-543, 1970-2 C.B. 172; Rev. Rul. 56-594, 1956-2 C.B. 1126 (British manufacturer soliciting orders through commissioned agents of domestic corporation not permanent establishment); Rev. Rul. 55-282, 1955-1 C.B. 634 (domestic agent with discretionary power to purchase securities for Canadian investment corporation is permanent establishment); Rev. Rul. 54-588, 1954-2 C.B. 657 (American showroom of British M Corporation as agent for British N Corporation is permanent establishment of British N Corporation), *revoked on other grounds*, Rev. Rul. 63-31, 1962-1 C.B. 367; Rev. Rul. 54-119, 1954-1 C.B. 156 (Canadian corporation deriving income from personal appearances of entertainers not permanent establishment).

208 For example, in DeAmodio v. Commissioner, 34 T.C. 894 (1960), *aff'd*, 299 F.2d 623 (3d Cir. 1962), a Swiss resident owned buildings in the United States that were managed by American real estate agents. The court held that the agent's activity was insufficient to create a permanent establishment within the meaning of the Convention on Double Taxation, May 24, 1951, United States-Switzerland, art. II(1)(c), 2 U.S.T. 1751, T.I.A.S. No. 2316, *reprinted in* T.D. 6149, 1955-2 C.B. 814-36. The convention defines a permanent establishment as "an office, factory, workshop, warehouse, branch, or other fixed place of business . . . [it] does not include the casual and temporary use of merely storage facilities. It implies the active conduct of a business enterprise." DeAmodio v. Commissioner, 34 T.C. at 908 n.7.

It is interesting to note that the U.S.-Israeli Income Tax Treaty deals indirectly with the issue of whether leasing activity constitutes a permanent establishment. Under art. 5(3)(g) of the U.S.-Israeli Treaty the maintenance of equipment within a contracting state for less than six months does not constitute a permanent establishment.

209 United States Treasury Department's Model Income Tax Treaty, art. 7(7), [1981] 1 TAX TREATIES (CCH) ¶ 153, at 227.

right to use, . . . industrial, commercial or scientific equipment . . . ."[210]

Among the more intriguing aspects of the lease characterization process is the effect of domestic lease characterization policy on the resolution of an international income tax treaty issue.[211] In particular, the domestic distinction between a lease and a credit sale may determine whether the lessor will be exempt from tax on "industrial and commercial profits," or will be subject to withholding tax under treaty provisions covering royalties and interest. For example, Australia defines royalties to include any payment for "the use of, or the right to use, any . . . industrial, commercial or scientific equipment"[212] and taxes such payments on a net basis at a rate of 42.5%.[213] Because royalties paid by Australians normally are deemed income from an Australian source,[214] a United States lessor bears tax at the full 42.5% rate. The income tax treaty between Australia and the United States expressly excludes royalties from the definition of "industrial and commercial profits"[215] and provides no rate reduction for taxation of royalties by the source country. On the other hand, if Australian law characterized the transaction as a sale,[216] then an American equipment supplier would escape Australian taxation on what would be recharacterized as sale proceeds.[217]

Lease payments incident to the provision of services frequently are classified as business profits. For example, a hotel room rental or short-term car rental should be characterized as bona fide service income. To

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210 OECD Model Double Taxation Convention on Income and Capital, art. 12(2), *reprinted in* I.F.A., The Revised OECD Model Double Taxation Convention on Income and Capital 35-49 (1977).

211 The interdependence of various levels of the characterization process is analogous to the problem of "the incidental question" in conflict of laws doctrine. Applying the law of one country to a dispute may raise a second legal issue that requires the application of a different national law. *See* Gotlieb, *The Incidental Question Revisited: Theory and Practice in the Conflict of Laws*, 26 INT'L & COMP. L.Q. 734, 769 (1977).

212 Income Tax Assessment Act § 6(1), ACTS AUSTL. P. No. 4, § 3(6) (1968). The author received helpful comments on the tax aspects of leasing in Australia from Mr. Brian Norris, who practices tax law in Sydney.

213 *See generally* Peden & Seidler, *Form and Substance in Commercial Leasing of Equipment*, 54 AUSTL. L.J. 251, 254-67 (1980).

214 Royalties paid by an Australian resident for equipment located in Australia are deemed to be domestic source income. Income Tax Assessment Act § 6C, ACTS AUSTL. P. No. 4, § 4 (1968); Federal Comm'n of Taxation v. United Aircraft Corp., 68 C.L.R. 525 (Austl. 1943).

215 Convention on Double Taxation, May 14, 1953, United States-Australia, art. II(1)(n), 4 U.S.T. 2274, 2278, T.I.A.S. No. 2880, at 5.

216 See generally §§ 82KH, 82KJ, Income Tax Assessment Act, for lease related Australian anti-abuse measures.

217 This presumes, of course, that the United States lessor does not have a permanent establishment in Australia. Convention on Double Taxation, May 14, 1953, United States-Australia art. III(2), 4 U.S.T. 2274, 2279, T.I.A.S. No. 2880, at 6. The interest element, however, would be taxable by Australia. The United States-Australia Trcaty currently provides no reduction for tax on interest by the source country.

prevent the artificial shifting of profits among relatcd taxpayers, however, United States foreign personal holding company provisions subject such rentals to penalty taxation unless they represent more than 50% of gross income.[218] This standard is justifiable; a large proportion of rental income implies that the corporation is conducting an active business and not merely insulating receipts from direct contact with its shareholders.[219]

Investment receipts of nonresident aliens and foreign corporations generally are subject to a flat rate withholding tax by the source country for reasons of administrative convenience. The United States, for example, imposes a 30% tax on "fixed or determinable annual or periodical gains," including dividends, interest, rents, and royalties[220] that are unrelated to business activity within its borders.[221] Tax treaties generally provide a withholding rate reduction that varies according to income category. Therefore, the treaty characterization of lease payments may affect significantly the taxation of the equipment supplier. For example, the OECD Model Treaty classifies equipment rentals as royalties, which are tax-exempt in the source country.[222] The source country may tax interest, however, at a rate of up to 10%.[223] The United States Treasury Department's Model Income Tax Treaty provides that both royalties and interest are tax-exempt in the source country,[224] but defines "business profits" to include rental payments for movable property, taxable by the United States only if the lessor maintains a permanent establishment in the United States.[225]

The provisions concerning taxation of equipment rentals and inter-

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218 I.R.C. §§ 543(a)(2)(A), 553(a)(7).

219 Air and sea shipping also involve both renting and services if the carrier leases space to the shipper and provides the ancillary service of supplying containers for transporting the goods to the port of departure. Income from the container activity may be treated as income from international shipping operations, thus exempt from tax under certain treaties. See Rev. Rul. 74-92, 1974-1 C.B. 373, holding income from container activity exempt from tax under Article V of the Income Tax Convention between the United States and the Federal Republic of Germany as long as no special charge is exacted for the containers. In theory, the company that leases containers to the shipper would receive United States source income. I.R.C. § 861(a)(4). In practice, however, the IRS is unlikely to discover that the shipper is using leased goods. *See also* United States Treasury Department's Model Income Tax Treaty, art. 8(3), [1981] 1 TAX TREATIES (CCH) ¶ 153, at 227; Convention on Double Taxation, July 28, 1967, United States-France, art. 7, 19 U.S.T. 5280, 5291, T.I.A.S. No. 6518, at 12.

220 I.R.C. §§ 871(a), 1441(b).

221 *Id.* § 881(a). To encourage foreign deposits in United States financial institutions, however, interest from United States banks is excluded from the definition of United States source income. *Id.* § 861(c).

222 OECD Model Double Taxation Convention on Income and Capital, art. 12.

223 *Id.*, art. 11.

224 United States Treasury Department's Model Income Tax Treaty, arts. 11, 12, [1981] 1 TAX TREATIES (CCH) ¶ 153, at 228-29.

225 *Id.*, art. 7, ¶ 153, at 226-27.

est under the income tax treaties negotiated by the United States, as well as the relevant provisions of the OECD Model Treaty and the United States Treasury Department's Model Income Tax Treaty, are set out in the Appendix. The different tax treatment of interest and royalties illustrates the consequences of characterizing a finance lease as a loan or credit sale under the different treaties.[226]

A recent IRS private letter ruling highlights the relationship between treaty provisions and lease characterization.[227] A Canadian company, through its American and Swiss subsidiaries, was engaged in

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[226] U.S. Income Tax Treaties

Australia	May 14, 1953	4 U.S.T. 2274, T.I.A.S. No. 2880
Austria	Oct. 25, 1956	8 U.S.T. 1699, T.I.A.S. No. 3923
Belgium	July 9, 1970	23 U.S.T. 2687, T.I.A.S. No. 7463
Brazil	Mar. 13, 1967	47 U.S.T. 2620, T.I.A.S. No. 16
Canada	Oct. 25, 1966	18 U.S.T. 3186, T.I.A.S. No. 6415
	Sept. 26, 1980	56 Stat. 1399, T.I.A.S. No. 983
Cyprus	Mar. 26, 1980	[1981] 1 TAX TREATIES (CCH) ¶ 2001
Denmark	May 6, 1948	62 Stat. 1730, T.I.A.S. No. 1854
	June 17, 1980	[1981] 1 TAX TREATIES (CCH) ¶ 2051
Finland	Mar. 6, 1970	22 U.S.T. 40, T.I.A.S. No. 7042
France	July 28, 1967	19 U.S.T. 5280, T.I.A.S. No. 6518
Germany	July 22, 1954	5 U.S.T. 2768, T.I.A.S. No. 3133
Greece	Feb. 20, 1950	5 U.S.T. 47, T.I.A.S. No. 2902
Hungary	Feb. 12, 1979	30 U.S.T. 6359, T.I.A.S. No. 9560
Iceland	May 7, 1975	26 U.S.T. 2004, T.I.A.S. No. 8151
India	Nov. 10, 1959	[1981] 1 TAX TREATIES (CCH) ¶ 3801
Ireland	Sept. 13, 1949	2 U.S.T. 2303, T.I.A.S. No. 2356
Israel	Nov. 20, 1975	[1981] 1 TAX TREATIES (CCH) ¶ 4201
Italy	Mar. 30, 1955	7 U.S.T. 2999, T.I.A.S. No. 3679
Jamaica	May 21, 1980	[1981] 1 TAX TREATIES (CCH) ¶ 4385
Japan	Mar. 8, 1971	23 U.S.T. 967, T.I.A.S. No. 7365
Korea	June 4, 1976	30 U.S.T. 5253, T.I.A.S. No. 9506
Luxembourg	Dec. 18, 1962	15 U.S.T. 2355, T.I.A.S. No. 5726
Malta	Mar. 21, 1980	[1981] 1 TAX TREATIES (CCH) ¶ 5401
Morocco	Aug. 1, 1977	[1981] 1 TAX TREATIES (CCH) ¶ 5601
New Zealand	Mar. 16, 1948	2 U.S.T. 2378, T.I.A.S. No. 2360
Norway	Dec. 3, 1971	23 U.S.T. 2832, T.I.A.S. No. 7474
Pakistan	July 1, 1957	10 U.S.T. 984, T.I.A.S. No. 4232
Philippines	Oct. 1, 1976	[1981] 2 TAX TREATIES (CCH) ¶ 6601
Poland	Oct. 8, 1974	28 U.S.T. 893, T.I.A.S. No. 8486
Romania	Dec. 4, 1973	27 U.S.T. 165, T.I.A.S. No. 8228
South Africa	Dec. 13, 1946	3 U.S.T. 3821, T.I.A.S. No. 2510
Sweden	Mar. 23, 1939	54 Stat. 1759, T.S. No. 958
Switzerland	May 24, 1951	2 U.S.T. 1751, T.I.A.S. No. 2316
Thailand	Mar. 1, 1965	[1981] 2 TAX TREATIES (CCH) ¶ 7501
Trinidad & Tobago	Jan. 9, 1970	22 U.S.T. 164, T.I.A.S. No. 7047
U.S.S.R.	June 20, 1973	27 U.S.T. 1, T.I.A.S. No. 8225
United Kingdom	Dec. 31, 1975	__ U.S.T. __, T.I.A.S. No. 9580

[227] Private Letter Ruling 8033069, May 22, 1980, *modified*, Private Letter Ruling 8043049, July 30, 1980.

drilling oil wells. The Swiss subsidiary leased drilling rigs to its American counterpart. The IRS's exegesis of the United States-Switzerland Double Income Taxation Treaty focused on the significance of a parenthesis present in the treaty but absent in the corresponding Treasury Regulations. Although the IRS held that rental payments for industrial equipment could be considered royalties, which are exempt from withholding tax under the Treaty, it "express[ed] no opinion as to whether the lease . . . constitute[d] a valid lease or [might have been] characterized as some other transaction."[228] Among the alternate characterizations is a credit sale, which would involve the imputation of an interest element that would be taxable by the United States at 5%.[229]

Characterization problems under treaty provisions are compounded by the existence of separate provisions that cover real estate, which may be subject to taxation without regard to the existence of a permanent establishment.[230] Equipment that is accessory to land and buildings is included within the definition of "immovable," as is equipment used in agriculture and forestry.[231] Thus, rental of computers might be considered business profits taxable by the lessee's country only if the lessor has a permanent establishment, while the lease of a saw mill would be taxable as income from real property.

An equitable approach to trans-border finance lease taxation would embody a withholding tax applied to the portion of the rental that in substance constitutes a finance charge. If the finance lease is functionally equivalent to a loan, it should be treated as such. Mexico has recently taken this approach as to any "written contract granting the use or enjoyment of assets" where the payments for such use exceed the asset cost, and options to purchase or renew are granted at less than fair market value.[232] A withholding tax of 21%[233] is applied to the difference between total rentals and equipment cost, with the latter determined by capitalizing the rentals at a rate equal to the interest charged in the London market for interbank operations.[234]

Lease characterization should reflect the purposes of the substan-

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228 *Id.*

229 Convention on Double Taxation, May 24, 1951, United States-Switzerland, art. VII(1), 2 U.S.T. 1751, 1757, T.I.A.S. No. 2316, at 7. Presumably, the transaction could also be characterized as a contribution to capital, with payments deemed to be dividends to either the Canadian parent or its Swiss sibling.

230 OECD Model Double Taxation Convention on Income and Capital, art. 6; United States Treasury Department's Model Income Tax Treaty art. 6, [1981] 1 TAX TREATIES (CCH) ¶ 153, at 226.

231 *Id.*

232 CCH translation of Mexican Income Tax Law, art. 19(VI)(h); art. 1, Decree of Nov. 15, 1974.

233 *Id.*, art. 41.

234 *See* RUIZ, URQUIZ Y CIA, MEXICAN TAX BRIEFS, No. 80-2 (Jan. 10, 1980), at 6-7.

tive rule or rules to be applied. The many goals of tax treaties,[235] however, make this difficult for both the treaty negotiator and those who interpret the treaties. For example, the United States-France Double Taxation treaty permits the debtor's country to tax interest, except interest on bank loans, at a rate not exceeding 10%.[236] Industrial royalties are subject to tax by the source country at a rate of 5%,[237] while true equipment rentals are fully taxed as "business profits" if, but only if, there is a permanent establishment.[238] When considering the appropriate treatment of finance leases, the reasons behind any reduction in withholding rates should be identified. Such reasons might include free flow of capital and technology; this would support making equipment rentals tax-exempt in the source country. Horizontal equity, however, demands that tax consequences not hinge on the taxpayer's characterization of the transaction. The alternative characterizations of "business profits" or interest may be equally plausible, in which case horizontal equity would demand that lessors be taxed accordingly.

National self-interest, however, may require different results. If the balance of payments on industrial royalties appears to be overwhelmingly against one treaty partner, industrial leases might be subjected to a higher rate of withholding in the source country in order to reduce revenue loss.[239] If trans-border royalty payments are not equal, losses incurred by the excmption of royalties paid to foreigners will not be compensated for by reduction of foreign tax levied on royalties received by residents. The host country may also fear that a parent company will extract profits from its subsidiary by charging excessive royalties, thereby reducing taxable subsidiary profits. Taxing equipment rentals at a high withholding rate would reduce, although perhaps not eliminate, this temptation to evade taxes. Moreover, it would augment the host country's sharc of the revenue from multinational enterprise activity within the host country.

B. *The Foreign Tax Credit*

The Internal Revenue Code limits the foreign tax credit[240] to prevent it from offsetting United States tax liability on domestic source in-

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235 *See generally* H. LAZEROW, *supra* note 206.

236 Convention on Double Taxation, July 28, 1967, United States-France, art. 10, 19 U.S.T. 5280, 5294-96, T.I.A.S. No. 6518, at 15-17.

237 Industrial royalties include payments for the right to use patents, designs, or know-how. *Id.*, art. 11(4), 19 U.S.T. at 5297, T.I.A.S. No. 6518, at 18.

238 *Id.*, art. 6(5), 19 U.S.T. at 5290-91, T.I.A.S. No. 6518, at 11-12.

239 *See* H. LAZEROW, *supra* note 206, at 56-57.

240 On the foreign tax credit and the policy questions it raises, see E. OWENS, THE FOREIGN TAX CREDIT (1961); E. OWENS & G. BALL, I & II THE INDIRECT CREDIT (1975 & 1979).

come. The credit may not exceed that fraction of United States tax liability that foreign source income bears to total income.[241] Thus, a taxpayer with equal amounts of foreign and domestic source income could take a foreign tax credit equal only to half of the total United States tax liability, even if the foreign tax were greater.[242]

Income source is determined differently for interest, rentals, and sales. Characterization is therefore vital to the availability of the foreign tax credit to the domestic lessor. The United States classifies interest as foreign source income if received from a foreign debtor[243] and rents as foreign source income if derived from personal property located abroad.[244] The sale proceeds of personal property constitute foreign source income only when title to the property is transferred outside the United States.[245]

Asymmetrical lease characterization thus places the United States lessor between the proverbial rock and hard place. If the lessee's country characterizes the transaction as a lease, there normally will be a withholding tax on the entire payment. If the IRS, however, decides that the transaction is an installment sale, the amount of foreign source income will be limited to the interest element of the payments—unless the United States lessor can structure the transaction so that title passes abroad.[246]

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241 I.R.C. § 904. Another approach would be to trace income items and disallow credit for foreign taxes imposed at rates in excess of the United States rate. Because of its administrative burden, this approach is followed only in the case of the special foreign earned income exemption of I.R.C. § 911. *See* Treas. Reg. § 1.911-5(b) (1980).

242 If we assume $1 million of foreign income, $1 million of United States income, and a United States tax rate of 50%, the foreign tax credit limit is $500,000. If the foreign tax on the $1 million foreign source income had been levied at 60%, or $600,000, the excess of $100,000 would not qualify for the foreign tax credit (I.R.C. § 904) although it might be carried back or forward as provided by I.R.C. § 904(c).

243 *Id.* §§ 861(a), 862(a)(1).

244 *Id.* §§ 861(a)(4), 862(a)(4).

245 *See* Treas. Reg. § 1.861-7(c); United States v. Balanovski, 236 F.2d 298 (2d Cir. 1956). Thus, a sale C.I.F. a foreign port would produce foreign source income. S. ROBERTS & W. WARREN, *supra* note 201, at VI-57. If the IRS deems the sale to have taken place in the United States, the interest element still will be foreign source, assuming the debtor-lessee is resident abroad. I.R.C. §§ 861-862.

246 A recent case illustrates the effect of rental characterization on the foreign tax credit. AMP Inc. v. United States, 492 F. Supp. 27 (M.D. Pa. 1979), involved an exclusive license of patents to the foreign affiliates of an American manufacturer. The licensor treated payments for use of the patents as royalties, which, like rentals, have their source in the country in which the property is used. I.R.C. §§ 861(a)(4), 862(a)(4). This increased foreign source income, thereby raising the limit on the allowable foreign tax credit. The IRS, however, considered the transaction to be a sale of the patents in Pennsylvania, where the agreements were made. Although the taxpayer had previously labelled the transaction a sale in order to obtain capital gains treatment, the court found the payments to be royalties, reasoning that "the same words may have different meanings, dependent on where they are found . . . ." 492 F. Supp. at 32.

Rental characterization also may decrease the foreign tax credit limitation because of the very depreciation deductions that make leasing attractive. Depreciation deductions might offset an equal amount of gain from other foreign activity, thus eliminating foreign source income and preventing the taxpayer from taking the credit for the foreign tax incurred on the other foreign activity. The foreign tax credit limitation must be calculated on an "overall" basis—relevant foreign source income includes that from all foreign operations regardless of country.[247] Depreciation deductions from leasing in Germany, for example, may offset profits earned in France, thus eliminating any credit for French taxes paid.[248]

The 1976 Tax Reform Act[249] exacerbated the impact of depreciation deductions on the foreign tax credit by providing for "recapture" of foreign losses.[250] A foreign loss results in the IRS deeming the foreign income of subsequent years to be domestic source income.[251] This bizarre fiscal alchemy arguably is justified because the original foreign loss could offset domestic gain, thereby reducing United States tax. United States attempts to tax subsequent foreign profits can be thwarted, however, by the foreigu tax credit if the foreign country does not allow a carryover of the previous loss. The loss recapture provisions thus restrict the credit obtained from foreign taxes paid in years after the depreciation deductions are taken.[252]

247 I.R.C. § 904; Rev. Rul. 80-201, 1980-2 C.B. 221.

248 Prior to 1976, a per country limitation could be chosen. The foreign loss in Germany would then have reduced worldwide income—the denominator of all § 904 limitation fractions—without having affected the numerator of the limitation fraction for France.

249 Pub. L. No. 94-455, 90 Stat. 1525 (1976).

250 I.R.C. § 904(f).

251 For example, a taxpayer with $100 of "overall" foreign loss in year 1 followed by $100 of foreign gain in year 2 will find the foreign source gain converted into United States source income for purposes of calculating the foreign tax credit limitation. The amount of foreign tax allowable as a credit is thereby reduced accordingly.

252 Special provisions of the Internal Revenue Code treat income or losses from the lease of aircraft, spacecraft, and vessels as United States source in order to assist the financing of such items. I.R.C. § 861(e). Thus, the typical tax shelter losses from such items do not limit the lessor's foreign tax credit. The benefits of this special source rule are available when the craft is American-made, is eligible for the investment tax credit, and is leased to a United States lessee. Until December 1980, application of the rule was elective for the taxpayer; today it is required.

The special source rules recognize that a portion of finance lease rentals should be recharacterized as interest for purposes of determining income source. If the financial institution had merely lent money to the user of the craft or vessel, the interest would have been United States source because it would have been paid by a United States debtor. I.R.C. § 861(a)(1). The lessor may thus obtain the benefits of two different characterizations: the accelerated depreciation and investment tax credit of a lessor, as well as the foreign tax credits of a financier.

C. *Anti-Avoidance Legislation*

Lease income lends itself to tax avoidance schemes because rentals are easily assignable. Lessors may be tempted to divert rents to captive companies set up in tax haven jurisdictions that impose little or no income tax.[253] The most significant anti-avoidance regime is Subpart F of the Internal Revenue Code,[254] which attributes to the domestic shareholder profits that are shifted artificially abroad to a controlled foreign corporation.[255] Canada,[256] West Germany,[257] Japan,[258] and France[259] have enacted analogous national legislation imposing tax liability on income shifted to tax havens.

In the absence of anti-avoidance legislation, rents generally constitute "foreign personal holding company income,"[260] a category of Subpart F tainted income,[261] unless they represent at least half of the company's gross income.[262] This standard is intended to identify rents arising from the active conduct of a business, such as hotel operations, rather than rents diverted to a foreign entity to avoid taxation. Subpart F, however, applies to all rentals "without regard to whether or not [they] constitute [fifty per cent] or more of gross income."[263] Subpart F excludes from its scope only those rentals derived from the active conduct of a business.[264] Treasury Regulations define "active business" to include leasing when the lessor produces the leased property on a regnlar basis[265] or performs substantial marketing functions that generate

253 *See generally* M. LANGER, HOW TO USE FOREIGN TAX HAVENS (1975).

254 I.R.C. §§ 951-964.

255 Briefly, the scheme works as follows. "Foreign personal holding company income" includes rentals that represent less than 50% of gross income. I.R.C. § 553(a)(7). The Subpart F regime catches foreign personal holding company income as well as sales and service income earned by American-controlled foreign companies in dealing with affiliated corporations. *See* Park, *supra* note 192.

256 Act of Dec. 23, 1971, c. 63, [1970-72] Can. Stat. 1311 [hereinafter cited as Canadian Income Tax Act]. *See generally* Brown, *International Tax Planning*, 24 CAN. TAX J. 494 (1976); Tillinghast, *Canadian Tax Reform and International Double Taxation: A View From the United States*, 21 CAN. TAX J. 472 (1973).

257 Aussensteuerreformgesetz [AStG] [1972], Bundesgesetzblatt [BGB1] I 1718 (W. Ger.) (subsequent references to AStG will be to this 1972 Reform Law). *See generally* Killius, *A New German Statute Regulating International Tax Aspects—Its Implications for Multinational Companies*, TAX MANAGEMENT INT'L J. (1973); Landwehrmann, *Legislative Development of International Corporate Taxation in Germany: Lessons for and from the United States*, 15 HARV. INT'L L.J. 238 (1974).

258 Sozei Tokubetu Sochi-hoo Art. 66-6, Diet Statute No. 14 of 1978, *described in* MINISTRY OF FINANCE, THE INTRODUCTION OF ANTI-TAX HAVEN TAX MEASURES (Foreign Press Center, Japan, No. R-78-06 1978).

259 Art. 70, Loi No. 80-30, Jan. 18, 1980.

260 I.R.C. § 553(a)(7).

261 *Id.* § 954(a)(1).

262 *Id.* § 553(a)(7).

263 *Id.* § 954(c)(2).

264 *Id.* § 954(c)(3).

265 Treas. Reg. § 1.954-2(d)(1)(ii)(a)(l) (1964).

expenses of at least 25% of gross income, adjusted for depreciation and the lessor's own rental payment.[266]

Application of the Subpart F regime to rentals requires two levels of characterization. First, profits are classified as either sales proceeds or rents. The latter is a type of income that is diverted easily to foreign tax havens. If the transaction is characterized as a sale, only the interest element of the installment sale is tainted.[267] Second, if the transaction is characterized as a lease, then the rents must be connected sufficiently with active business income in order to exclude the transaction from the purview of the anti-avoidance scheme.

Among the other categories of tainted income taxed by Subpart F are profits derived from services "performed for or on behalf of any related person,"[268] which includes the lease of equipment,[269] and profits from the purchase and sale of personal property to, from, or on behalf of a "related party."[270] The distinction between tainted sales and tainted services can affect the operation of the Subpart F regime significantly. For example, prior to the amendment of the installment sales provisions,[271] income from a sale of personalty included all future payments regardless of when received, unless the taxpayer expressly elected installment sale treatment.[272] The controlled foreign corporation might have had more tainted income from a sale than from a lease, because in the latter case only rents would have been included in the foreign company's gross income. The difference could push the controlled foreign corporation's tainted income above the 10% *de minimis* threshold that triggers the anti-avoidance provisions.[273]

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266 Treas. Reg. § 1.954-2(d)(1)(ii)(b)(2) (1964).

267 If a lease is recharacterized as an installment sale, the IRS will deem an interest element to be included in the lease payments. *See* Rev. Rul. 55-540, 1955-2 C.B. 39; text accompanying notes 117-30 *supra*.

268 I.R.C. § 954(e).

269 Treas. Reg. § 1.954-4 (1964).

270 I.R.C. § 954(d).

271 The Installment Sales Revision Act of 1980, Pub. L. No. 96-471, 94 Stat. 2247 (1980), attenuates the tax distinction between a lease and a sale. The seller of personalty automatically takes into income only a portion of profit, which varies according to the amount of annual receipts. Timing of the seller's income still may differ from that of the lessor, because depreciation by the latter depends on the asset's useful life. Assume, for example, that an asset has a 10 year useful life, a price of $100, a cost of $50, and that annual payments are $10. If straight line depreciation is used, the lessor will have $5 of taxable income during the first year; if depreciation is accelerated, taxable income will be less. The seller, however, always has $5 taxable income. Either a sale or a lease characterization would benefit the taxpayer, depending on how much income it has from other sources. The seller might try, for instance, to shelter income from other sources by structuring the transaction as a lease with accelerated depreciation.

272 I.R.C. § 453 (before the passage of the Installment Sales Revision Act of 1980, Pub. L. No. 96-471, 94 Stat. 2247 (1980)).

273 I.R.C. § 954(b)(3)(A).

D. *Sovereign Immunity*

Lease characterization can also determine whether the doctrine of sovereign immunity will insulate a foreign lessor from taxation. To avoid creating foreign relations problems, federal courts traditionally have granted immunity from process to foreign states and their property.[274] The Foreign Sovereign Immunities Act,[275] which gives federal courts jurisdiction over foreign states only in cases involving commercial activity of foreign states,[276] permits a levy on foreign government property only if the property is used for a commercial activity in the United States.[277]

The characterization process affects sovereign immunity claims because a lease may be classified as a "commercial activity," whereas the mere lending of money is not so classified. In addition, the Internal Revenue Code expressly exempts from federal income taxation any foreign government income that is "received from investments in the United States."[278] Under recently proposed Treasury Regulations,[279] "investment" is defined such that net leasing is considered "commercial activity," for which immunity is unavailable.[280] This standard is problematic. It would be anomalous, for example, to tax a government on the "rent" from a net lease when tax liability could be avoided by restructuring the transaction as a loan, the proceeds of which have been used to buy or to build an apartment. Because interest on the bond securing such a loan would be exempt from federal income tax, there appears to be no reason why net leases should not be accorded similar treatment.[281]

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274 *See, e.g.,* Rich v. Naviera Vacuba, 295 F.2d 24 (4th Cir. 1961) (per curiam) (service of process on Cuban vessel in Virginia precluded by grant of immunity by Department of State). For a brief summary of the doctrine of sovereign immunity, see I. BROWNLIE, PRINCIPLES OF PUBLIC INTERNATIONAL LAW 314-32 (2d ed. 1973).

275 Pub. L. No. 94-583, 90 Stat. 2891 (1976) (codified at 28 U.S.C. §§ 1602-1611 (1976)).

276 28 U.S.C. § 1605 (1976).

277 *Id.* § 1610 (1976).

278 I.R.C. § 892. *See generally* Jarchow, *United States Taxation of Foreign Governments, International Organizations and Their Employees—I.R.C. §§ 892, 893, 895 and the Proposed Regulations*, 34 Sw. L.J. 790 (1980); Tillinghast, *Sovereign Immunity From the Tax Collector: United States Income Taxation of Foreign Governments and International Organizations*, 10 L. & POL'Y INT'L BUS. 495 (1978).

279 Proposed Treas. Reg. § 1.892, 43 Fed. Reg. 36,111 (1978).

280 Proposed Treas. Reg. § 1.892-1(c)(2), 43 Fed. Reg. 36,113 (1978). The exemption is made inapplicable to commercial activity by Proposed Treas. Reg. § 1.892-1(a)(3), 43 Fed. Reg. 36,112 (1978).

281 The imposition of local property taxes also may be easier if the foreign government is characterized as lessor rather than a lender. In County Bd. v. German Democratic Republic, No. 78-293-A (E.D. Va. Sept. 6, 1978), *reprinted in* 17 INT'L LEGAL MATERIALS 1404 (1978), the foreign government owned an apartment building in Arlington County which was leased to its embassy employees. The county claimed delinquent real estate taxes on the building. In denying the defendant's pretrial motions, the court held that because the lease constituted

IV

ASYMMETRICAL LEASE CHARACTERIZATION AND INTERNATIONAL TRADE: THE "DOUBLE DIP" LEASE

When the parties to a lease reside in different countries, divergent national lease characterizations can either increase or decrease aggregate tax deductions and credits, thereby distorting patterns of international trade. The cost of financing the purchase of capital equipment varies inversely with the number of parties that can claim tax benefits from the transaction. Although asymmetrical lease characterization creates no double tax or double benefit in a strictly juridical sense, discriminatory taxation exists between transactions when one lease bears more tax than another.

Leases in which both lessor and lessee take depreciation and tax credits for the same leased equipment commonly are referred to as "double dip" because both parties benefit from the tax incidents of owning the same asset. The most publicized "double dip" transactions have been between British banks as lessors and American industrial or commercial enterprises as lessees.[282] Such leases might be structured as follows. The British bank purchases capital equipment for use by the American company. The lessor leases the equipment with a renewal option at a nominal price. As long as there is no purchase option, and the British bank retains legal title,[283] the British bank will receive the 25% "writing down" allowance if the equipment is used in the United States, or even the 100% first year allowance if it is used in the United Kingdom.[284] In the United States, however, the lessee may be deemed to have economic ownership of the equipment, because of the nominal price of the renewal option, thus enabling the lessee to claim depreciation and investment tax credits.[285] Because legal title determines tax ownership in the United Kingdom and economic substance may determine tax ownership in the United States, the leased equipment may be

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commercial activity, the East German government was not exempt from local property taxation. The court referred without elaboration to a "course of conduct being carried on by the defendant government." 17 INT'L LEGAL MATERIALS 1404, 1405. One wonders whether the same result would have been obtained had the East German government entered into a long-term net finance lease with an American lessee.

282 *See, e.g.*, LEASING DIGEST, June 1981, at 4; Wayne, *Double Tax Breaks on Leases*, N.Y. Times, Apr. 7, 1981, at D1, col. 3-5; The Financial Times, May 30, 1981. Criticism of double dip leases by the Bank of England is reported in The Financial Times, May 30, 1981 and LEASING DIGEST, June 1981, at 4.

283 The lessor may lose the legal title necessary to its capital allowance claim if the equipment is deemed a fixture to realty.

284 Finance Act, 1971, c. 68 § 44.

285 *See* text accompanying notes 123, 144-50 *supra*. Special rules limit the availability of depreciation and the investment tax credit for property used outside of the United States. *See* I.R.C. §§ 48(a)(2)(B), 168(f)(2).

depreciable by both parties under their respective tax systems, thereby giving rise to a double tax benefit.

Similar double dip leases are possible if lessors are located in other countries that look to legal form in determining tax ownership, such as France[286] or Switzerland.[287] Potential double dip lessees may be found in other countries that look to the economic substance of a lease to determine tax ownership, notably Germany[288] and Canada.[289] Thorough tax planning for any double dip lease, of course, must include an examination of the impact of relevant tax treaties on rates of withholding tax at the source of the lease payments.[290]

A double dip lease in the reverse direction also might be possible, between a lessor resident in a country with an economic substance test for tax ownership and a lessee in a country that looks to legal form. For example, a United States corporation that leases equipment may claim depreciation if the purchase option is at a fair market price.[291] If the user resides in the United Kingdom, however, the mere existence of the purchase option permits the user to claim capital allowances;[292] therefore, the lessee qualifies for depreciation deductions as well.

For example, an American bank might purchase an aircraft and lease it to a British bank, which would then lease the plane to an airline. If the lease includes a purchase option at fair market value, the British bank would be entitled to a capital allowance and the American bank would be entitled to depreciation deductions and investment tax credit. Because both banks received tax benefits, the airline could acquire use of the plane at a finance cost lower than the market rate. A lease in the opposite direction, of course, would deprive both parties of depreciation deductions and would thus increase the aggregate tax burden on the transaction.

If both the United States manufacturer and its potential customer own subsidiaries in several countries, multiple options exist for structuring the lease. The possibility of arranging the tax incidents of ownership

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286 *See* text accompanying notes 61-78 *supra*.

287 *See* M. Giovanoli, Le Crédit-Bail En Europe: Developpement Et Nature Juridique 209-10 (1980).

288 *See* text accompanying notes 109-16 *supra*.

289 *See* text accompanying notes 187-91 *supra*.

290 For example, Swiss anti-avoidance measures may deny the benefits of the reduced treaty withholding rates if the Swiss recipient enterprise is not controlled by Swiss residents. *See, e.g.,* Convention for the Avoidance of Double Taxation on Income and Fortune, Sept. 9, 1966, France-Switzerland, art. 14, [1967] J.O. 9972, 772 U.N.T.S. 275, 299. The anti-avoidance measures would not apply if the Swiss lessor is engaged in true leasing—the income from which would be eategorized as business profits. Articles 6 and 7 of the Franco-Swiss Income Tax Treaty.

291 I.R.C. § 168(f)(2) provides special rules for depreciation of property used outside the United States.

292 *See* text accompanying notes 91-93 *supra*.

so that they inure to more than one taxpayer will influence the lease structure. The parties may try to arrange for supply of the equipment by a company located in a country that characterizes such arrangements as a lease, and the acquisition of the equipment by a company located in a country that treats the transaction as a sale, so that both customer and manufacturer receive depreciation benefits.[293]

Divergent characterization might also present special tax shelter opportunities for a multinational group of related enterprises. For example, if a United States company owns a British operating subsidiary, an equipment lease through an intermediary subsidiary incorporated in Delaware but "resident" in the United Kingdom for purposes of British taxation would yield tax savings for the multinational group.[294] If the subsidiary leases equipment to the parent, the subsidiary (under British principles) as well as the parent (under American principles) may depreciate the equipment.[295] The intermediate subsidiary and the parent could file a consolidated return in the United States[296] and claim both depreciation and the investment tax credit. Rental income to the subsidiary would be offset by the parent's deductions, and British "group relief" provisions would permit the British capital allowance to offset the rental income received by the Delaware Company as well as other income of the subsidiary.[297] Tax benefits of the equipment acquisition thus offset operating income in both the United States and the United Kingdom. In addition, an American company could lease equipment to its foreign subsidiary under terms that create a lease for United States tax purposes but a purchase under the law of the subsidiary's corporate residence. Under such circumstances, depreciation would reduce the taxable income of both parent and subsidiary.[298]

Asymmetrical characterization also affects the terms offered by an equipment supplier. Suppose, for example, that a French enterprise seeks to obtain a computer from British, French, and German financiers. The British financier will not offer a purchase option for fear of losing its

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293 A triple benefit might exist by virtue of a "back to back" lease through the manufacturer's Dutch subsidiary, under conditions that are deemed a purchase by the Dutch company and a lease to the British user under Dutch law. Thus, the American company depreciates as owner, the Dutch company depreciates as purchaser-lessor, and the British company takes a capital allowance if the lease has a purchase option.

294 The test of tax status is that of management and control. Income and Corporation Taxes Act, 1970, c. 10, § 482(7).

295 The lease must be drafted carefully. For example, the lease term might cover 90% of the equipment's useful life, *without* a purchase option.

296 I.R.C. §§ 1501-1504.

297 The Finance Act of 1967 provided group relief similar in effect to the consolidated return. *See* Income and Corporation Tax Act, 1970, c. 10, §§ 258-264. *See generally* B. PINSON, REVENUE LAW 256-57, 267-68 (12th ed. 1978).

298 The effectiveness of this scheme assumes that the accelerated depreciation will exceed the rental income and thus offset other income of the parent.

capital allowances[299] and, therefore, will be at a competitive disadvantage against the other two suppliers. The French *crédit-bail* company can offer a purchase option at a nominal price without losing its depreciation benefits, whereas a nominal option price would prevent the German lessor from taking depreciation deductions.[300]

Finally, asymmetrical lease characterization affecting the determination of the source of income may also cause economic double taxation. For example, assume that an American supplies goods to a foreign user, and the IRS characterizes the transaction a sale with title passage in the United States. If the foreign tax authorities characterize the transaction as a lease, then the rents will be subject to a foreign withholding tax, which cannot be credited against United States tax liability because the source of the income under United States characterization principles is the United States.[301]

V

HARMONIZATION OF DIVERGENT CHARACTERIZATION STANDARDS

The extent to which policy makers will decide to reduce tax-induced distortion of trade and capital flows depends on their conclusions as to the benefits of transnational business and assumptions about the opportunities for alternative domestic economic activity. Economic inefficiency may result from the movement of goods, services, capital, and other factors of production that are unrelated to real productivity differentials. Analysis of such fiscal distortions of trade and investment is often subsumed under the rubric of tax "neutrality." From a global perspective, neutrality is achieved when profits from an international transaction are taxed at the same rate as a domestic transaction.[302] To achieve this neutrality, a domestic lease should bear the same tax burden as its trans-border competitor. Accepting tax neutrality as a goal presupposes the benefits of free competition among countries.

Free competition arguably optimizes the use of resources and maxi-

299 *See* text accompanying notes 90-91 *supra*; Clark, *Equipment Leasing—Some Tax Thoughts*, 1977 BRIT. TAX REV. 282.

300 *See* text accompanying note 111 *supra*.

301 *See* note 246 *supra*, discussing AMP Inc. v. United States, 492 F. Supp. 27 (M.D. Pa. 1979). The "mutual agreement" provisions of bilateral income tax treaties might be invoked to avoid the double taxation from such inconsistent characterization. For a general discussion of the mutual agreement procedure, see G. LINDEIRONA & N. MATTSON, ARBITRATION IN TAXATION 47-58 (1981).

302 *See* Ture, *Taxing Foreign-Source Income*, in U.S. TAXATION OF AMERICAN BUSINESS ABROAD 37-66 (1975). There is, however, no universal definition of tax neutrality. One can view neutrality from the perspective of a credit-exporting country or a credit-importing country. Ture remarks that the definition of neutrality varies "very much as Humpty-Dumpty put it to Alice: 'When *I* use a word, it means just what I choose it to mean.' " *Id.* at 38.

mizes the potential economic welfare of all nations participating in the transnational exchange of goods, services, and capital. Efficiency is promoted because each nation specializes in what it does best and trades for the other items it needs.[303] Leasing is an element in the flow of equipment and credit, the factors of production. Tax-induced distortion of leasing patterns impedes optimum resource allocation, because resources move in response to tax-induced rather than real rates of return.

There is evidence of an emerging international norm against distortion of the movement of the factors of production.[304] This trend manifests itself in regional economic cooperation through common markets and free trade areas,[305] as well as pronouncements of international economic organizations such as the International Monetary Fund and the Organization for Economic Cooperation and Development.[306] The

303 In the early nineteenth century, the English economist David Ricardo proposed a theory of comparative costs, later supplemented by John Stuart Mill. The following example illustrates the theory. Frenchmen produce a bolt of cloth for two cost units and a bottle of wine for one unit; thus, in the French value system, one bolt of cloth equals two bottles of wine. Englishmen produce a bolt of cloth for five cost units and a bottle of wine for ten units; thus, in the English value system, one bolt of cloth equals one-half bottle of wine. Even though the French have an absolute advantage in both products, it would be beneficial to both countries to exchange goods. If the Frenchman gives the Englishman one bottle of French wine for one bolt of English cloth, both will be the richer, and each will specialize in what he does best. On the theory of comparative advantage, see generally H. GRAY, INTERNATIONAL TRADE, INVESTMENT, AND PAYMENTS 16-20, 33-39 (1979); C. KINDLEBERGER & P. LINDERT, INTERNATIONAL ECONOMICS 16-23 (6th ed. 1978).

304 *See* 19 U.S.C. §§ 2101-2487 (1976); Treaty Establishing the European Economic Community, Mar. 25, 1957, arts. 67-73, 298 U.N.T.S. 11 (1958) [hereinafter cited as Treaty of Rome]; ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, CODE OF LIBERALISATION OF CAPITAL MOVEMENTS art. 1(a) (1973) [hereinfter cited as OECD CODE OF LIBERALISATION]; Articles of Agreement of the International Monetary Fund, Dec. 27, 1945, art. VI, § 3, art. VIII, § 2(a), art. XIV, art. XIX, 60 Stat. 1401, T.I.A.S. No. 1501, 2 U.N.T.S. 39 [hereinafter cited as IMF Articles of Agreement]. On the process by which international norms are created, see McDougal & Reisman, *The Prescribing Function in the World Constitutive Process: How International Law is Made*, 6 YALE J. WORLD ORD. STUD. 249 (1980).

305 Common markets and free trade areas outside of the European Economic Community include the Latin-American Free Trade Association (LAFTA), the Andean Group within LAFTA (ANCOM), the European Free Trade Association (EFTA), and the Caribbean Community. *See generally* K. RYAN, INTERNATIONAL TRADE LAW 86-93 (1975).

306 The IMF Articles of Agreement state its purposes as "to facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members." IMF Articles of Agreement, *supra* note 304, art. I(ii). The OECD Code of Liberalisation of Capital Movements reflects the same commitment to the elimination of trade barriers by providing that "Members shall progressively abolish between one another . . . restrictions on movements of capital to the extent necessary for effective economic cooperation." OECD Code of Liberalisation, *supra* note 304, art. 1(a). Among the goals of the EEC is the abolition of "obstacles to the free movement of persons, services, and capital." Treaty of Rome, *supra* note 304, art. 3. Although extension of credit by banks is considered a service, *id.* art. 61(2), a Council Directive provides that banking services related to capital movements are to be liberalized according to the schedules for liberalizing eapital movements. Directive issued on Dec. 18, 1961, published in Official Journal No. 2, Jan. 16,

United States Congress also has acknowledged the benefits of free trade in the Trade Act of 1974, which seeks "to harmonize, reduce, and eliminate barriers to trade on a basis which assures substantially equivalent competitive opportunities for the commerce of the United States . . . ."[307] The unification of trade and tax law should be viewed in terms of these desiderata.

General attempts to unify trade law, thereby facilitating international commerce, also demonstrate a concern about tax-induced trade distortion.[308] The League of Nations,[309] the United Nations,[310]

1962, at 32; 5 J.O. EUR. COMM. 32 (1962). Moreover, a Council Directive on the Abolition of Restrictions on Freedom of Establishment explicitly applies to "Installment sales finance undertakings," "Commercial" and "Industrial credit undertakings," and states that lack of harmonization impedes free competition among credit undertakings. 16 O.J. EUR. COMM. (L 194) 1-8 (1973), art. 2; Annex II, Category 2.

The EEC and OECD policies in matters of credit insurance and export loans are also evidence of the norm against distortions of trade and capital flows. It may be easier, for example, to export products or services if one government provides its nationals with financing at 1%, rather than the 5% export finance provided by another. *See The War of the Export Loans*, NEWSWEEK, Jan. 26, 1981, at 19. The resulting benefit is closely analogous to the effect on finance leases of tax benefits that enable one lessor to grant a lower implicit interest rate than another.

Leasing contracts are expressly treated as credit by the E.E.C. Regulations for "Consultation and Information Procedures in Matters of Credit Insurance, Credit Guarantees and Finance Credits." 16 O.J. EUR. COMM. (L 346) 2, Annex I, Section 2 (1973). *See generally* E. STEIN, P. HAY & M. WAELBROECK, EUROPEAN COMMUNITY LAW AND INSTITUTIONS IN PERSPECTIVE 990-1000 (1963). The Organization for Economic Cooperation and Development adopted finance standards with a similar goal. The OECD "Understanding on a Loeal Cost Standard" provides that OECD member nations will not grant export credits for more than the value of the goods or services. This rule prevents governments from giving a "kicker" to stimulate their exports and benefit their exports over those of another country. The OECD "Understanding" is discussed in E. STEIN, P. HAY & M. WAELBROECK, *supra*, at 961, and by the European Court of Justice in a decision of Nov. 11, 1975, discussed at 18 O.J. EUR. COMM. (C 268) 18 (1975).

307 19 U.S.C. § 2102(2) (1976).

308 *See generally* R. DAVID, INT'L UNIFICATION OF PRIVATE LAW, II INT'L ENCYCLOPEDIA OF COMPARATIVE LAW ch.5 (1971).

309 The League Assembly and Council appointed its own expert committee on the unification of private international law. *See, e.g.,* International Convention for the Abolition of Import and Export Prohibitions and Restrictions, Nov. 8, 1927, 97 L.N.T.S. 391.

310 The United Nations Commission on International Trade Law (UNCITRAL) was created December 1966. Resolution No. 2205, 21 U.N. GAOR Supp. (No. 16) 99, U.N. Doc. A/6316 (1966). UNCITRAL works to unify private international law in several substantive areas. UNCITRAL's work includes a Convention on the Carriage of Goods by Sea, 31 U.N. GAOR Supp. (No. 17) 17, U.N. Doc. A/31/17 (1976) (text adopted in substantial part by U.N. Conference on the Carriage of Goods by Sea, 33 U.N. GAOR, U.N. Doc. A/CONF. 89/13 (1978); a draft Convention on Contracts for the International Sale of Goods, *see* 33 U.N. GAOR Supp. (No. 17) 10, U.N. Doc. A/33/17 (1978) (adopted by the U.N. Conference on Contracts for the International Sale of Goods, *see* 35 U.N. GAOR Supp. (No. 17) 6, U.N. Doc. A/35/17 (1980)); arbitration rules, 31 U.N. GAOR Supp. (No. 17) 34, U.N. Doc. A/31/17 (1976); and conciliation rules, 35 U.N. GAOR Supp. (No. 17) 11, U.N. Doc. A/35/17 (1980). The Report of UNCITRAL on the work of its 13 sessions indieates current areas of Commission efforts. *See* 35 U.N. GAOR Supp. (No. 17), U.N. Doc. A/35/17 (1980).

UNIDROIT,[311] and the Hague Conference on Private International Law have all made unification endeavors.[312] Areas of concern include sales of goods,[313] maritime law,[314] civil aviation,[315] land transport,[316] ne-

See generally Farnsworth, *UNCITRAL—Why? What? How? When?*, 20 AM. J. COMP. L. 314 (1972).

311 The Italian government created the International Institute for the Unification of Private Law, or "UNIDROIT," by statute in March 1926. Although largely Italian funded, the Institute originally operated under the auspices of the League of Nations and was dedicated to the study of methods for the assimilation and coordination of private law between states or groups of states and to prepare for a gradual adoption by the various states of uniform private law legislation. D. MYERS, HANDBOOK OF THE LEAGUE OF NATIONS 65-67 (1935). *See also* R. DAVID, *supra* note 308, ch. 5, at 133-34. Like UNCITRAL, the Institute addresses issues of substantive law and attempts to avoid duplicating the efforts of other international organizations. *See* Note, 68 AM. J. INT'L L. 97 (1974). One of its latest products is a Draft Convention on the Law Applicable to Ageney, adopted June 16, 1977, *reprinted in* 16 I.L.M. 775 (1977). *See also* Bonnell, *The UNIDROIT Initiative for the Progressive Codification of International Trade Law*, 27 INT'L & COMP. L.Q. 413 (1978).

312 In existence since 1893, the Hague Conference originally examined questions of choice of law, jurisdiction, and enforcement of judgments. The Conference began as a European institution, but has since increased its membership to include the United States, Canada, and Japan. *See* Nadelmann, *The United States Joins the Hague Conference on International Private Law*, 30 LAW & CONTEMP. PROB. 291 (1965); Van Hoogstraten, *The United Kingdom Joins an Uncommon Market*, 12 INT'L & COMP. L.Q. 148 (1963). The experiences of the Hague Conference demonstrate that international and regional goals occasionally confiict. In a number of procedural law areas, the European Economic Community's harmonization initiatives eaused significant problems for the Conference. *See* Barrett, *International Unification of Private Law—Current Activities*, 6 INT'L LAW. 675 (1972); Nadelmann, *Clouds Over International Efforts to Unify Rules of Conflict of Laws*, 41 LAW & CONTEMP. PROB. 54 (1977).

313 The U.N. Conference on Contracts for the International Sale of Goods, held in Vienna from March 10 to April 11, 1980, adopted UNCITRAL's Convention on Contracts for the International Sale of Goods, which covers the formation of such contracts and the rights of the parties once a contract is formed. UNCITRAL is also studying selected aspects on international trade contracts (for example, clauses covering "hardship," *force majeure*, liquidated damages, and penalties) and is nearing completion of a Draft Convention on International Bills of Exchange and International Promissory Notes and Uniform Rules on International Cheques. *See* 35 U.N. GAOR Supp. (No. 17) 8-10, U.N. Doc. A/35/17 (1980). Another U.N. Conference adopted the UNCITRAL Draft Convention on Prescription (Limitation) in the International Sale of Goods. *See* 29 U.N. GAOR, U.N. Doc. A/CONF. 63/15 (1974). The conditions affecting the validity of contracts for the international sale of goods was the subject of a UNIDROIT study submitted to UNCITRAL in 1974, but the Commission finally abandoned the project as too complex. *See* UNIDROIT, *Sale* VI, DIGEST OF LEGAL ACTIVITIES OF INTERNATIONAL ORGANIZATIONS AND OTHER INSTITUTIONS (1980).

314 Since its inception in 1896, the International Maritime Committee has achieved some success in unifying international maritime law. Conventions sponsored by the Committee include a 1924 agreement that unifies certain rules regarding bills of lading. *See* R. DAVID, *supra* note 308, at 152-56. The Inter-Governmental Maritime Consultative Organization, another United Nations Organization, examines issues of health and safety. *See* Juda, *IMCO and the Regulation of Ocean Pollution from Ships*, 26 INT'L & COMP. L.Q. 558 (1977).

315 Civil aviation has received concerted international action on matters such as carrier liability and documentation standards. *See* Warsaw Convention on Unifieation of Certain Rules Relating to International Transportation by Air, Oct. 12, 1929, 49 Stat. 3000, 2 Bevans 983. The Chicago Convention created the Interuational Civil Aviation Organization, Dec. 7, 1944, 59 Stat. 1516, E.A.S. No. 469. The I.C.A.O. has sponsored conventions dealing with liability of carriers, liability for damages caused by aircraft to third parties on the ground,

gotiable instruments,[317] and arbitration.[318]

The policies underlying tax neutrality and harmonization sometimes conflict with the protection of more parochial interests. Governments may interfere with tax neutrality to obtain short-term advantages such as the promotion of particular types of investment. Even organizations committed to freer international trade and investment recognize that some exclusive national interests may take precedence.[319]

Fiscal harmonization programs intended to reduce tax-induced trade distortion have received much attention from modern economic unions[320] such as the Benelux Economic Union[321] and the European Economic Community.[322] The treaty establishing the European Eco-

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and other topics, thereby facilitating international trade and transportation via air. *See generally* R. DAVID, *supra* note 308, at 156-62.

316 The European states have been the chief actors in this area, especially in regard to rail transportation. The "CIM," Oct. 23, 1924, 77 L.N.T.S. 367 (rail transport of goods), and the "CIV," Oct. 23, 1924, 78 L.N.T.S. 17 (rail transport of passengers and luggage), which covered many details of contract content as well as carrier liability, were augmented in 1966 by a third convention dealing with the same subject matter. 1966 Tractatenblad 174-6. *See also* UNIDROIT, *Transportation by Rail I*, DIGEST OF LEGAL ACTIVITIES OF INTERNATIONAL ORGANIZATIONS AND OTHER INSTITUTIONS (1980).

317 *See, e.g.,* Convention on a Uniform Law on Bills of Exchange and Promissory Notes, June 7, 1930, 143 L.N.T.S. 257; Convention on a Uniform Law for Cheques, Mar. 19, 1931, 143 L.N.T.S. 355.

318 *See, e.g.,* Protocol on Arbitration Clauses, Sept. 24, 1923, 27 L.N.T.S. 158; Convention on Execution of Foreign Arbitral Awards, Sept. 26, 1927, 92 L.N.T.S. 301; New York Convention of 10 June 1958 for the Recognition and Enforcement of Foreign Arbitral Awards, June 10, 1958, 330 U.N.T.S. 3; and the UNCITRAL arbitration and conciliation rules. *See generally* R. DAVID, *supra* note 308, at 130-33.

319 The OECD guidelines provide that "serious economic and financial disturbance" are grounds for derogation of the guidelines. OECD CODE OF LIBERALISATION, *supra* note 304, art. 7(b). The IMF Agreement permits exchange restrictions by a state that avails itself of transitional arrangements. IMF ARTICLES OF AGREEMENT, *supra* note 304, art. XIV, § 2. The European Economic Community Commission has opined that although "Member States should not seek to outbid each other in their offers of general tax exemptions," tax incentives may be justified by "specific economic . . . policy objectives." [1980] COMMON MARKET REP. (CCH) ¶ 10,174.

320 On customs unions and tax harmonization, see Dosser, *Economic Analysis of Tax Harmonization*, and Musgrave, *Harmonization of Direct Business Taxes: A Case Study*, in FISCAL HARMONIZATION IN COMMON MARKETS 1-57, 207-59 (C. Sharp ed. 1967).

321 *See generally* M. KRAUSS, FISCAL HARMONIZATION IN THE BENELUX ECONOMIC UNION (1969).

322 The rich literature on "approximation" of national tax laws in the European Economic Community includes: E. STEIN, P. HAY & M. WAELBROECK, *supra* note 306, at 376-84, 693-727; C. SULLIVAN, THE SEARCH FOR TAX PRINCIPLES IN THE EUROPEAN ECONOMIC COMMUNITY (1963); Anschutz, *Harmonization of Direct Taxes in The European Economic Community*, 13 HARV. INT'L L.J. 1 (1972); Surrey, *Implications of Tax Harmonization in the European Common Market*, 46 TAXES 398 (1968); Vogelaar, *Tax Harmonization in the European Community*, 7 COMMON MKT. L. REV. 323 (1970); Address by Richard Burke (Member of the Commission of the European Communities) to the Institute of Chartered Accountants in England and Wales (Centenary Conference) (London, May 15, 1980); Information Memo No. P-23 from Commission of the European Communities, *discussed in* [1980] COMM. MKT. RPTR. (CCH) ¶ 10,214. Commission of the European Communities, Programme for Harmonization of Di-

nomic Community[323] explicitly provides for harmonization of indirect taxes, such as excise and turnover duties,[324] and implicitly provides for harmonization of direct taxes in the "approximation of [laws] directly affecting the establishment or functioning of the common market."[325] The European Economic Community Commission has considered taxation of mergers,[326] parent-subsidiary taxation,[327] and integration of corporate and shareholder taxation[328] in its harmonization efforts. In addition, the European Parliament has called for harmonization of the corporate tax base;[329] this is particularly relevant to leasing because of the importance of depreciation to any definition of taxable income.[330]

Proposals for harmonizing lease characterization have heretofore addressed only commercial law issues related to nonpossessory security interests in personal property. Studies have been conducted by the United Nations Commission on International Trade Law (UNCITRAL),[331] the Council of Europe, and the International Institute for Unification of Private Law (UNIDROIT),[332] a private institution that has undertaken the progressive codification of the law of international

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rect Taxes, *discussed in* [1980] COMM. MKT. RPTR. (CCH) ¶ 3211. *See also* the so-called Newmark Report, Report of the Fiscal and Financial Committee, *E.E.C. Reports on Tax Harmonization*, unofficial translation by H. Thurston (Int'l Bureau of Fiscal Documentation 1963). Bryan, *International and Corporate Double Taxation Problems in the Light of European Economic Community Proposals for Harmonization of Company Taxation*, 8 GA. INT'L & COMP. L.J. 833 (1978).

323 Treaty of Rome, *supra* note 304.

324 *Id.* art. 99: "The Commission shall consider in what way the law of the various Member States concerning turnover taxes, excise duties and other forms of indirect taxation, including compensatory measures applying to exchanges between Member States, can be harmonized in the interest of the Common Market."

325 *Id.* art. 100. The term "direct tax" designates taxes such as the income tax imposed directly on the individual or entity intended to bear them, rather than on a transaction. *See* Musgrave, *supra* note 320, at 207.

326 *See* 12 J.O. COMM. EUR. (No. C39) 1 (1969).

327 *See id.* at 7.

328 *See* Proposal for a Council Directive Concerning the Harmonisation of Systems of Company Taxation and of Withholding Taxes on Dividends, 10 BULL. E.C. 7 (1975).

329 *See* Interim Report on the Harmonisation of Company Taxation and of Withholding Taxes on Dividends, [1979-80] EUR. PARL. DOC. (No. 104) 5-6 (1979).

330 The fiscal aspects of economic integration are described in E. CALE, LATIN AMERICAN FREE TRADE ASSOCIATION: PROGRESS, PROBLEMS, PROSPECTS (1969); THE CARIBBEAN COMMUNITY SECRETARIAT, THE CARIBBEAN COMMUNITY: A GUIDE (1973); EUROPEAN FREE TRADE ASSOCIATION SECRETARIAT, THE EUROPEAN FREE TRADE ASSOCIATION (2d ed. 1980); V. WATKIN, TAXES AND TAX HARMONIZÁTION IN CENTRAL AMERICA (1967); Oliver, *The Andean Foreign Investment Code*, 66 AM. J. INT'L L. 763 (1972).

331 *See* Drobnig, *Legal Principles Governing Security Interests*, U.N. Doc. No. A/CN.9/131 (1977). *See generally* Farnsworth, *supra* note 310; Symposium, *Unification of International Trade Law: UNCITRAL's First Decade*, 27 AM. J. COMP. L. 201 (1979); Comment, *U.N. Commission On International Trade Law: Will A Uniform Law In International Sales Finally Emerge?*, 9 CAL. W. INT'L L.J. 157 (1979).

332 *See* COUNCIL OF EUROPE, SALES OF MOVABLES BY INSTALLMENT AND ON CREDIT IN MEMBER STATES OF THE COUNCIL OF EUROFE (1970). Although published in Strasbourg,

commercial transactions.[333]

UNIDROIT has examined extensively the legal aspects of trans-border finance leasing[334] and proposed uniform leasing rules for the triangular *sui generis* finance lease, in which a financier purchases capital goods on the specifications of the equipment user.[335] Transactions involving "merchant" or "vendor" lessors—what American accountants would call a "sales-type" lease[336]—are beyond the scope of the draft rules, as are tax and accounting aspects of leasing.[337] The *crédit-bail* model of the tripartite finance lease, conceived as a proxy conferred on the equipment user to act on the financier's behalf in dealings with the manufacturer,[338] has influenced significantly the UNIDROIT study.

The UNIDROIT study primarily concerns the pitfalls faced by a lessor operating directly in a foreign country, including attempts to repossess equipment from a defaulting lessee,[339] the effect of purchase options,[340] and the effect of publicity informing other creditors of the lessor's title.[341] The draft rules provide that the lessor is not liable for equipment defects unless they result from the lessor's technical interven-

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the study was prepared in Rome by the International Institute for the Unification of Private Law, commonly known as UNIDROIT. On UNIDROIT, see note 311 *supra*.

333 *See generally* M. MATTEUCCI & R. MONACO, UNIDROIT 1926-1976 (1976); Bonell, *The UNIDROIT Initiative for the Progressive Codification of International Trade Law*, 27 INT'L & COMP. L.Q. 413 (1978).

334 To date, UNIDROIT has produced 13 reports, classified as "Study LIX," Documents 1 (March 1975) through 13 (Oct. 1980) [hereinafter cited as UNIDROIT Doe. Nos. 1-13] and "Draft of Uniform Rules on the Sui Generis Form of Leasing Contract," contained in UNIDROIT Doc. No. 13 [hereinafter cited as UNIDROIT Draft Uniform Rules].

335 UNIDROIT Draft Uniform Rules, *supra* note 334, art. 1, at 2.

336 FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 13 (Nov. 1976).

337 The June 1980 version of the Preamble to the UNIDROIT Draft Rules (UNIDROIT Doc. No. 10) states explicitly that the Rules deal "only with the private law aspects of [finance leasing] to the consequent exclusion of the revenue and accounting aspects thereof . . . ." However, the October 1980 revised version (UNIDROIT Doc. No. 13) omits the "to the consequent exclusion of the revenue and accounting aspects" language. Although the report accompanying the October 1980 version does not explain this omission, two Study Group spokesmen have indicated that the omission is insignificant. *See* Remarks of Peter Coogan and Detlev Vagts (United States representatives to UNIDROIT Study Group) and Martin Stanford (Secretary to UNIDROIT Study Group) at ALI-ABA Symposium on Unification of the Law Governing International Leasing of Equipment, New York, May 7-8, 1981. Materials used during the Symposium are printed as ALI-ABA Document No. 3599 and Appendix.

338 *See, e.g.,* E. BEY, *supra* note 15, at 210-12. The financier confers the *mandat* on the user, both to select the equipment and to sue the manufacturer in the event of equipment defect. The *mandat* is combined with a sale (to the financier by the manufacturer) and rental (by the financier to the user).

339 *See, e.g.,* UNIDROIT Doc. No. 1, at 36 (¶ 32-35); UNIDROIT Doc. No. 7, at 19 (¶ 50).

340 *See, e.g.,* Remarks of Professor Gavalda, UNIDROIT Doc. No. 7, at 8 (¶ 18).

341 See, *e.g.,* Drafts in UNIDROIT Doc. No. 8, art. 5, Doc. No. 10, art. 4, requiring lessor registration to assert title against other creditors.

tion.[342] Thus, the UNIDROIT rules would give finance lessors the best of both worlds—they would be owners for purposes of equipment repossession but mere financiers for product liability.

Although the UNIDROIT proposals do not cover the tax aspects of leasing, they inadvertently could have a fiscal impact. The draft treaty covers only leases of a purely financial nature. If a lessor were to claim the benefits of the treaty, the IRS might argue that the lessor had admitted that the transaction is not a true lease and, therefore, deny depreciation deductions.

The harmonization of divergent characterization standards also can be expected to further international economic integration and interdependence by promoting a sense of commonly shared values among trading partners. Although the effects of economic integration do not lend themselves to empirical measurement,[343] the logic of the hypothesis is strong. Rules of law represent feelings about "obligation, legitimacy and the like."[344] Legal homogeneity thus may exert an integrative force on an international community by encouraging value cohesion and facilitating the transactions that contribute to integration.

International economic interdependence also has political implications.[345] The relationship between economic interdependence and the reduction of international conflict, asserted by commentators throughout much of this century,[346] is based on the belief "that increasing the volume of shared transactions and common tasks can erode hostility";[347]

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342 *See, e.g.*, UNIDROIT Doc. No. 1, at 27 (¶ 99); UNIDROIT Doc. No. 3, at 36 (¶ 75); *id.* at 62 (¶ 175); UNIDROIT Doc. No. 10, art. 6.

343 *See* E. STEIN, HARMONIZATION OF EUROPEAN COMPANY LAWS 2 (1971).

344 *Id.* at 1.

345 The diverse effects of international economic integration are generally addressed in H. ALKER JR., L. BLOOMFIELD, & N. CHOUCRI, ANALYZING GLOBAL INTERDEPENDENCE (M.I.T. Center for Int'l Studies n.d.); R. COOPER, THE ECONOMICS OF INTERDEPENDENCE: ECONOMIC POLICY IN THE ATLANTIC COMMUNITY (1968); J. VINER, THE CUSTOMS UNION ISSUE (1950); Humphrey, *Constructive Economic Interdependence*, 26 LAB. L.J. 615 (1975); Sutton, *World Peace Through Foreign Trade*, 17 DE PAUL L. REV. 38 (1967).

346 This view is not shared by all. One writer has stated:

> But close interdependence . . . raises the prospect of at least occasional conflict. The fiercest civil wars and the bloodiest international ones have been fought within arenas populated by highly similar people whose affairs had become quite closely knit together. It is hard to get a war going unless the potential participants are somehow closely linked. Interdependent states whose relations remain unregulated must experience conflict and will occasionally fall into violence. If regulation is hard to come by, as it is in the relations of states, then it would seem to follow that a lessening of interdependence is desirable.

Waltz, *The Myth of National Interdependence*, in THE INTERNATIONAL CORPORATION 20 (C. Kindleberger ed. 1970).

347 Bloomfield, *Toward a Strategy of Interdependence*, DEPARTMENT OF STATE SPECIAL REPORT No. 17, at 8 (July 1975). In this regard, former United States Secretary of State Cordell Hull stated that "if goods can't cross borders, armies will." Gardner, *The Hard Road to World*

international exchange of goods, services, and capital generally should be mutually advantageous.

In sum, a uniform approach to lease characterization is a desirable step toward reducing potential trade distortion and facilitating the efficient allocation of resources. The selection of a uniform approach will be explored with these ends in view.

VI

A PROFILE OF ECONOMIC OWNERSHIP

A lessor is said to "own" the leased property. The search for a uniform approach to lease characterization thus requires an inquiry into the concept of ownership as it relates to the policies underlying income tax statutes and treaties.

A. *Characterization Methodology: Analogies or Goals?*

Analogical reasoning[348] is useful in tax law because it furthers equity among similarly situated taxpayers. Analogies, however, do not necessarily further the purposes of the applicable substantive rules. To decide that two transactions should receive similar treatment does not answer the question of *which* rule should apply. After the taxing authority decides that a finance lease resembles an installment sale, it must then decide whether the lease is to be taxed as a sale or the sale is to be taxed as a lease.

Lease characterization should properly begin with an inquiry into the function or purpose of the applicable rule. Such teleological characterization recognizes that rules of law typically are made to solve particular perceived difficulties—they have an end in view or a policy to be furthered. The meaning of terms used in the rule of law must relate to their desired consequences.[349] Thus, legal definitions inevitably become policy statements.[350] By saying "John owns this car," one may be saying

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Order, 52 FOREIGN AFF. 556, 567-68 (1974). Similarly, President Nixon contemplated a "network of relationships and interdependencies . . . that take the profit out of war." Bloomfield, *supra*, at 7.

348 To determine whether a creature is a rabbit or a fish, one might study the beast in question and compare it with other creatures commonly regarded as rabbits or fish. Sueh reasoning is analogical, asking whether one thing looks like another.

349 The need for teleological reasoning has been illustrated by the ease of a pedestrian injured by an automobile racing through a small town park, in response to which the town enacts an ordinance providing "No vehicles in the park." The word "vehicle," however, comprises motorcycles, baby carriages, and bicycles as well as automobiles. Therefore, in order to apply the ordinance, one would have to identify its intended consequences and consider its enforcement in light of these consequences. *See generally* Brest, *The Misconceived Quest for Original Understanding*, 60 B.U. L. REV. 201 (1980).

350 See, *e.g.*, CODE CIVIL, arts. 893, 913-19, which provides that parents cannot disinherit their children. Alienation of property is barred in an amount called the *réserve héréditaire*,

that Jane should leave it alone. But should it also mean that John has the right to fiscal benefits provided to those who invest in income-producing assets?

Examples of the teleological approach to characterization appear in United States tax law. In *Don E. Williams Co. v. Commissioner*,[351] a company using accrual-basis accounting executed and delivered promissory notes to an employee profit-sharing plan and later tried to deduct the amounts as contributions.[352] The Supreme Court held that the employer had "paid" the contributions a year later, when it actually had given cash for the notes.[353] The Court acknowledged that the term "paid" may be defined differently when it appears in other provisions of the Internal Revenue Code, in particular those intended to prevent the tax avoidance that might result from a lag betweeen a payer's deduction and a related recipient's recognition.[354] The Court observed, however, that the Code provision is intended to ensure that related parties receive consistent tax treatment.[355] In *Williams*, however, the pension plan was tax-exempt. Thus, according to the Court, the goal of furthering tax symmetry was not helpful to the proper interpretation of the term "paid."[356]

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which for a father of four would be equal to three-fourths of his estate. The descendants' participation in the estate even against the testator's express intent to the contrary has been supported by several policies: release of the state from the need to support indigent children, preservation of family ownership of its fortune, and prevention of discord over the family fortune.

If a Frenchman decides to give all his personal property to a New York trust of which someone other than a child is the sole beneficiary, a court will have to determine whether this arrangement unknown to French law is more like a will—whose validity depends on the law of the maker's last domicile—or a contract—whose validity depends on the law chosen by the parties to govern the agreement.

In 1970, a Paris court considered this ease, which involved a 1926 trust established under New York law by the Princess de Henin. The French court decided that the trust was not a testamentary disposition, but rather a contract subject to the law chosen by the parties. Judgment of Jan. 10, 1970, Cour de Paris, discussed in a note by Droz, 64 REV. CRIT. DR. INT. PRIVE 525 (1975) and by Loussouarn, 100 J. DR. INT. 207 (1973).

Criticism of this decision has focused on its failure to give attention to the function of the rule rejected by the court, *i.e.*, protection of the family unit. A teleological view would consider the purposes of the relevant rules and their appropriateness in the given situation. *See* Ancel, *L'Objet de la Qualification*, 107 J. DR. INT. 227 (1980).

On the origins and goals of the *réserve héréditaire*, see Lemann, *In Defense of Forced Heirship*, 52 TUL. L. REV. 20 (1977).

On the application of the reserve to non-French family contexts, see Audit, note on Van Leyden v. Van Leyden, 64 REV. CRIT. DR. INT. PRIVE 431 (1975). *See also* Note, *Avoiding Civil Law Forced Heirship by Stipulating that New York Law Governs*, 20 VA. J. INT'L L. 887 (1980).

351 429 U.S. 569 (1977).

352 I.R.C. § 404(a) allows for deduction of certain "contributions . . . paid by an employer to or under a stock bonus, pension, profit-sharing, or annuity plan . . . ."

353 429 U.S. at 578-79.

354 *See* I.R.C. § 267.

355 429 U.S. at 580-82.

356 In AMP Inc. v. United States, 492 F. Supp. 27 (M.D. Pa. 1979), the court considered

The provisions of Subpart F,[357] designed to prevent the artificial shifting of income to foreign tax havens,[358] illustrate one drafting approach to characterization issues. Because of the potential for abuse, Congress has deemed rents received by foreign companies to be tainted with a tax avoidance purpose. Such a presumption seems unwarranted when the foreign company manufactures, markets, or services the rented product. Therefore, the Code and Treasury Regnlations simply exclude rentals of the latter type from the coverage of Subpart F because their inclusion does not further the statutory purposes and policies.[359] This approach eliminates the need to redefine "rentals" in some instances.

B. *Competing Policies*

Assume, with respect to a domestic automobile lease, that a single issue must be decided: Should the lessor or the lessee take depreciation? If the purchase option is at a nominal price, the goal of measuring net enrichment requires that the lessor be treated as having terminated its interest in the vehicle, and the lessee be treated as owner.

If the lessor is foreign, however, the question arises as to whether the lease income is United States source income. Should characterization be affected because a lease, in contrast to a credit sale, results in taxable income in the full amount of the rentals rather than merely the interest element? When a single concept such as "lease" or "ownership" becomes relevant to a number of purposes, teleological reasoning becomes more difficult, and interpretive fine-tuning becomes costlier. Although some goals support one particular characterization, others do not.[360]

The plethora of tax issues related to leasing, including depreciation deductions, investment tax credits, rental deductions, capital gains and losses, foreign tax credits, fiscal jurisdiction, tax haven regimes, and the rates applied by treaty to income of foreigners, complicates the characterization process. These issues raise several identifiable policy goals.

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the characterization of payments for transfer of patents to foreign subsidiaries. The court relied on *Williams* in finding the payments to be license royalties for purposes of expanding the taxpayer's foreign tax credit. These payments had also been classified as sales proceeds, giving the taxpayer preferential capital gains treatment on the transfer. The court stated, "[T]he same words may have different meanings, dependent on where they are found in the Code." *Id.* at 32.

357 I.R.C. §§ 951-960.

358 *See* text accompanying notes 253-73 *supra*.

359 *See* I.R.C. § 954(c)(3); Treas. Reg. § 1.954-2(d)(1) (1964).

360 The characterization process may bring to mind Dickens's Pickwick Club, where Mr. Blotton called Mr. Pickwick a humbug not in "a common sense," but in a "Pickwickian sense." C. DICKENS, PICKWICK PAPERS ch. 1 (1836). *Cf.* Lewis Carroll's world in *Through The Looking Glass*: " '[w]hen I use a word,' Humpty Dumpty said, 'it means just what I choose it to mean—neither more nor less.' " L. CARROLL, THROUGH THE LOOKING GLASS ch. 6 (1972).

First, it is necessary to protect the integrity of the revenue system against arbitrary shifting of deductions and credits. Income tax systems measure net enrichment; this requires that allowance be made for income-related expenditures, including the depreciation of capital assets and expenditures for items that will last no longer than the annual tax accounting period. The cost of an asset lasting longer than an accounting period should be apportioned over the asset's useful life to offset the income produced by that asset, and gains and losses on property value fluctuations should be reported on a transactional basis when the asset is disposed. It is thus necessary to determine when a taxpayer has relinquished the property. The most logical conclusion is that relinquishment occurs upon termination of the taxpayer's right to the asset's return.[361]

Second, in order to stimulate investment in productive assets, tax incidents of ownership such as accelerated depreciation arguably should be allocated where they give the most benefit: to the party with the greatest capacity to offset income. Such a policy, however, may conflict with the goal of accurate measurement of income,[362] particularly if a distinction is made between assets used domestically and assets used abroad.[363]

Simplicity is a third policy goal. Simple rules typically present businessmen with fewer surprises than do complex rules, thereby permitting more confident risk calculation. Simplicity also might facilitate administration of the tax system. But the benefits of a simple rule—such as characterization according to legal form—may confiict with the goals of taxpayer equity and government revenue collection if the parties manipulate title so as to maximize the benefits available from deductions and credits.

Fourth, a state's assertion of jurisdiction to tax foreigners presumes a relevant nexus between the taxing sovereign and the taxpayer.[364] One nexus is the conduct of commercial activity within the borders of the

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361 In some cases, this might cause hardship to the taxpayer. Assume that a foreign corporation owns a plot of land in New Hampshire, purchased for $100, which it rents for $10 a year for 10 years. A $100 gain is recognized. The land then declines in value, and the foreigner sells to the American lessee for $50. Because there has been no capital gain to offset, the capital loss may not be allowed. I.R.C. § 1211(a). If the foreigner had sold for $150, payable in 10 annual $10 installments with a $50 balloon at the end, the aggregate tax gain would have been only $50—the economic gain on the transaction—rather than the rental income of $100.

362 For a recent debate on the neutrality of accelerated depreciation, see Blum, *Accelerated Depreciation: A Proper Test 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).

363 See discussion of British rules in text accompanying notes 95-106 *supra*.

364 See Park, *supra* note 192, at 1609-10 n.3 for a discussion of generally accepted jurisdictional connections.

taxing state. Jurisdiction also may be based on the protection accorded property within the national territory. Thus, there may be more justification for imposing taxes on a true lessor than on a seller or lender, because the former possesses a bundle of rights that are returned at the end of the lease term and are in need of protection during the interim.

Fifth, the prevention of tax avoidance is a goal relevant to lease characterization. For example, if a controlled foreign corporation leases land, all rental income may be considered Subpart F income.[365] If the land is sold on an installment basis, however, the controlled foreign corporation would have Subpart F income only in an amount equal to the interest received.[366] The controlled foreign corporation thus has an interest in disguising a true lease as a sale, perhaps by setting a final payment so large that the buyer is sure to default, so that the property remains with the seller. But to say that the taxpayer is trying to disguise the lease as a sale is to presume the conclusion, for the same code that taxes foreign rentals permits deferral of tax on sales income.

Finally, the promotion of international trade, a goal implicit in the foreign tax credit provisions[367] and the reduced rates of tax under treaties,[368] is relevant to lease characterization. If this were the only consideration, governments would characterize transactions with an international element so as to produce the highest credit and lowest tax. This, of course, would conflict with considerations of equity as well as the policy underlying the foreign tax credit limitation.[369] Moreover, some treaties allow the source country to tax interest but not royalties. If tax treaties seek to encourage the transfer of technology, it probably can be done as well, or even better, by a loan to buy the asset as by a lease.[370]

C. *Non-Tax Lease Characterization*

It may be helpful at this point in the quest for a profile of ownership to examine the methods by which lawyers and accountants have tried to define a true lease for purposes unrelated to taxation. These

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365 I.R.C. §§ 954(a)(1), 553(a)(7).
366 *Id.* §§ 954(a)(1), 553(a)(1).
367 *Id.* §§ 901-907.
368 *See* text accompanying notes 205-19 *supra*.
369 I.R.C. § 904. The limitation is designed to prevent foreign taxes from offsetting United States tax liability on United States source income.
370 The multiplicity of options may bring to mind "the old sailor" in the A.A. Milne poem of the same title:

> There was once an old sailor my grandfather knew
> Who had so many things which he wanted to do
> That, whenever he thought it was time to begin,
> He couldn't because of the state he was in.

A. A. MILNE, *The Old Sailor*, in NOW WE ARE SIX (48th ed. 1976).

commercial and financial analogies provide an interdisciplinary perspective to the search for appropriate tax characterization standards and the concept of economic ownership.

1. *Banking Regulations*

American commercial banks and bank-holding companies are prohibited from engaging in nonbanking commercial activity.[371] The National Bank Act,[372] however, permits national banks to exercise "all such incidental powers as shall be necessary to carry on the business of banking,"[373] and the Comptroller of the Currency has issued regulations enabling commercial banks to engage in lease transactions.[374] The Federal Reserve Board, under its authority to determine what activities are "closely related to banking,"[375] also has authorized bank-holding company affiliates to engage in "[l]easing personal property."[376] Most states permit banks chartered within their jurisdictions to conduct leasing activities as well.[377]

As released in 1963, the Comptroller's regulation provided that national banks "may become the owner or lessor of personal property acquired upon the specific request and for the use of a customer and may incur such additional obligations as may be incident to becoming an owner and lessor of such property."[378] Amended in 1979, the regulation now limits bank leases in three ways. First, the equipment's residual value may not exceed 25% of the original cost. Second, the lease must be "net," in that the lessor is not obligated to provide service, insurance, repair, or replacements. Finally, the rentals, tax benefits, and estimated residual value must cover equipment cost plus financing costs.[379] Although leases are taken into account for purposes of the maximum amount a bank may lend to one entity,[380] the Comptroller of the Cur-

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371 12 U.S.C. §§ 24, 1843 (1976). Congress feared that banks or bank-holding companies might allocate credit to commercial enterprises on a basis other than the creditworthiness of the borrower, such as "sweetheart deals" to non-banking affiliates or their customers. *See generally* H.R. REP. NO. 609, 84th Cong., 1st Sess. 16 (1955); P. HELLER, HANDBOOK OF FEDERAL BANK HOLDING COMPANY LAW 157-66 (1976).

372 National Bank Act of 1864, ch. 106, 13 Stat. 99 (codified in scattered sections 12, 19, 31 U.S.C.).

373 12 U.S.C. § 24, ¶ 7 (1976).

374 12 C.F.R. §§ 7.3400, 7.7376 (1981).

375 Bank Holding Company Act, 12 U.S.C. § 1843(c)(8) (1976).

376 12 C.F.R. § 225.4(a)(6) (1981).

377 *E.g.,* HAW. REV. STAT. § 403-47.1 (1976); MD. ANN. CODE § 3-605 (1980); N.Y. BANKING LAW § 98(1) (McKinney 1971).

378 The text of the regulation that was in effect until June 12, 1979, is reprinted in P.L.I., EQUIPMENT LEASING 529 (1980).

379 12 C.F.R. § 7.3400(b) (1981).

380 *Id.* § 7.3400(g). The limits are imposed under 12 U.S.C. §§ 84, 371(c) (1976).

rency has opined that usury limits do not apply to bank leases.[381] This position originally was justified under the theory that "lease payments are in the nature of rent rather than interest,"[382] but later rested on the fact that the usury statutes "do not directly attempt to protect the soundness of the bank by limiting financial risks."[383]

The Federal Reserve Board, which regulates bank-holding companies, has issued similar limitations on the leasing activities of bank-holding company affiliates. To constitute "the functional equivalent of an extension of credit,"[384] a lease must yield a return equal to the cost of the property plus interest.[385] The residual value may not exceed 20% of the equipment's cost,[386] and the lease term cannot exceed forty years.[387] Although the validity of this regulation has been sustained,[388] independent leasing companies have asserted that it has not been applied strictly enough to certain banks that have allegedly speculated on residual values.[389]

Tax and banking regulations are thus analogous with respect to their emphasis on the concept of risk, as measured by the existence of some residual value.[390] Without the minimum residual value, the IRS

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381 *See* Office of Comptroller of the Currency, Release of April 10, 1979, *reprinted in* P.L.I., EQUIPMENT LEASING 531 (1980).

382 12 C.F.R. § 7.3400 as in effect prior to June 12, 1979.

383 Office of Comptroller of the Currency, Release of April 10, 1979, *reprinted in* P.L.I., EQUIPMENT LEASING 531 (1980).

384 12 C.F.R. § 225.4(a)(6)(i)(a) (1981), more commonly known as Regulation Y.

385 The profit must come from rentals, tax benefits, a residual value not in excess of 20% of equipment cost, and lessee guarantees not in excess of 60% of the cost. *Id.* § 225.4(a)(6)(i)(d).

386 *Id.*

387 *Id.* § 225.4(a)(6)(i)(e).

388 *See* BankAmerica Corp. v. Board of Governors of the Fed. Reserve Sys., 491 F.2d 985 (9th Cir. 1974); National Automobile Dealers Ass'n v. Board of Governors of the Fed. Reserve Sys., 571 F.2d 674 (D.C. Cir.), *cert. denied*, 439 U.S. 875 (1978).

389 *See* Memorandum filed with Board of Governors of the Federal Reserve Board on behalf of U.S. Leasing Corp., Dec. 31, 1978, *discussed in* Equipment Leasing Journal (Jan./Feb. 1979), and P.L.I., EQUIPMENT LEASING 389 (DeKoven & Reisman eds. 1979). U.S. Leasing Corp. charged Citicorp Finance with speculating in word processors.

Independent leasing companies have also brought suit to invalidate the Comptroller's regulation. In M & M Leasing Corp. v. Seattle-First Nat'l Bank, 391 F. Supp. 1290 (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 trial court held that "open end" leases, in which the lessee guarantees the property's residual value, are functionally interchangeable with a secured loan. 391 F. Supp. at 1295. On the other hand, the trial court concluded that the "closed end" lease, in which the bank assumes the fluctation of residual value, involves risks not approriate for national banks. *Id.* The Ninth Circuit reversed as to closed end leases, holding that even they might be the equivalent of a loan if the residual value constitutes an "insubstantial" part of the bank's recovery of profit. The court excluded only "a lease, which from its inception inevitably must be repeated or extended to enable the bank to recover its advances plus profit." 563 F.2d at 1384.

390 Rev. Proc. 75-21, 1975-1 C.B. 715 (20%); 12 C.F.R. § 225.4(a)(6)(d) (1981) (20%); 12 C.F.R. § 7.3400 (1981) (25%).

will not find a true lease. If there is too much residual value, however, bank regulators will not find the transaction the functional equivalent of a loan. Bankers *qua* bankers avoid risk, in the sense of gamble or danger, but bankers *qua* taxpayers may seek risks, in the sense of fluctuation in residual value.

Both approaches view the bundle of rights that the lessor receives at the termination of the lease as the essence of ownership. Traditional lenders do not possess such rights. The tax inspector thus may be told that the lease presents a risk, and therefore is a true lease, while the banking regulators are told that the risk is minimal and therefore is the functional equivalent of a loan.[391]

2. *Security Interests*

The true lessor traditionally has prevailed against both the bankruptcy trustee and other creditors of the lessee in disputes involving leased equipment.[392] In contrast, the seller or moneylender typically cannot recover the equipment, even as against the debtor, without a properly perfected security interest.[393] Consequently, merchants have been tempted to cast installment sales in the form of leases. The commercial law aspects of leasing thus are tied to issues involving security interests.[394]

The challenge to the lessor may arise not only from the lessee's other creditors, but also from the lessee-debtor's own claim to the difference between the total indebtedness and the sale proceeds of the repossessed equipment. Although a seller or lender must return to the debtor any surplus that remains after the sales proceeds are applied to the debt, a lessor can recover the property *in toto*.[395] Moreover, if the user sells the equipment, the true lessor generally may recover the equipment from

391 National banks can satisfy both tests if the ratio of residual value to equipment cost falls between 20% and 25%. Affiliates of bank holding companies must hit it right on the nose: at least 20% to satisfy the IRS and not more than 25% to avoid vexing the Federal Reserve Board.

392 *See, e.g., In re* National Eng'r & Equip. Co., 256 F. 985 (W.D. Wash. 1918). *See generally* J. WHITE & R. SUMMERS, *supra* note 41, at 877-83.

393 U.C.C. § 9-203.

394 *See* COUNCIL OF EUROPE, SALES OF MOVABLES BY INSTALLMENT AND ON CREDIT (1970); U.N. COMM. ON INT'L TRADE LAW, REPT. OF THE SECRETARY GENERAL: STUDY ON SECURITY INTERESTS, U.N. Doc. A/CN.9/131 (1977) (presenting a study by Professor U. Drobnig [hereinafter cited as DROBNIG REPORT]).

395 U.C.C. § 9-504. The equity of redemption issue is perhaps more easily illustrated in a real estate context. Assume that *X* rents a house from *Y*, having paid $5,000 per year to *Y* for 20 years. If *X* fails to pay rent, *Y* takes back the house without giving *X* credit for rent paid during the previous 20 years. If *Y* is merely a lender with a mortgage, however, then on *X*'s default, *Y* must foreclose on the house and give *X* the difference between the sale proceeds and the outstanding debt. On the debtor's equity in property subject to a security interest, see U.C.C. §§ 9-501 to 507. For a recent case holding the secured party to a high standard of

the purchaser;[396] alternatively, creditors of an insolvent lessor may attempt to attach the leased property to satisfy their claims against the lessor. Further, the lessor can attempt to terminate the lease of a bankrupt lessee.[397]

In all states except Louisiana,[398] an enforceable security interest must comply with Article Nine of the Uniform Commercial Code. To prevail against the bankruptcy trustee, the creditor must give notice of the security interest by public filing or by notation on the title certificate.[399] In contrast, the true lessor traditionally has prevailed without filing[400]—at least such was the case prior to the new Bankrupty Code.[401]

The UCC offers little guidance for determining whether a lease agreement creates a security interest for the purposes of Article Nine.[402] The mere filing of a financing statement under the terms "lessor" or "lessee" is not dispositive of the lease characterization issue.[403] Those cases defining a true lease have received substantial comment from practitioners and scholars.[404] Courts have looked to factors similar to those siguificant in tax characterization: the purchase option price and the equipment's residual fair market value,[405] allocation of risk of loss, and the practicality of leasing the equipment to another user at the termination of the lease.[406] The common theme of the cases is that the leased property eventually will return to the lessor. A true lessor, in other words, retains an interest in the property throughout the lease term.

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care in disposing of the collateral, see Lamb Bros., Inc. v. First State Bank of Oregon, 285 Or. 39, 589 P.2d 1094 (1979); 16 WILLAMETTE L.J. 756 (1980).

396 The lessor can cite the familiar maxim *nemo dat qui non habet*—he who hath not cannot give.

397 *See* Siegel, *Landlord's Bankruptcy: A Proposal for Treatment of the Lease By Reference to Its Component Elements*, 54 B.U. L. REV. 903 (1974).

398 For a discussion of security interests in Louisiana, see *In re* Trahan, 283 F. Supp. 620 (W.D. La. 1968), *aff'd sub nom.* Bernard v. Beneficial Finance, 402 F.2d 796 (5th Cir.), *cert. denied*, 394 U.S. 930 (1969) (involving "vendor's privilege" against bankrupt purchaser of furniture).

399 U.C.C. § 9-302.

400 *See, e.g., In re* National Eng'r & Equip. Co., 256 F. 985 (W.D. Wash. 1918). *See generally* J. WHITE & R. SUMMERS, *supra* note 41, at 877-83.

Property rights are determined by state law. The validity of a secured interest and the determination of secured status under the Bankruptcy Code (11 U.S.C. § 506 (1976)) are governed by the local law of property situs. *See* Security Mortgage Co. v. Powers, 278 U.S. 149 (1928) (secured obligation to pay attorney's fees); *In re* Trahan, 283 F. Supp. 620 (W.D. La. 1968), *aff'd sub nom.* Bernard v. Beneficial Finance, 402 F.2d 796, *cert. denied*, 394 U.S. 930 (1969).

401 11 U.S.C.A. §§ 1-15,324 (West 1979 & Supp. 1981).

402 *See* U.C.C. § 1-201(37).

403 U.C.C. § 9-408.

404 *See generally* J. WHITE & R. SUMMERS, *supra* note 41, at 877-83; Coogan, *supra* note 41.

405 *See In re* Alpha Creamery, Inc., 4 U.C.C. 794, 797-98 (W.D. Mich. 1967); *In re* Washington Processing Co., 3 U.C.C. 475, 477-79 (S.D. Cal. 1966).

406 *See* W.O. Co. v. Benjamin Franklin Corp., 20 U.C.C. 1015 (D.N.H. 1976).

Lease characterization is also relevant to the lessor's bankruptcy status, particularly in the case of long-term real estate leases in which the value of the property has appreciated. General creditors will want to realize the increased value of the lessor's property, an increase normally reflected in higher rentals. The tenant or lessee, on the other hand, will want to retain the lease without alteration, because its terms have become a bargain. The Bankruptcy Code provides that a trustee in bankruptcy, subject to the court's approval, may elect to "assume or reject any executory contract or unexpired lease of the debtor."[407] One commentator suggests that the appropriate treatmcnt of a lease upon the lessor's bankruptcy is to recognize the hybrid nature of many leases as both a conveyance of property and covenant for performance of services and to treat each component differently.[408] This approach may be useful for tax characterization of those leases in which service elements predominate.

Hybrid legal forms called "hire-purchase"[409] and "*crédit-bail*"[410] have developed in the United Kingdom and France, respectively.[411]

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407 11 U.S.C. § 365 (Supp. 1979).

408 Siegal, *supra* note 397, at 905-06, 928.

409 *See generally* P. ATIYAH, SALE OF GOODS 6-11 (5th ed. 1975).

410 *See* text accompanying note 61 *supra*.

411 Until the end of the nineteenth century, British law distinguished only between a bailment and a sale. A bailor's security was the ultimate redelivery of the property, and a seller could register a sale for his protection. Bills of Sale Act, 1878, 41 & 42 Vict., c. 31, § 10 (providing for registration of written sales instrument to protect seller's title). The hire-purchase, however, provided greater protection of the seller's security interest, for the seller retained ownership of the goods during the lease, subject to purchase of the goods by the lessee at the end of the lease term. Hire-purhcase agreements became the dominant vehicle in consumer transactions. *See* P. ATIYAH, *supra* note 409, at 10. The hire-purchase system occasionally resulted in the loss of the lessee's equity beeause the seller might seize and sell goods from a defaulting hirer and retain the sale proceeds in excess of the debt due. Legislation and judicial decisions have corrected these abuses. *See* Consumer Credit Act, 1974, 22 & 23 Eliz. 2, c. 39, § 90 (limiting creditor's right to recover possession in case of default); Hire-Purchase Act, 1965, 13 & 14 Eliz. 2, c. 66, §§ 33-49 (regulating right of recovery of possession and other remedies); Hire-Purchase Act, 1964, 12 & 13 Eliz. 2, c. 53, §§ 4-11 (regulating right of cancellation); Hire-Purchase Act, 1938, 1 & 2 Geo. 6, c. 53, § 1 (first comprehensive regulation of hire-purchase agreements); Starside Properties v. Mustapha, [1974] 1 W.L.R. 16 (no distinction exists between relief from forfeiture for nonpayment of rent, and relief from forfeiture for nonpayment of installments).

British judges have also remedied abuse in sale/leaseback arrangements by examining the intention of the parties to determine whether the purported sale, usually coupled with a hire-purchase contract, is in fact only a sham to disguise a loan of money. *See* Snook v. London & West Riding Invs., [1967] 2 Q.B. 786, 802; Kingsley v. Sterling Indus. Sec. Ltd., [1965] 2 Q.B. 747, 780.

French case law distinguishing sales from leases has had less commercial import since 1966, when legislation established *crédit-bail* as a special regime for the *sui generis* tripartite finance lease. *See* Law No. 66-455, July 2, 1966. The French statute specifically designates the financial institution as owner of the leased equipment. This is a considerable privilege not afforded other vendors. In fact, other vendors could not, until 1980, even retain a security interest (*clause de réserve de propriété*) valid against the buyer's other creditors. *See* Law No. 80-

These agreements are intended to protect the financier's security interest in equipment. They couple the form of a lease with the economic substance of a sale.

3. *Usury*

A recent Idaho case[412] involving cattle transactions considered the application of state usury limits to leases.[413] To finance their herd increase, dairy farmers entered into a forty-five month "cow lease agreement," with an option to purchase the beasts for $1 per cow. The agreement stated a time-price differential of 12%. In fact, the financier realized a profit of almost 50%.[414] The real and the nominal interest rates differed because the financier calculated the time/price differential on a sales price double the actual cost of the livestock. Concluding that the dairy farmers were not "the necessitous debtors whom the usury statutes were designed to protect,"[415] the court held that the transactions constituted a bona fide sale to which the usury law did not apply. A vigorous dissent, however, advocated that there be no distinction between a loan and the type of lease at issue.[416]

Other courts have employed the concept of an acceptable time/price differential to avoid application of usury law when the credit price exceeds cash price plus lawful interest.[417] Courts disregard the time/price differential logic, however, when it is used to mask a clearly usurious transaction.[418] Factors that indicate a credit sale or loan include a close relationship between seller and finance company[419] and a

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335, May 12, 1980, [1980] J.O. 1201; *see also* Ohl, *La Clause de Reserve de Propriété Mobilière et son Opposabilité à la Masse en Droit Francais*, 1980 DROIT & PRATIQUE ON COMMERCE INT'L 587.

412 Buchanon v. Dairy Cows, 97 Idaho 481, 547 P.2d 526 (1976). *See* Jarvis, *Which Is To Be Master: A Comparison of Credit Sale and Loan*, 13 IDAHO L. REV. 116 (1977).

413 Usury is the exaction of profit greater than that allowed by law on the loan of money or forbearance of a debt. Payment must be for money lent, rather than as a price for goods sold. Statutory bans on excessive interest rates are presumably intended to protect borrowers that lack business acumen or are prey to lenders with superior bargaining power. For a useful summary of state usury statutes, see Note, *Stemming Abuses of Corporate Exemptions from the Usury Laws: A Legislative and Judicial Analysis*, 59 IOWA L. REV. 91, 91 n.2 (1973).

414 Buchanan v. Dairy Cows, 97 Idaho 481, 485, 547 P.2d 526, 529 (1976); Idaho law limits interest on loans to 12%. IDAHO CODE § 28-22-104 (Supp. 1981).

415 97 Idaho at 482, 547 P.2d at 527.

416 I am unable to join with the majority in their tour through the fantasy land of high finance. Unlike the majority, I cannot step through the looking glass to that land where a loan becomes a lease, finance charges become a time price differential, and interest rates are not interest rates simply because the lender, Dairy Cows, says so.

Id. at 483, 547 P.2d at 528 (McFadden, J., dissenting).

417 *See* Note, *Usury—Limiting The Time Price Differential, Sale Exception*, 39 MO. L. REV. 111 (1974).

418 *Id.* at 112-13.

419 *See* Hare v. General Contract Purchase Corp., 220 Ark. 601, 249 S.W.2d 973 (1952).

credit price based on a percentage of cash price.[420]

Some courts have found usurious loans disguised as sale/leaseback transactions. In *Woods-Tucker Leasing Corp. v. Hutcheson-Ingram Development Co.*,[421] a group of real estate developers approached a Georgia finance company for a $75,000 loan. Instead of granting the loan, the finance company bought $85,000 of farm equipment from the developers and then leased the equipment back to them. The developers bore the entire risk of loss, theft, destruction, and damage to the equipment, and also maintained the insurance. The developers thus received the "loan" they wanted, while the finance company received the collateral it desired.[422] The court purported to employ the test set forth in the UCC to determine whether the transaction was a lease or a loan,[423] yet the substance of the test was not elucidated. The court did note, however, that the financier maintained no inventory of the equipment, implying an agreement that the developers would retain the equipment at the end of the lease.[424] On rehearing, the court held that parties are free under the UCC to avoid state usury laws so long as they do not evade such laws willingly, conspicuously, or fraudulently.[425]

4. *Products Liability*

The victim who suffers personal injury because of defective leased equipment may wish to sue not only the manufacturer but also the financier or lessor. Although a lessor normally is held to certain implied warranties as to the quality of leased goods, a financier is not.[426] Hence, the status of the finance lessor is critical.[427] Implied warranties of merchantability and fitness for purpose may apply to a true lessor,[428] and case law has by analogy applied the provisions of Article Two of the UCC to true leases as well.[429]

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420 *See* Lloyd v. Gutgsell, 175 Neb. 775, 124 N.W.2d 198 (1963).

421 626 F.2d 401 (5th Cir. 1980), *vacated on other grounds*, 642 F.2d 744 (5th Cir. 1981).

422 626 F.2d at 404.

423 U.C.C. § 1-201(37).

424 626 F.2d at 413.

425 642 F.2d at 753.

426 RESTATEMENT (SECOND) OF TORTS § 405 (1965).

427 Although a direct right of action against the manufacturer might not pose problems in the United States, the International Institute for the Unification of Private Law specifically addresses this question of liability in Document 10 of its uniform rules on leasing transactions. *See* note 335 *supra*. Article Six of the draft provides that a financier shall not be liable for any contractual or tortious duties except such as may arise from the negligence of its technical staff. Article Seven provides that the user shall have a direct cause of action for damages against the supplier for any loss or damage sustained as a result of the supplier's breach of contract or warranties.

428 U.C.C. §§ 2-313, 2-314, 2-315.

429 Citrone v. Hertz Truck Leasing & Rental Servs., 45 N.J. 434, 212 A.2d 769 (1965). Further, UCC commentary specifically alludes to warranties that may arise "in the case of bailments for hire." U.C.C. § 2-313, Comment 2.

Tort liability for defective products arises under theories of strict liability.[430] Although such tort liability lies against a seller of defective goods,[431] it is more problematic whether liability attaches to a mere supplier of funds used to purchase defective goods. Some courts have imposed liability only because the defendant was a "link in the chain of distribution."[432] Presumably, the finance lessor would fit into this category, although it is difficult to reconcile such liability with the immunity traditionally enjoyed by lenders. Lessor liability often turns on the distinction between a "merchant-lessor," who regularly deals in the injury-causing products, and a "finance-lessor," who does not.[433] Policies supporting liability of the "merchant" or "vendor" lessor include superior knowledge and control of the products, user reliance, and putting the product into "the stream of commerce."[434]

5. *Jurisdiction*

Jurisdiction over a foreigner may depend on whether the foreigner owns property or does business within the forum state.[435] In certain civil

430 RESTATEMENT (SECOND) OF TORTS §§ 401, 402A (1965).

431 *Id.*

432 *See, e.g.,* Little v. Maxam, 310 F. Supp. 875 (S.D. Ill. 1970) (taking order for injury-causing machine creates liability on sales representative); Canifax v. Hercules Powder Co., 237 Cal. App. 2d 44, 46 Cal. Rptr. 552 (1965) (failure to warn of timing on explosive fuse creates liability for explosives manfacturer and wholesaler).

433 *See generally* Carlin, *Product Liability for the Equipment Lessor? Merchant-Lessor Versus Finance-Lessor*, in EQUIPMENT LEASING-LEVERAGED LEASING, *supra* note 15, at 565-93 (1977). For a survey of recent cases on lessor tort liability, see Mooney, *Recent Cases Relating to Equipment Leasing*, in P.L.I, EQUIPMENT LEASING 52-54 (1980).

434 *See, e.g.,* Dewberry v. LaFollette, 598 P.2d 241, 242 (Okla. App. 1979) (commercial lessor held liable on basis of having put article in "stream of commerce"); *cf.* Francioni v. Gibsonia Truck Co., 472 Pa. 362, 372 A.2d 736 (1977) (strict liability not applieable to finance-lessor).

The liability of a financier for property damage was examined in a 1968 case involving housing construction loans. In Connor v. Great Western Sav. & Loan, 69 Cal. 2d 850, 447 P.2d 609, 73 Cal. Rptr. 369 (1968), the Supreme Court of California imposed liability on the bank that had financed an inexperienced real estate developer's construction of single family homes. The builder's negligence resulted in cracked foundations, diminishing the home's value and requiring costly repair. Although it had exerted supervision and control over the project (to the extent of employing a geologist to determine an adequate water supply), the bank was not considered a joint venture partner. The court imposed a duty to exercise eare to prevent the inexperienced and thinly-capitalized builder from constructing defective homes. Policy considerations considered relevant included the extent to which the loan was intended to affect the plaintiff, the policy of preventing future harm, and the bank's ability to bear the loss. For a critique of this case, see Note, *The Expanding Scope of Enterprise Liability*, 69 COLUM. L. REV. 1084, 1092-95 (1969). The legislative response to *Connor* is found in CAL. CIV. CODE § 3434 (West 1970).

435 On a state's power to apply its own law, generally referred to as "legislative jurisdiction," see D. HARRIS, CASES & MATERIALS ON INTERNATIONAL LAW 235 (1973); F. MANN, *The Doctrine of Jurisdiction in International Law*, in STUDIES IN INTERNATIONAL LAW 15-110 (1973); R. WEINTRAUB, COMMENTARY ON THE CONFLICT OF LAW 378-95 (1971); RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 9 (1971); Reese, *Legislative Jurisdiction*, 78 COLUM.

law systems such as Germany and Austria, *in personam* judicial jurisdiction may rest on ownership of property situated within the forum state.[436] The relevance of property ownership to jurisdiction generally arises when a state applies its long-arm statute or licenses a foreign corporation to transact intrastate business.[437] Amenability to long-arm jurisdiction generally depends on such factors as the regularity of soliciting or doing business, intrastate activity of agents, or the substantiality of intrastate revenues.[438]

The extension of credit normally does not require registration even if the lender or installment seller accepts local notes or mortgages.[439] Lessors may be required, however, to register before commencing business. In Massachusetts, for example, a foreign corporation is subject to registration if it "owns or leases real estate or tangible personal property [within the Commonwealth of Massachusetts] without having such a usual place of business [in the Commonwealth of Massachusetts] . . . ."[440]

As a practical matter, qualification or registration may depend less on the transaction's characterization than on the activity ancillary thereto. For example, the foreign corporation may repair and maintain the leased property. In *Rochester Capital Leasing Corp. v. Schilling*,[441] a New York lessor purchased vending machines from an independent dealer for subsequent lease in Tennessee. In upholding the lessor's right to sue in Tennessee on one of the leases, the court analogized the lease to

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L. REV. 1587 (1978). On judicial jurisdiction, see generally F. MANN, *supra*, at 131-62 (classifying judicial jurisdiction within "enforcement jurisdiction"); J. MARTIN, CONFLICT OF LAWS 471-607 (1978); RESTATEMENT (SECOND) OF CONFLICT OF LAWS §§ 24-79 (1971).

436 *See generally* H. STEINER & D. VAGTS, TRANSNATIONAL LEGAL PROBLEMS 753-55 (2d ed. 1975); De Vries & Lowenfeld, *Jurisdiction in Personal Actions—A Comparison of Civil Law Views*, 44 IOWA L. REV. 306, 330 (1959); Nadelmann, *Jurisdictionally Improper Fora in Treaties on Recognition of Judgments: The Common Market Draft*, 67 COLUM. L. REV. 995, 1006-11 (1967). Steiner & Vagts have translated the German statute (ZPO § 23) as follows: "For complaints asserting pecuniary claims against a person who has no domicile within the country, the court of the district within which this person has property . . . has jurisdiction." H. STEINER & D. VAGTS, *supra*, at 754.

The basis for jurisdiction was publicized beyond the circle of comparativist lawyers by a 1968 press report that an Austrian paternity suit was pending against Jean-Claude Killy, the famous French skier, with jurisdiction based on underwear that had been left in an Austrian hotel. Siegel, *Pack Up Your Troubles—Carefully*, N.Y.L.J. (1968).

437 Penalties for failure to qualify include fines and denial of recourse to the courts to enforce contracts. *See, e.g.,* ABA-ALI MODEL BUS. CORP. ACT § 124 (1979) (fines); MD. CORP. & ASS'NS CODE ANN. § 7-301 (1975) (denial of recourse to courts); MASS. ANN. LAWS ch. 181, §§ 4, 7, 9 (Michie/Law. Co-op 1977) (fines).

438 *See, e.g.,* N.Y. CIV. PRAC. LAW § 302(a) (McKinney Supp. 1980).

439 ABA-ALI MODEL BUS. CORP. ACT § 106(g) (1979) provides that "creating as . . . lender, or acquiring, indebtedness or mortgages or other security interests in real or personal property" will not constitute doing business so as to require qualification.

440 MASS. ANN. LAWS ch. 181, § 3 (Michie/Law. Co-op 1977).

441 223 Tenn. 478, 448 S.W.2d 64 (1969).

the holding of a "promissory note of a Tennessee citizen payable to a non-resident payee."[442] Jurisdiction has been denied, however, in cases in which lessors service leased equipment.[443]

6. *Accounting Standards*[444]

A corporation must account to its shareholders and creditors for the property in its custody. To protect its credit rating, however, an equipment user may desire "off balance sheet" financing. Because a large debt/equity ratio reduces the company's ability to obtain additional financing, it may wish to avoid reporting a long-term obligation incurred by the purchase of an asset.[445] The equipment manufacturer, in contrast, may want to record the transaction as a sale, thus reporting the sale proceeds as revenue for the year in which the sale occurs.

The conflicting interests of manufacturers and users has resulted in some transactions being recorded as a sale by the lessor and as a lease by the lessee.[446] This lack of symmetry has created the accounting phenomenon of disappearance of assets. The Securities and Exchange Commission, aware that investors rely on debt/equity ratios, has moved to curtail this practice.[447]

Statement Number Thirteen of the Financial Accounting Standards Board sets forth current American accounting practice as it relates to lease characterization.[448] FASB No. 13 attempts to provide users of financial statements with information to make judgments about the

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442 *Id.* at 484, 448 S.W.2d at 66.

443 Cases in which service obligations result in a finding of unlawfully "doing business" include Houston Canning Co. v. Virginia Can, 211 Ala. 232, 100 So. 104 (1924) (installation and service of canning machines), and State v. Robertson, 221 Mo. 475, 196 S.W. 1132 (1917) (intrastate lease of 300 linotype machines during 10 year period plus installation, inspection and repair services).

444 As this Article goes to print, the Financial Accounting Standards Board has proposed rules to deal with "tax leases" entered into within the safe harbor of the Economic Recovery Tax Act of 1981. *See* Financial Accounting Standards Board, Accounting for the Sale or Purchase of Tax Benefits Through Tax Leases (Exposure Draft, Oct. 29, 1981).

445 For a summary of the significance of solvency ratios, see J. COX, FINANCIAL INFORMATION ACCOUNTING AND THE LAW 606-29 (1980). *See also* Nelson, *Capitalizing Leases—The Effect on Financial Ratios*, 116 J. OF ACCOUNTANCY 49 (1963).

446 *See* FINANCIAL ACCOUNTINC STANDARDS BOARD, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 13, ¶ 60 (Nov. 1976) [hereinafter cited as FASB No. 13].

447 Ro, *The Disclosure of Capitalized Lease Information and Stock Prices*, 16 J. OF ACCOUNTING RESEARCH 315 (1978) (discussing the Securities and Exchange Commission, ASR No. 147 (Oct. 5, 1973) entitled "Notice of Adoption of Amendments To Regnlation S-X Requiring Improved Disclosure of Leases").

448 The Securities and Exchange Commission has applied the principles of FASB No. 13 to the majority of SEC registrations and reports. *See* 17 C.F.R. § 210.4-08(i) (1981). SEC Regnlation S-X defines a finance lease as one covering at least 75% of the useful life of the equipment, or "assuring the lessor a full recovery of the [property's] fair market value . . . subject only to limited risk in the realization of the residual interest in the property and the credit risk generally associated with several loans."

equipment user, manufacturer, and financier. It defines a "capital lease" as any lease arrangement that is the equivalent of a credit sale or a loan[449] and in which there has been a "transfer of substantially all the benefits and risks of ownership."[450] The accountant's concept of ownership is based on the right to use an asset. Thus, a lessee that has all of the use of an asset should report the asset as such on its balance sheet.[451] When the consideration given for this right is an irrevocable obligation, as in the case of a noncancelable lease, the lessee should report its obligation as a long-term liability.

A lease will be considered a capital lease if (1) title to the equipment passes by the end of the lease term; (2) the lease contains a bargain purchase option; (3) the lease term equals at least 75% of the equipment's useful life; or (4) the present value of rentals[452] equals at least 90% of the property's fair market value.[453] The time ratio (lease term divided by useful life) may be manipulated by lessee renewal options at fair market value.[454] Therefore, the cost ratio (rentals to equipment value) is often the determinative test. For lessors, two additional criteria must be met for capital lease treatment: The collectability of the rentals must be "reasonably predictable," and there must be no "important uncertainties" such as a guarantee of the equipment's performance in the lessor's costs.[455]

The present value of rentals is determined through calculations that assume some rate of interest. Lessors must use the implicit rate built into lease payments, whereas lessees normally must use an incremental interest rate equal to that at which they could borrow funds in the open market.[456] The use of different interest rates by lessors and lessees for present value calculations thus may result in asymmetrical lease accounting.[457]

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449 For a history of the accounting profession's struggle with the treatment of leases, see Coogan, *supra* note 41, at 968-71.

450 FASB No. 13, *supra* note 446, ¶ 61. The circularity of this reasoning results from the Statement's use of the concept "ownership"—the very term it tries to define.

451 There are, of course, some things that fall outside this rule. Light and air, for example, are not capitalized.

452 Rentals are discounted at an interest rate equal to that which would have been paid on funds borrowed to purchase the asset, or the rate "implicit" in the lease, whichever is lower. FASB No. 13, *supra* note 446, ¶ 10. A useful explanation of the concept of "present value" is given in A. ALCHIAN & W. ALLEN, UNIVERSITY ECONOMICS 205-09 (2d ed. 1967), an excerpt of which is included in M. CHIRELSTEIN, FEDERAL INCOME TAXATION 331-36 (2d ed. 1979).

453 FASB No. 13, *supra* note 446, ¶ 7.

454 *Id.* ¶ 5(f) does not include fair market renewals in lease term unless the lessor has an option to force renewal (*i.e.,* a "put").

455 *Id.* ¶ 8.

456 *Id.* ¶¶ 7, 8. If the lessee knows the lessor's implicit rate, and it is lower than the market borrowing rate, then the implicit rate is used.

457 To illustrate, assume a computer is leased for five years at $100 per month. The

Lessors report capital leases as either "sales-type," which arise from a manufacturer's or dealer's product marketing, or "direct finance," which result from the lessor's extension of credit to a third party for the purchase of an asset.[458] A sales-type lease gives rise to sales profit plus finance income.[459] A direct finance lease gives the lessor interest income but not sales proceeds.[460] In an operating lease, the lessor recognizes rental payments as current income and depreciates the leased equipment.[461]

Lessees, however, do not distingnish between sales-type and direct finance leases. If the lease is a capital lease, the lessee depreciates the asset.[462] If the lease is an operating lease, the lessee takes normal rental deductions.[463]

D. *A Proposal for Symmetrical Lease Characterization*

Similar characterization of similar transactions is desirable both to

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manufacturer's cost is $4,000, residual value is $1,000, and the estimated useful life is eight years. The implicit interest rate is 12.4% per year, based on the price of $5,000, at which the manufacturer would sell the computer outright for cash. The lessee would have paid annual interest of 11% if he had borrowed funds in order to purchase the asset.

The lease clearly passes the first three tests: (1) title is not transferred; (2) there are no bargain options; and (3) the lease term is only 63% of the computer's useful life. The critical factor is the discounted present value of the lease payments. In determining the present value of the rentals, the lessee uses the 11% interest rate at which it would borrow similar funds to purchase the equipment outright, while the lessor uses the 12.4% rate implicit in the contract. Thus, the lessee will have a higher present value of rentals than will the lessor. The lower the interest rate, the more likelihood of capitalization. A lower rate will raise present discounted value of future payments, thus increasing the ratio of present value of rentals to the equipment value. *E.g.,* receipt of $100 at the end of 10 years will today be worth $74 if a 3% interest rate is assumed, but only $56 assuming a 6% rate. The present value of the sixty $100 rentals calculated at an 11% rate is $4,600, which is greater than 90% of the equipment value, and the lessee will capitalize the lease.

The lessor, however, will trcat the transaction as an operating lease. The present value of the rentals at the implied rate of 12.4% is only $4,459, which is less than 90% of the equipment's fair market value. Ninety percent of $5,000—the fair market value of equipment—is $4,500, which is less than the present value of the rentals, $4,600.

Both lessor and lessee will record the lease, and the number of equipment owners will increase in a way reminiscent of the gospel multiplication of the loaves and fish.

458 FASB No. 13, *supra* note 446, ¶¶ 17, 18. Lessor accounting may differ for "nonrecourse" leveraged leases, in which part of the equipment cost is provided by a long-term creditor whose loan is secured by the equipment rather than personal liability of the lessor. For "direct finance leases," in which the lessor is not a manufacturer or dealer, the lessor must report income in phases termed "primary carnings"—rental receipts, investment tax credits, and residual value—and "earnings from reinvestment"—the income sheltered from tax in early years because of leverage depreciation deductions. The lessor recognizes the sheltered income during the later years when depreciation deductions are unavailable. *Id.* ¶ 43.

459 *Id.* ¶ 17.

460 *Id.* ¶ 18.

461 *Id.* ¶ 19.

462 *Id.* ¶ 11.

463 *Id.* ¶ 15.

avoid trade distortion and to further horizontal taxpayer equity.[464] The American accounting profession's characterization standards seem best suited for adoption as a uniform characterization rule. They comport with the goal of measuring enrichment properly and are based on the premise that use of an asset for most of its useful life is the essence of ownership. The supplier's retention of a substantial residual value, equal to 25% of the asset's useful life, is an appropriate test of ownership for tax purposes.[465]

One aspect of the accounting rule may be inappropriate for tax purposes in that it denies lessor status to a financier who recoups most of the equipment's cost over the lease term. If the lessor obtains a favorable bargain, the equipment may have a substantial residual value even after its cost has been recovered and may be available for lease to another user. There is no reason why the transaction should not be treated as a lease for tax purposes if the equipment still has substantial value at the end of the lease term.[466]

Adoption of a modified version of the accounting standards in international tax treaties would further trade neutrality as well as the accurate measurement of income. To this end, the Treasury and OECD should encourage adoption of the accountants' standards in income tax treaties for all provisions, including withholding rates and source of income, that involve lease characterization.

Tax treaties should recognize three methods to obtain use of an asset: (1) the true lease, which gives rise to rents; (2) the installment sale, which gives rise to sales proceeds and interest; and (3) the loan, which gives rise to interest. A user would be characterized as either lessee or purchaser; a supplier would be characterized as either lessor, seller, or financier. Tax treaties could define rentals associated with regular marketing activity or services as industrial and commercial profits, or otherwise explicitly subject them to a special withholding rate. If a state is willing to accept a withholding tax exemption on equipment rentals but not on industrial royalties for patents and trademarks, a separate treaty provision for equipment rentals would provide the necessary flexibility.

Paradoxically, free election to assign depreciation and investment credits might also help to remove the current disparity of tax treatment between economically similar transactions cast in different legal forms. The equipment supplier, user, and any secured financier who provides credit for acquisition of the property could then assign depreciation de-

464 For a case in which disparate statutory interpretations were justified, see discussion of *Don Williams* in text accompanying notes 351-56 *supra*.

465 *See* text accompanying note 452 *supra*.

466 *See* text accompanying notes 474-75 *infra*.

ductions among themselves.[467] Bargaining for benefits would to some extent replace forcing transactions into molds to comply with leasing definitions. Assignment of tax benefits would not increase total deductions and credits available; it would merely make them more effective.[468] A domestic manufacturer, for example, might find the accelerated depreciation useful while a foreign user with no United States trade or business would not.

A free right of election to transfer investment incentives for new equipment financing does not contravene the goal of furthering symmetrical lease characterization, provided the requirements for electing owner status are also harmonized. The tax incidents of ownership would be put to maximum use by the party that could best absorb the credits and deductions. If all rules were uniform, however, the tax benefits of ownership would be available to only *one* of the parties.

A uniform lease characterization standard will not ensure complete neutrality, because differences in the generosity of a nation's tax incentives still will generate some tax-induced trade distortion.[469] Nevertheless, the supply and financing of capital equipment among trading partners would not be distorted by the excess burdens otherwise imposed by asymmetrical characterization. A convergence of rules imposing a degree of accounting symmetry will reduce, albeit not eliminate, the trade distortion created by divergent characterization standards.

Non-tax legal disciplines, recognizing the chameleon-like quality of ownership when property interests are atomized among different persons, distinguish temporary use from more permanent economic dominion.[470] The accounting characterization standard comports with this

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467 Because money is fungible, one must trace loaned funds to these specific uses, similar to the tracing required by other provisions of the tax law, *see, e.g.,* I.R.C. § 265.

468 Those opposed to using the tax system to achieve social policies other than the measurement of net enrichment may oppose the shift in tax benefits. *See* Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925 (1967); Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison With Direct Government Expenditures*, 83 HARV. L. REV. 705 (1970). Allocation of tax benefits would aggravate the horizontal inequity that exists because of the incentives. Two financiers would be treated differently because one provided a loan for acquisition of a machine tool and the other for education expenses.

469 For example, the British lessor with a "first year allowance" may still have an advantage over a lessor from a country that permits only straight-line depreciation and grants no investment credits.

470 Ancient Roman law used the term *dominium* to describe the absolute property right in an object; the inferior interest constituted by monitary ownership was an equity interest given by the Praetor, separating *dominium* and practical enjoyment. Similarly, in the feudal system one person held the immediate enjoyment of land for life, while future enjoyment was held by another. Easements, equitable servitudes, and trust law are modern day manifestations of a similar atomization of rights between "legal" and "equitable-beneficial" owners. *See generally* C. NOYES, THE INSTITUTION OF PROPERTY (1936); Baldwin, *Concept of Property from a Jurisprudential Viewpoint*, 23 GA. B.J. 171 (1961); East, *The Property Concept*, 6 LOYOLA L. REV. 33 (1951); Epstein, *Possession as the Root of Title*, 13 GA. L. REV. 1221 (1979); Fellman, *The Euro-*

concept of economic ownership.[471] The elements of economic ownership include both possession[472] (although the lessor has expressly relinquished possession for a period) and control (although a lessor does not control leased property any more than a shareholder necessarily controls a company whose stock he owns).[473] More important, however, economic ownership is associated with the risks and rewards of fluctuation in market value. Property is a bundle of rights used at different times in different ways. When all rights are transferred to another for a limited time, the original holder still may expect the return of a portion of the rights.[474] Asking who bears the risk and reward associated with fluctuations in residual value is a convenient way of determining whether the original owner has a realistic expectation of a return of something substantial.[475]

Lease characterization standards that focus on the risks and rewards of property value fluctuations also comport with the analysis used to distinguish between partners and creditors and between corporate debt and equity.[476] For example, courts have considered the opportu-

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pean Background of Early American Ideas Concerning Property, 14 TEMPLE L.Q. 497 (1940); Jones, *Forms of Ownership*, 22 TULANE L. REV. 82 (1947); Philbrick, *Changing Conceptions of Property in Law*, 86 U. PA. L. REV. 691 (1938); Turner, *Some Reflections in Ownership in English Law*, 19 CANADIAN B. REV. 342, 343 (1941). For a general discussion of ownership in tax law, see Keesling, *Conflicting Conceptions of Ownership in Taxation*, 44 CALIF. L. REV. 866 (1956).

471 Moreover, tax law already distinguishes between legal and economic ownership of an income stream in cases where higher bracket tax payers attempt to shift income to lower bracket family members through trusts, contracts, or partnerships. *See generally* W. ANDREWS, BASIC FEDERAL INCOME TAXATION 701-67 (2d ed. 1979).

472 *See* Epstein, *supra* note 470.

473 On the disassociation between ownership and control in the publicly held corporation, see E. STEIN, HARMONIZATION OF EUROPEAN COMPANY LAWS 79 (1971).

474 For example, assume *A* chooses to give *B* the right to use *A*'s plot of land, Terra, as a farm for one year. *B* certainly has the right to physical possession of Terra, as well as the right to raise crops for *B*'s own financial benefit. *A* retains extensive rights, however, including the right to exploit any subsurface minerals, to sell the land to someone after the lease expires, or to lease the land to *C* at the end of *B*'s tenancy. Under such circumstances, *B* cannot claim "ownership" of *A*'s land, because *A*'s retained rights outweigh the right of *B* during the lease term both in number and economic importance.

475 Some confusion may arise from use of the term "risk." Insurance can guard against downward fluctuations of residual value, especially those due to equipment obsolescence. Even if insurance eliminates the risk of loss, however, the owner is the one who benefits from upward fluctuations, that is, retains the rewards of ownership. Thus, the owner may be said to have the "risk" that the value will not increase.

On the use of insurance to guard against downward fluctuations in the residual value of leased equipment, through obsolescence or otherwise, see the story of Lloyd's "J" policy, reported in *The Times*, Nov. 28, 1978; *The Financial Times*, Nov. 24, 1978. Lloyd's sustained over $200 million in losses on computer residuals as a result of technological advancement in the computer industry.

476 Other tax issues to which "economic ownership" is relevant include the allowance of losses from commodities transactions and deductions for mineral depletion.

On May 23, 1977, the IRS issued Rev. Rul. 77-185, 1977-1 C.B. 49, advising that a taxpayer cannot deduct short-term capital loss from a series of transactions in silver futures nity to share in gains and the risk of suffering losses as criteria to distinguish mere money lenders from partners who are vicariously liable for each other's obligations in tort and contract.[477] Tax law similarly regards the sharing of profits as indicative of partnership.[478] The partner's share of an enterprise's profit is analogous to the lessor's gain from appreciation in equipment's residual value. In both cases, the potential for reward is the appropriate measure of economic ownership.

The distinction between corporate debt and equity creates a corresponding need to differentiate an owner from a lender. Like the shareholder, the lessor owns property. The seller and lender, however, are merely creditors.[479] Controlling shareholders may classify their debt as equity, thus subordinating their claims to those of other creditors.[480] Similarly, lease recharacterization may alter priorities among the lessee's creditors.

The distinction between corporate debt and equity is also significant in tax law. Interest payments are deductible for purposes of calculating corporate income; dividends are not. Factors considered in classifying corporate instruments as debt or equity include the corpora-

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contracts under I.R.C. § 165(a). The aim of the so-called "silver straddles" was to reduce the tax on unrelated short-term gain. The Ruling assumes that the silvers futures contracts never resulted in a real economic loss. A straddle usually involves the simultaneous ownership of contracts to deliver or to take delivery in the same commodity. A "long" contract buys for future delivery; a "short" contract sells for future delivery. The "spread" between the two positions limits the taxpayer's risk. In the set of hypothetical facts given in the revenue ruling, the taxpayer's risk was limited to the "margin" deposit with the brokers, equal to .25% of his purchases. The balanced position meant that the taxpayer did not close and complete a transaction, and never took an economic risk. The absence of economic risk indicated that the taxpayer never owned anything that could give rise to a loss through sale.

I.R.C. § 611 allows a "reasonable allowance for depletion" of mineral deposits. The regulations limit the deduction to the "owner of an economic interest" in minerals. Treas. Reg. § 1.611-1(b) (1960). The Supreme Court recently affirmed a court of claims decision granting a lessee the right to take depletion allowances for mineral rights, despite the lessor's right to terminate the lease on 30 days' notice. United States v. Swank, 101 S. Ct. 1931 (1981).

477 *See generally* Douglas, *Vicarious Liability and Administration of Risk II*, 38 YALE L.J. 720 (1929).

478 *See* Haas v. Commissioner, 248 F.2d 487 (2d Cir. 1957) (discussion of profit and loss sharing), *remanded to Tax Court*, 18 T.C.M. 401 (CCH 1959) (loss deduction denied to husband and wife who supplied capital to mill); E.C. Hartman, 17 T.C.M. 1020 (CCH 1958) (partnership in operation of river ferry found from agreement to share profits); Treas. Reg. § 1.761-1 (1960). The characterization of business entities is beyond the scope of this Article. For tests distinguishing between corporations, partnerships, and trusts, see generally Treas. Reg. §§ 301.7701-2 to 301.7701-4 (1970).

479 The debt/equity analogy may be a treacherous one. The shareholder of the corporation has sold his money to the company in return for shares, whereas the borrower leases his money to the company and obtains its return at the end of the loan term. The one who sells his money, however, ends up owning the corporation.

480 *See, e.g.,* Pepper v. Litton, 308 U.S. 295, 310 (1939); Taylor v. Standard Gas & Elec. Co., 306 U.S. 307 (1939). It is interesting to note that the court in *Taylor* assumes that an owner will stand in line behind other claimants of the corporate assets—an ironic twist given the priority of the equipment owner over other creditors.

tion's leverage ratio, the convertability of the debt into stock, and whether the instrument is subordinated to or given preference over other corporate instruments.[481] This last criterion points to a connection between ownership and risk. Preference over other debt reduces the holder's risk, whereas subordinated instruments present greater risk. And, as might be expected, greater risk increases the likelihood that the instrument will be classified as equity.

CONCLUSION

The twin brothers in Shakespeare's *Comedy of Errors* were "one so like the other, [a]s could not be distinguished but by names."[482] The same observation might be made about many finance leases and credit sales. To prevent the shift of tax benefits and to provide a measure of horizontal equity among taxpayers, some tax systems have established rules to ensure that substantially similar methods of asset financing receive substantially similar tax treatment. But different countries employ different characterization standards, leading to asymmetrical treatment of trans-border leases and causing an inefficient and distorted international flow of goods and credit.

The trade-distorting effects of divergent national characterization standards argue for the adoption of a uniform rule for lease characterization. The uniformity of such a rule may be more important than its content. An equipment user should not seek financing from a French rather than a British supplier or financier merely because of tax considerations, such as the impossibility for the latter to grant a purchase option without losing depreciation deductions. Nor should an equipment user be induced to seek financing from a British rather than a West German bank merely because "double dip" depreciation deductions may be possible in the former case.

The adoption of a uniform rule in bilateral income tax treaties may achieve harmonization of lease characterization. A modified version of the characterization standards embodied in the Financial Accounting Standards Board's Statement No. 13 would be the most desirable uniform tax rule. The principles of FASB No. 13 provide certainty, comport with the goal of measuring net enrichment, and are based on the premise that the right to unrestricted use of an asset for most of its useful life is the essence of ownership. Lessor status is tested by the equipment supplier's retention of a reversionary interest of sub-

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481 Treas. Reg. §§ 1.166-9, 1.385-1, 1.385-12, 1.482-2 (1980). On the need for debt/equity characterization standards, see S. REP. NO. 91-522, 91st Cong., 1st Sess. 142, *reprinted in* [1969] U.S. CODE CONG. & AD. NEWS 2169.

482 *Comedy of Errors*, I.i.51-52. *Cf.* "That which we call a rose by any other name would smell as sweet." *Romeo and Juliet*, II.ii. 43-44.

stantial residual value, equal to at least 25% of the asset's useful life.[483]

National provisions for the assignment of the tax incidents of ownership also should be uniform. Free transferability of investment incentives does not mean they should be available twice. The requirements for assignment should be harmonized by income tax treaties so that only one party may elect owner status. A free contractual allocation of the tax incidents of ownership in itself would reduce the importance of divergent characterization standards, because less energy would be devoted to trying to squeeze finance transactions into the desired mold.

The concept of ownership has evolved to meet historical exigencies, and it has changed to accommodate the new commercial significance of the finance lease. The tax characterization of international leasing transactions should be in line with these financial trends.

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483 The test that requires that the present value of the rentals not exceed 90% of the asset's fair market value is inappropriate for tax characterization. *See* text accompanying note 466 *supra*.

Appendix: Withholding Rates Under U.S. Income Tax Treaties

	Royalties (1)			Interest		Industrial & Commercial Profits (2)	
Country	Article	Rentals Specifically Included	Rate Withheld	Article	Rate Withheld	Article	Rentals Specifically Included
Australia	No Reduction by Treaty			No Reduction by Treaty		3	No
Austria	8	Yes	Exempt	7	Exempt	3	No
Belgium	12	No	Exempt	11	15%	7	Yes
Brazil	14	No	15%	13	15%	8	Yes
Canada (In force)	13	No	15%	11	15%	1	No
Canada (Not yet in force)	12	Yes	10%	11	15%	7	No
Cyprus (Not yet in force)	14	No	Exempt	13	10%	8	Yes
Denmark	8	No	Exempt	7	Exempt	3	No
Denmark (Not yet in force)	12	No	Exempt	11	Exempt	7	Yes
Finland	14	No	Exempt	13	Exempt	8	Yes

Appendix - continued

Country	Royalties (1)			Interest		Industrial & Commercial Profits (2)	
	Article	Rentals Specifically Included	Rate Withheld	Article	Rate Withheld	Article	Rentals Specifically Included
France	11	No	5%	10	10%	6	Yes
Germany	8	No	Exempt	7	Exempt	3	No
Greece	7	Yes	Exempt	6	Exempt	2	No
Hungary	11	No	Exempt	10	Exempt	2	No
Iceland	14	No	Exempt	13	Exempt	8	Yes
India (Not yet in force)	No Reduction by Treaty			No Reduction by Treaty		3	No
Ireland	8	No	Exempt	7	Exempt	3	No
Israel (Not yet in force)	14	No	15%	13	17.5%	8	Yes
Italy	8	Yes	Exempt	No Reduction by Treaty		3	No
Jamaica (Not yet in force)	12	No	10%	11	12.5%	7	Yes
Japan	14	No	10%	13	10%	8	Yes

Appendix - continued

	Royalties (1)			Interest		Industrial & Commercial Profits (2)	
Country	Article	Rentals Specifically Included	Rate Withheld	Article	Rate Withheld	Article	Rentals Specifically Included
Korea	14	No	15%	13	12%	8	Yes
Luxembourg	7	Yes	Exempt	8	Exempt	3	No
Malta (Not yet in force)	12	No	12.5%	11	12.5%	7	Yes
Morocco (Not yet in force)	12	No	10%	11	15%	7	Yes
New Zealand	No Reduction by Treaty			No Reduction by Treaty		3	No
Norway	10	No	Exempt	9	Exempt	5	No
Pakistan	8	No	Exempt if "fair and reasonable"	No Reduction by Treaty		3	No
Philippines (Not yet in force)	13	No	15%	12	15%	8	Yes
Poland	13	No	10%	12	Exempt	8	No
Romania	12	No	15%	10	10%	7	Yes

Appendix - continued

Country	Royalties (1)			Interest		Industrial & Commercial Profits (2)	
	Article	Rentals Specifically Included	Rate Withheld	Article	Rate Withheld	Article	Rentals Specifically Included
South Africa	No Reduction by Treaty			No Reduction by Treaty		5	No
Sweden	6	Yes	Exempt	8	Exempt	2	No
Switzerland	8	Yes	Exempt	7	5%	3	No
Thailand (Not yet in force)	11	No	15%	10	Exempt	4	No
Trinidad & Tobago	14	No	15%	13	15%	8	Yes
U.S.S.R.	3	No	Exempt	3	Exempt	4	No
United Kingdom	12	No	Exempt	11	Exempt	7	Yes
OECD Model	12	Yes	Exempt	11	Exempt	7	No
U.S. Treasury Model	12	No	Exempt	11	Exempt	7	Yes

General Notes

(1) Taxed as royalties if not effectively connected with a permanent establishment.

Rates refer to "industrial and scientific" equipment royalties unless otherwise stated. ("Literary and cultural royalties" and "movie royalties" are not included.)

(2) Business income is fully taxed or exempt depending on whether it is effectively connected with a permanent establishment.

Notes on Particular Treaties

Austria	The exemptions in Articles 7 and 8(1) are only available if the charge is "in an amount not exceeding fair and reasonable consideration."
Belgium	Interest on "commercial credit" is exempt.
Brazil	Article 14 only applies to "so much of the royalty as represents a fair and reasonable consideration." Interest is subject to the withholding limitation of 15% only if the recipient is a bank or financial institution or the debt arose from a sale of property. Otherwise, interest may be taxed by both contracting parties.
Canada (in force)	Article 11 applies to income other than earned income and dividends. Article 2 specifieally excludes from industrial and commercial profits income in the form of "rentals and royalties."
Canada (not yet in force)	Article 11 exempts from withholding interest beneficially owned by a seller in connection with the sale on credit of any equipment.
Cyprus	Interest is excmpt if the recipient is a bank or financial institution or the debt arose from a sale of property.
France	Interest paid on bank loans is exempt under Article 10(9).
Greece	Interest is cxempt to the extent that it does not exceed 9%.
Ireland	The exemption for intcrest taxed by the other contracting party is not available if the corporate payee controls more than 50% of the voting power of the corporate payor. Article 9 limits U.S. taxation of real estate rental income to 15% if paid to an Irish resident in whose hands it is taxed. Rental income derived in Ireland and paid to a U.S. resident in whose hands it is taxed is exempt. Interest exempt only if taxcd by U.S.
Israel	Interest withheld at 10% if paid to a financial institution.
Japan	Article 14 applies to ships or aircraft rentals if the lessor is not engaged in operation in international traffic.
Korea	Article 14 applies to ships or aircraft rentals if the lessor is not engaged in operation in international traffic.
Philippines	"Interest on deferred payment sales" specifically included in Article 12.
Trinidad & Tobago	Interest must be "fair and reasonable."
U.S.S.R.	Interest is not exempt if derived from general banking business.