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Taxation of Business Rent

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TAXATION OF BUSINESS RENT

George Mundstock*

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* Professor of Law, University of Miami School of Law. The author would like to thank William Andrews, Alan Auerbach, Thomas Barthold, Patrick Gudridge, Daniel Halperin, Elliott Manning, and participants in the Harvard Fund for Tax and Fiscal Research Seminar on Current Research in Taxation, August 1991, for their help with this Article. Research on this Article was completed as of March 30, 1992.
The federal income tax treatment of rent has received little attention, presumably because it generally is viewed as obvious and simple. In fact, the economics of the taxation of rent generally are misperceived. A clear view of these economics shows that the current rules controlling the taxation of rent are seriously defective and require reform. Economic rent should be greater when a depreciating asset is new; yet current law respects level rent stated in long-term leases. This mistaxation distorts economic behavior and

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1 The basic analysis of leasing in this Article was first suggested in George Mundstock, The Mistaxation of Rent: Eliminating the Lease/Loan Distinction, 53 Tax Notes 353 (Oct. 21, 1991).

2 The current taxation of other long-term, non-loan contracts also is defective. For example, current law allows remarkably generous deferral of service income to cash basis taxpayers. See Rev. Rul. 60-31, 1960-1 C.B. 174. A consideration of these problems is beyond the scope of this Article. An argument can be made that reform of the taxation of rent should be deferred pending a general reform of the taxation of long-term contracts. However, current law with regard to leases is particularly troubling. Since the long-term relationship that most closely resembles a lease is a loan, and since current law with regard to loans is not as defective as with regard to leases, the lease/loan distinction presents real manipulation problems. See infra Parts I.B.2 and I.B.3. After all, leases are commonly regarded as a tax-
loses revenue. Unfortunately, once the current defects are identified, it is hard to see a workable reform, as there is little data on economic rent. Reform becomes possible, however, if one applies the present value and related concepts developed in the loan context to the taxation of rent. These same concepts provide insight into transactions similar to leases, like sales of terms for years. This Article provides that analysis.

Part I discusses the taxation of rent. It shows that the economic rent of depreciable property should be greater when the asset is newer — and, thus, presumably, more useful — and lower later — when the property is older and less useful. Notwithstanding these underlying economics, most long-term leases state level, or near-level, rent. In a level-rent lease, the lessor, in effect, lends the rent "shortfall" (as compared to economic rent) in the early years of the lease, to be repaid out of "excess" rent in the later years. Current law generally respects a level-rent lease. This mistaxation of rent undertaxes lessors and overtaxes lessees, in present value terms. When the lessor is in a higher tax bracket than the lessee, the current mistaxation effects a net reduction in taxes. Since taxpayers will organize their behavior to take advantage of this mistaxation of rent, tax-favored leasing is encouraged and revenue is lost needlessly.

A perfect reform would tax both the economic rent and any loan hidden in a long-term lease that does not state economic rent. This would be quite complicated — and probably unworkable — since there is little data on economic rent. It is possible to devise a workable reform, however, by using the present value, compounding, and related concepts that Congress increasingly uses in the taxation of loans. One applies these concepts to the taxation of long-term leases by comparing a given lease with a loan that provides the same payments. The economics of this loan should be very

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Driven form of financing. See infra Part I.B.2. More generally, it probably is easier for taxpayers to take advantage of defects in the current law with regard to the taxation of leases than these other defects without changing the economics of transactions (cash flows and risk) materially. Additionally, since the current defects in the taxation of leases arise from a failure to account properly for the return on the capital invested in the leased property at the outset, as discussed infra Part I.B.3, the problems considered here are likely to be less of a concern with long-term service contracts, which are the principal other type of long-term contract; others include licensing, construction, and supply contracts, which customarily involve capital. In sum, it seems best to proceed with an examination of leasing.
close to the economics of the parallel lease. Thus, taxing a long-term lease as if it were a loan proxy should radically reduce the current mistaxation. This simple reform, by drawing on related recent developments in the law, would be readily understandable by taxpayers and the Internal Revenue Service (the “Service”).

Many lease transactions present the issue of how any unrealized gain or loss in the leased property should be taxed to the lessor. Current law taxes a portion of any gain through reduced depreciation over the lease term. Similarly, a portion of any loss is taxed through increased depreciation over the lease term. Part II points out that the problem of when gain or loss should be realized is virtually intractable, since there is no economic notion of realization to use as a benchmark in evaluating tax realization rules. In particular, the loan proxy suggested for taxing rent makes little sense as a realization rule. Fortunately, the proposal can be adjusted to provide realization rules that parallel the current rules and are quite acceptable.

Most of the analyses of long-term leasing focus on the lessor’s use of non-economic accelerated depreciation. Part III shows that, due to this focus, these analyses are incomplete. Once one takes the mistaxation of rent into account, lessor accelerated depreciation is less troubling. Moreover, the proposed loan proxy reform facilitates dealing with accelerated depreciation.

Part IV considers transactions that are similar to long-term leases, primarily sales of terms for years. These transactions are also mistaxed under current law. Loan concepts motivate a simple reform here as well. The impact of inflation on this Article’s basic analysis is considered in Part V. Part VI then discusses how the recently resuscitated capital gains preference affects this Article’s conclusions. Part VII briefly concludes.

I. Mistaxation of Rent

Current law generally respects level rent provided in long-term leases. In fact, economic rent of depreciable property probably is greatest when the property is new. Thus, current law troublingly mistaxes rent. This mistaxation results in undertaxation when the lessor is subject to higher tax rates than the lessee. As a result, taxpayers can organize their affairs so as to exploit the mistaxation, which results in an unjustified tax interference with economic behavior and in a loss of revenue. The perfect reform, taxing eco-
nomic rent and any loans hidden in non-economic rent structures, is quite complicated. Fortunately, taxing leases as if they were loans is a close and workable proxy for this reform.

A. Basic Assumptions

Rent is the compensation paid by a lessee to a lessor for the use of the lessor's property. Rent pays the lessor for (i) the lessor's financial costs of owning the property and (ii) for any related non-financial services. This Article is concerned only with economic problems associated with the financial side of rent, and, consequently, ignores the services side in the economic analysis. Thus, repairs and maintenance are not reflected in this discussion. This Article focuses on leases of depreciating tangible property, including structures. No account is taken of intangibles or mineral and other depletable properties. The analysis with regard to land that is not subject to depletion is noted where appropriate.

It is important to understand the economics of rent in order to tax rent. If the tax law does not tax rent in accordance with its

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3 Services are ignored only for purposes of the basic economic analysis. The discussion infra, Part I.B.5, takes services into account for purposes of this Article's reform proposal. It is reasonable to ignore services in the economic analysis when the lessee can purchase the services at the same price, and with the same tax treatment, from either the lessor or a third party. This is customarily assumed in the economics literature. See, e.g., Merton Miller & Charles Upton, Leasing, Buying, and the Cost of Capital Services, 31 J. Fin. 761, 761-62 (1976). Since this assumption seems reasonable, it also is adopted here. Not all economists agree, however. See, e.g., David Flath, The Economics of Short-Term Leasing, 18 Econ. Inq. 247 (1980). To the extent this assumption is wrong, the analysis in this Article must be appropriately limited.

4 This Article is limited in many ways. It looks only at leasing and similar transactions involving taxable unrelated businesses not subject to the hobby loss rules. Thus, for example, no account is taken of issues presented by gratuitous transfers of interests in property. All rent is potentially deductible. This Article looks only at the basic tax accounting for leasing and related transactions with no foreign connection under the regular income taxes. No account is taken of the impact of leasing on (or the impact on leasing of) such provisions as the minimum taxes, the tax on tax-exempts' unrelated business income, the (now repealed) investment tax credit, the foreign tax credit, the depletion allowance, the at-risk and passive activity loss rules, and the rules controlling utilization of net operating losses. This Article does not consider the impact of rent guarantees on the analysis, since the problems presented by guarantees extend well beyond the leasing context.

As discussed below, leasing is a close substitute for borrowing. Many are concerned that borrowing presents problems with respect to the current "double taxation" of corporations — where income is taxed to the corporation as earned and, again, to the shareholders as dividends or capital gains. Thus, leasing presents double tax problems. See U.S. Department of the Treasury, Integration of the Individual and Corporate Tax Systems — Taxing Busi-
economics, problems arise. For example, if two lease transactions reflect identical economic rent but are taxed differently, taxpayers will enter into the lease transaction that provides the more favorable tax treatment, even if that lease otherwise makes less economic sense. The different tax treatments reduce revenues and distort economic behavior. Rent should be taxed in accordance with its economics.5

B. Rent in a Riskless World (with No Change)

1. The Accelerated Nature of Rent

The theoretical economics of rent are relatively straightforward. In the case of depreciating property, the rent generally should be greater when the property is new.

Some simplifying assumptions, to be relaxed later, are helpful. Assume that markets work perfectly and that the tax system has no effect on prices, prices do not change, transactions are costless,6 there is no risk,7 and all investments provide the same pre-tax return. Also, assume that the tax system taxes interest8 as it accrues economically and that the tax system provides deductions for depreciation that exactly match the depreciating assets' decline in value, i.e., that the tax law provides "economic depreciation."9

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6 For a more complete exposition of the analysis underlying this policy criterion, see George Mundstock, Taxation of Business Intangible Capital, 135 U. Pa. L. Rev. 1179, 1183 (1987).
7 This assumption is somewhat troubling, since some suggest that transaction costs play a significant role in the lease/loan distinction. See, e.g., Flath, supra note 3, at 248-55.
8 To elaborate, there is no fluctuation in relative market prices, all obligations always are paid, and there is no theft or destruction of property.
9 For simplicity, this Article uses "interest" to include original issue discount. The discussion also assumes that all indebtedness bears adequate interest for tax purposes. See I.R.C. § 1274.
10 There is no one "economic depreciation" for most properties. A given property's value at a point in time depends on how the property has been used and how it has been maintained. For example, a car that has been driven hard over long distances without an oil change is likely to be worth less than an equally old car that has been driven only a little with perfect maintenance. This limitation on the notion of economic depreciation is particularly relevant here, as some economists believe that a business' decision whether to lease or buy a given property is influenced by the economics of the different effects that owning and leasing have on the quality of use and maintenance of the property. See, e.g., Clifford Smith & MacDonald Wakeman, Determinants of Corporate Leasing Policy, 40 J. Fin. 895 (1985).
flation is not considered until Part V.

With these assumptions, it is possible to determine what market or economic rent should be. Under the perfect markets assumption, economic rent of a property for a year should be sufficiently high to compensate potential lessors for their total economic cost associated with such property for the year. Otherwise, these lessors would sell their properties or use the properties themselves rather than rent. Similarly, looking at leasing from the perspective of potential lessees, the economic rent for a year should not exceed the total cost of owning the property. Otherwise, these lessees would just buy the properties themselves. Thus, since the rent should be neither less nor more than the total cost of owning the property, the rent should equal this total cost. This rent makes lessors and lessees indifferent between leasing and owning, which is required by the perfect markets and related assumptions.10

What is the total economic or financial cost for a year of owning leased property? There are two component costs. One cost of owning the property is the loss of the investment in the property due to the property losing value — economic depreciation. Further, the funds invested in the property could be invested otherwise, e.g., in a bank account earning interest. Thus, another cost of owning the property is lost alternative profit — for convenience, this is referred to here as “economic interest.” Consequently, under the instant assumptions, economic rent exactly equals economic depreciation plus economic interest.11 This straightforward statement leads to some potentially surprising results, as can be seen with an example.

Assume that all indebtedness bears 10% interest.12 A machine costs $30,721.13 The machine is purchased and placed in service on the first day of Year 1, at which time it begins to lose value on a straight-line basis over ten years, after which the machine is

Nevertheless, the instant analysis, as is customary in the literature, does not reflect this additional complexity in order to be consistent with the assumption, discussed supra note 3, that maintenance costs are fixed and consequently can be ignored. See, e.g., Miller & Upton, supra note 3, at 764.

10 See Miller & Upton, supra note 3, at 761-67.
11 See Miller & Upton, supra note 3, at 761-67.
12 In this Article, all interest and discount rates are annual yields.
13 This price was arbitrarily chosen in order to generate the level rent of 5 in Table II.
worthless, i.e., has no salvage value. The following table presents the economics:

**TABLE I**

<table>
<thead>
<tr>
<th>Year</th>
<th>Rent</th>
<th>Depreciation</th>
<th>Net Income</th>
<th>Net Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>6.14</td>
<td>3.07</td>
<td>3.07</td>
<td>30.72</td>
</tr>
<tr>
<td>2</td>
<td>5.84</td>
<td>3.07</td>
<td>2.77</td>
<td>27.65</td>
</tr>
<tr>
<td>3</td>
<td>5.53</td>
<td>3.07</td>
<td>2.46</td>
<td>24.58</td>
</tr>
<tr>
<td>4</td>
<td>5.22</td>
<td>3.07</td>
<td>2.15</td>
<td>21.51</td>
</tr>
<tr>
<td>5</td>
<td>4.92</td>
<td>3.07</td>
<td>1.84</td>
<td>18.43</td>
</tr>
<tr>
<td>6</td>
<td>4.61</td>
<td>3.07</td>
<td>1.54</td>
<td>15.36</td>
</tr>
<tr>
<td>7</td>
<td>4.30</td>
<td>3.07</td>
<td>1.23</td>
<td>12.29</td>
</tr>
<tr>
<td>8</td>
<td>3.99</td>
<td>3.07</td>
<td>0.92</td>
<td>9.22</td>
</tr>
<tr>
<td>9</td>
<td>3.69</td>
<td>3.07</td>
<td>0.61</td>
<td>6.14</td>
</tr>
<tr>
<td>10</td>
<td>3.38</td>
<td>3.07</td>
<td>0.31</td>
<td>3.07</td>
</tr>
</tbody>
</table>

The rent in the second column is the only rent that is consistent with the straight-line economic depreciation. Rent less depreciation is shown in the fourth column. The fifth column is the original cost less accumulated depreciation, which balance is the lessor's outstanding investment in the machine. Note that the rent in Table I assures that the annual net income on the asset is exactly 10% of the net investment. Thus, the column one economic rent assures that the lessor earns exactly the assumed 10% annual return on its remaining investment (column five). This is the rent the lessor would charge in a series of one-year leases commencing at the beginning of each year.

This simple example is the heart of this Article. It shows that, even if one assumes that economic depreciation is straight-line, rent is not. In the early years of the asset's life, the lessor has a greater investment in the property, so that the interest component of rent, and, consequently, the rent, are greater in these years. For convenience, such a rent structure is referred to as "accelerated." The conclusion that rent should be greater when a machine is new makes sense. Since a newer machine probably works more reliably

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14 To simplify calculations, it is assumed that, on the last day of the year, (a) all depreciation occurs instantaneously and (b) all rent accrues economically and, for tax purposes, instantaneously, and is payable.

16 In all tables, numbers may not add up properly due to rounding.
and efficiently and, thus, is more productive, one would pay more rent for a newer machine. The use of a newer machine simply is worth more.

The essentially accelerated nature of rent for depreciable property can be seen from the other direction. One can look at what economic depreciation would have to look like if one believed that rent is level. Table II shows what the economic depreciation would be if the economic rent of a machine that cost 30.72 were level over ten years:

<table>
<thead>
<tr>
<th>Year</th>
<th>Rent</th>
<th>Depreciation</th>
<th>Net Income</th>
<th>Net Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>5.00</td>
<td>1.93</td>
<td>3.07</td>
<td>30.72</td>
</tr>
<tr>
<td>2</td>
<td>5.00</td>
<td>2.12</td>
<td>2.88</td>
<td>28.80</td>
</tr>
<tr>
<td>3</td>
<td>5.00</td>
<td>2.33</td>
<td>2.67</td>
<td>26.67</td>
</tr>
<tr>
<td>4</td>
<td>5.00</td>
<td>2.57</td>
<td>2.43</td>
<td>24.34</td>
</tr>
<tr>
<td>5</td>
<td>5.00</td>
<td>2.82</td>
<td>2.18</td>
<td>21.78</td>
</tr>
<tr>
<td>6</td>
<td>5.00</td>
<td>3.10</td>
<td>1.90</td>
<td>18.95</td>
</tr>
<tr>
<td>7</td>
<td>5.00</td>
<td>3.42</td>
<td>1.58</td>
<td>15.85</td>
</tr>
<tr>
<td>8</td>
<td>5.00</td>
<td>3.76</td>
<td>1.24</td>
<td>12.43</td>
</tr>
<tr>
<td>9</td>
<td>5.00</td>
<td>4.13</td>
<td>0.87</td>
<td>8.68</td>
</tr>
<tr>
<td>10</td>
<td>5.00</td>
<td>4.55</td>
<td>0.45</td>
<td>4.54</td>
</tr>
</tbody>
</table>

Level rent implies depreciation that is much smaller in the early years of an asset’s life, and much greater in the later years.\(^{16}\)

It is helpful to note that the instant analysis is consistent with level rent for non-depreciating undeveloped land. In this case, the lessor’s investment is constant from year to year. Land rent must compensate the lessor for only one cost: loss of the use of the money invested in the land, i.e., economic interest. Since the investment stays constant, economic interest and rent stay constant. In a lease of depreciating property, the net investment declines, and, therefore, the interest component of rent declines, i.e., is accelerated, so that rent will be accelerated unless the depreciation is very slow indeed.

The true economic rent can only be determined empirically. While there have been few studies of rent, a number of studies of

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economic depreciation conclude that economic depreciation generally is straight-line or faster.\textsuperscript{17} Thus, it seems quite likely that economic rent generally is quite accelerated. These empirical works also note widely different patterns of depreciation between different types of assets,\textsuperscript{18} implying that economic rent also must be quite variable.

The very accelerated nature of economic rent when the economic depreciation is fast can be seen in the context of the ongoing example. Assume that the economic depreciation of the machine that cost 30.72 is 150\% declining balance switching to straight line when more favorable over ten years, with no salvage value or averaging convention. Then, matters are as follows:

\begin{table}[h]
\centering
\begin{tabular}{|c|c|c|c|c|}
\hline
Year & Rent & Depreciation & Net Income & Net Investment \\
\hline
1 & 7.68 & 4.61 & 3.07 & 30.72 \\
2 & 6.53 & 3.92 & 2.61 & 26.11 \\
3 & 5.55 & 3.33 & 2.22 & 22.20 \\
4 & 4.72 & 2.83 & 1.89 & 18.87 \\
5 & 4.28 & 2.67 & 1.60 & 16.04 \\
6 & 4.01 & 2.67 & 1.34 & 13.36 \\
7 & 3.74 & 2.67 & 1.07 & 10.69 \\
8 & 3.47 & 2.67 & 0.80 & 8.02 \\
9 & 3.21 & 2.67 & 0.53 & 5.35 \\
10 & 2.94 & 2.67 & 0.27 & 2.67 \\
\hline
\end{tabular}
\caption{TABLE III}
\end{table}

Rapid economic depreciation is associated with quite accelerated economic rent.

2. Multi-Year Leases

The discussion, thus far, has not focussed on the term of a lease. Leases can extend over many years. The basic analysis above provides insights into multi-year leases.\textsuperscript{19} Most importantly, it shows


\textsuperscript{18} See Hulten & Wykoff, supra note 17, at 112.

\textsuperscript{19} The discussion assumes that the lease cannot be cancelled by the lessee without penalty, as discussed more fully infra.
that level-rent leases, a common practice,²⁰ result in considerable mistaxation. This mistaxation troublingly encourages revenue-losing leases between low-bracket lessees and high-bracket lessors.

A multi-year lease can provide annual rent equal to the economic rent for each year. This is not the only rent structure acceptable to the lessor and lessee, however. Under the instant assumptions, they should be indifferent between rent structures as long as the lessor earns a market return, or, equivalently, the lessee pays a market return. For example, even when economic rent is accelerated, the lessor should be willing to take an appropriate level rent.²¹ If so, the lessor is not receiving adequate rent in the early years of the lease, and is receiving excess rent in later years. In effect, the lessor is lending the economic rent shortfall in the early years, and the loan is repaid with interest in the later years. Current law applies this hidden loan analysis, but only when a lease explicitly provides that rent is to be paid after the period to which it relates under the terms of the lease.²²

This hidden loan analysis can be illustrated in the context of the ongoing example. Assume that the machine in Table I is rented for five years. The economic rent would be the same as in Table I. A five-year level rent structure that has the same present value as the first five years of this economic rent and, therefore, is equivalent to the lessor and lessee, would provide rent of 5.59 per year.²³ If the Table I machine is rented for this level rent, however, the tax consequences of the loan from the lessor to the lessee that


²¹ Miller & Upton, supra note 3, at 777. If the lessor anticipates a need for cash flow prior to that provided in the lease, under the assumptions at this point in this Article, it can plan to sell interests in the property, and in the lessor's rights under the lease, at a zero transaction cost when it needs cash.

²² I.R.C. § 467(a).

²³ In the real world, the lessor would factor its tax treatment into its pricing analysis. See James C. Ahlstrom & Iris C. Engelson, Economics of Leveraged Leasing, in Equipment Leasing — Leveraged Leasing 561 (Bruce E. Fritch, Albert F. Reisman & Ian Shrank eds., 3d ed. 1988). This is ignored here for two reasons. First, since the analysis generally assumes a perfect tax system, taxes generally should have no effect on prices. Second, since the only imperfect feature of the tax system under consideration at this point is rent mistaxation, and since the point of the discussion is to eliminate this feature so as to assure no tax effect on prices, consideration of tax effects on prices would not advance the analysis. See supra notes 4-9 and accompanying discussion.
is hidden in the rent structure must be taken into account to fully reflect the economics of the transaction, as follows:

### TABLE IV

<table>
<thead>
<tr>
<th>Economic Rent</th>
<th>Stated Rent</th>
<th>Hidden New Advance</th>
<th>Interest on Loan Balance</th>
<th>Year End Loan Balance (incl. int.)</th>
<th>Econ. Rent Plus Int.</th>
</tr>
</thead>
<tbody>
<tr>
<td>6.14</td>
<td>5.59</td>
<td>0.56</td>
<td>0</td>
<td>0.56</td>
<td>6.14</td>
</tr>
<tr>
<td>5.84</td>
<td>5.59</td>
<td>0.25</td>
<td>0.06</td>
<td>0.86</td>
<td>5.89</td>
</tr>
<tr>
<td>5.53</td>
<td>5.59</td>
<td>-0.06</td>
<td>0.09</td>
<td>0.89</td>
<td>5.62</td>
</tr>
<tr>
<td>5.22</td>
<td>5.59</td>
<td>-0.37</td>
<td>0.09</td>
<td>0.61</td>
<td>5.32</td>
</tr>
<tr>
<td>4.92</td>
<td>5.59</td>
<td>-0.67</td>
<td>0.06</td>
<td>0</td>
<td>4.98</td>
</tr>
</tbody>
</table>

Table I provides the economic rent. The third column (hidden new advance) is the money lent in the first four years of the lease through understated rent — the positive difference between the first two columns — to be repaid plus interest in the remaining years out of overstated rent — the negative difference between the first two columns. The fifth column shows the aggregate net loan — advances plus interest less payments. Interest on this balance is reflected in the fourth column. The total economic income in the sixth column is the economic rent in the first column plus the hidden interest in the fourth column.

Current tax law takes a different view. It generally respects the rent structure in a long-term lease. Section 467, enacted in 1984, improved matters somewhat. It provides that if stated rent

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For simplicity, this Article assumes that all stated rent in a lease is fixed and paid currently. Thus, for example, rent holidays are not considered. Current law works relatively well when the payment of stated rent is deferred. See I.R.C. § 467. Prepaid rent is discussed infra Part IV.A.1. More generally, this Article assumes that all items are paid as they accrue for federal income tax purposes, so that tax accounting methods are not relevant to the discussion. Current law provides minor variations in the accounting for rent depending on the taxpayer's accounting method, e.g., the cash method or the accrual method as modified by the economic performance requirement of I.R.C. § 461(h). These differences are not material for purposes of this Article. Contingent stated rent presents issues beyond the scope of this Article.

26 I.R.C. § 467.

is to be paid after the period to which it relates, the lessor generally is treated as receiving the present value of the rent and lending that amount at the applicable discount rate to the lessee.\textsuperscript{27} Special rules level increasing rent structures in certain transactions involving leasebacks and long-term leases.\textsuperscript{28} Section 467 did not go far enough, however, as it still essentially presumes that level rent is economic rent.

In short, under current law, the lessee in Table IV deducts the level rent. The lessor is taxed on the level rent and deducts the straight-line depreciation. Table V shows these calculations:

\begin{table}
\begin{tabular}{|c|c|c|c|c|c|c|}
\hline
\textbf{(1)} & \textbf{(2)} & \textbf{(3)} & \textbf{(4)} & \textbf{(5)} & \textbf{(6)} \\
Lessor Econ. Inc & Lessor Table IV & Lessor Loan & Lessee Econ. Ded & Lessee Table IV & Lessee Loan Ded. \\
Table IV Cur. Law & Table IV Treat. & Table IV & Table IV & Table IV Cur. Law & Table IV Loan Trt \\
\hline
3.07 & 2.52 & 3.07 & 6.14 & 5.59 & 6.14 \\
2.82 & 2.52 & 2.82 & 5.89 & 5.59 & 5.89 \\
2.54 & 2.52 & 2.54 & 5.62 & 5.59 & 5.62 \\
2.24 & 2.52 & 2.24 & 5.32 & 5.59 & 5.32 \\
1.90 & 2.52 & 1.90 & 4.98 & 5.59 & 4.98 \\
12.58 & 12.58 & 12.58 & 27.94 & 27.94 & 27.94 \\
\hline
\end{tabular}
\end{table}

For the lessor, economic income (the first column of Table V) is determined by taking economic rent plus interest (the sixth column of Table IV) and subtracting economic depreciation, assumed to be a level 3.07. Current-law taxable income (the second column of Table V) is determined by subtracting depreciation, a level 3.07, from the current-law rent, a level 5.59, to get level income of 2.52. For the lessee, the economic deduction (the fourth column of Table V) is the economic rent plus interest (the sixth column of Table IV). The current-law deduction (the fifth column of Table V) is the level rent of 5.59.

The total income to the lessor, or deduction to the lessee, over the lease term is the same under an economic analysis (the first and fourth columns of Table V) and current law (the second and fifth columns of Table V), but is accounted for later under current law, so that the present value of the tax to the lessor, and the pre-

\textsuperscript{27} I.R.C. § 467(a).
\textsuperscript{28} I.R.C. § 467(b).
sent value of deductions to the lessee under current law is less than would be the case under economic treatment.\(^2\) Moreover, the lessor is undertaxed by the exact amount that the lessee is overtaxed, i.e., allowed inadequate deductions.

Current law, by not taxing rent in accordance with the underlying economics, changes those economics. For example, current law, as opposed to economic accounting, increases the after-tax yield to a 34% tax bracket lessor on the machine in Table V approximately 0.5 percent. The relatively small effect is attributable to the relatively slow depreciation of the machine — a machine with a faster economic depreciation would experience greater mistaxation — and the relatively short term of the lease.\(^3\) With a ten-year level-rent lease of a property that depreciates economically over 15 years under the 150 percent declining balance switching to straight line when faster with no salvage value method in a 10% interest world, current law increases the after-tax yield to a 34% bracket lessor by nearly 8 percent. Longer leases of property with even faster depreciation show even more dramatic effects of current law. Presumably some of those benefits are shared with the lessee through lower rent,\(^4\) but quantifying this additional complexity is beyond the scope of this Article.

The instant analysis can seem counterfactual. After all, if a long-term lease provides level rent, that is the rent, right? This certainly would be true if the lessee could terminate the lease at will with no penalty. However, long-term leases customarily provide

\(^2\) Alvin C. Warren & Alan J. Auerbach, Transferability of Tax Incentives and the Fiction of Safe Harbor Leasing, 95 Harv. L. Rev. 1752, 1769 (1982). See also Miller & Upton, supra note 3, at 765. Miller and Upton explain the underlying economics as follows:

Any . . . pattern of rentals over the next n periods which has the same present value would be entirely equivalent, from the leasing company’s point of view, to the sequence of optimal one-period rentals . . . It will be a property of the present value computations, of course, that the leasing company’s rate of return will be exactly the same period by period as if it had engaged in a series of one-period rentals.

Id. Note that the rate of return (assumed to be fixed under the no risk assumption at the point in their article from which the quotation is taken), and not the net investment, is invariant with regard to the rent structure.

\(^3\) Of course, in a world with higher interest rates, the defects in current law also become more dramatic.

\(^4\) See Miller & Upton, supra note 3, at p. 783. The authors engage in a general equilibrium analysis and conclude that rents adjust for taxes perfectly. Id. A critique of their analysis is presented infra.
substantial termination penalties. The parties might not consciously view the penalty as protecting the premium rent in the lease's later years. They might view the penalty as protecting the lessor from market risks, or — less precisely, but more accurately — as protecting the cash flow upon which the deal is priced. The penalty provision might not be tailored to exactly compensate for the loss of future premium rent. Nevertheless, the penalty usually is enough to keep the lease in place, in which case the instant analysis of economic rent is valid.

In a given year, current law taxes income to the wrong taxpayer, but it does tax the correct total amount of income. Nevertheless, current law probably results in a net loss of revenue. If the lessee is in a low tax bracket or otherwise would receive little benefit from an economic rent deduction, the mistaxation under current law has little effect on the lessee and undertaxes the lessor. By merely adjusting the stated rent, the lessor and lessee can defer the lessor’s income and accelerate the lessee’s net income, reducing revenues. More importantly, taxpayers will go out of their way to structure lease transactions where the lessor is in a higher bracket than the lessee and avoid transactions where the lessee is in a higher bracket than the lessor.

There is no policy justification for this revenue loss. Moreover, current law undesirably influences business decisions. Since rent structures are designed with an eye on taxes, leasing becomes more desirable than other means of securing the use of an asset for a


A lease that provides above-market rent can be rejected by a lessee in bankruptcy, but damages (subject to limits, in the case of real property leases) are paid for the termination. See 11 U.S.C. §§ 365, 502. A lessor generally is as well or better protected in bankruptcy than a lender, on the apparent theory that a lessor owns the underlying property. For this purpose, bankruptcy courts look to the general commercial law distinction between leases and loans discussed infra note 55. See John D. Ayer, On the Vacuity of the Sale/Lease Distinction, 68 Iowa L. Rev. 667, 684-98 (1983); Reisman & Mooney, supra note 20, at 94-97.

34 Lease terminations are discussed infra Part II.C.

low-bracket lessee because of the lower rent resulting from the lessor's tax benefits. This other means might be more advantageous economically. Leasing becomes a more desirable type of investment activity for high-bracket lessors even if it is otherwise not economically advantageous. Other contracts involving capital transactions, such as options and swaps, are recognized as problem areas, but ready solutions are not forthcoming. As to leasing, however, policymakers simply do not realize that there is a problem and that there is a fairly simple solution. Reform of the taxation of rent is needed.

This Article's economic analysis essentially assumes that the user will either debt-finance or lease and concludes that problems are presented when a low-bracket user leases from a high-bracket lessor. Such focus is consistent with current, but not historical, leasing practice. The early large-scale lease transactions were viewed as providing excess lessee deductions and excess lessor income compared to borrowing, so that most lessors were low-tax or tax-exempt taxpayers. The basic analysis at the time compared the interest deduction under owning to the much larger rent deduction under leasing. This analysis, however, is incomplete in that depreciation must be factored in. In any event, more generous depreciation became available in 1954. This shifted the focus to transactions designed to provide tax benefits to lessors. For example, a chapter from a current leading text for leasing lawyers puts it bluntly as follows:

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39 See Cary, supra note 38, at 17, 28.


41 See Kripke, supra note 37, at 724; Shrank & Fritch, supra note 32, at 102-106. Also, as discussed infra note 60, the law might have dealt satisfactorily with lessee-favoring leasing, so that only lessor-favoring leasing could be done. The significance of non-economic accelerated depreciation is considered in Part III.
[A] lease transaction is a vehicle for making tax attributes of property ownership available to the lessor and passing a portion of the economic benefit of such attributes back to the lessee.\footnote{See William A. Macan IV & Richard L. Umbrecht, Tax Aspects of Equipment Leasing, in Equipment Leasing — Leveraged Leasing 313, 455 (Bruce E. Fritch, Albert F. Reisman & Ian Shrank eds., 3d ed. 1988). Of course, at this point in this Article, it is assumed that taxes have not affected prices, so that there has been no pass-back of benefits to the lessee as suggested in the quotation in the text.}

Interestingly, much of the finance literature takes a different tack, resulting in a much more sanguine view of leasing. This literature customarily starts by comparing a lease with an acquisition financed with debt and equity in a fixed ratio,\footnote{See, e.g., Wilbur G. Lewellen, Michael S. Long & John J. McConnell, Asset Leasing in Competitive Capital Markets, 31 J. Fin. 787, 787-97 (1976); Miller & Upton, supra note 3, at 781-83. This is not always the case, however. See, e.g., Richard A. Brealey & C. M. Young, Debt, Taxes and Leasing — A Note, 35 J. Fin. 1245, 1249 (1980) ("If an issue of equity is not a feasible option, leasing is likely to be the preferred method of financing for a tax-exempt charity.").} and concludes that leases are not the relatively tax-preferred form of financing. This is because an equity-financed acquisition is even more tax-preferred than leasing. Consider a tax-exempt organization: If it buys a machine using its own funds (equity financing), none of the return on the capital invested in the machine (economic interest) is taxed. If the organization leases the machine from a taxable entity, the return on capital in the rent is taxed to the lessor, although the return is relatively undertaxed because of the mistaxation of rent.\footnote{See Miller & Upton, supra note 3, at 781-83.} Only if the aggregate effect of the mistaxation of rent were a negative tax rate, which is impossible,\footnote{Non-economic accelerated depreciation plus rent mistaxation can result — and has resulted — in negative tax rates. See Alan J. Auerbach, Welfare Aspects of Current U.S. Corporate Taxation, 73 Amer. Econ. Rev. — Papers and Proceedings 76, 77-78 (1983). Non-economic depreciation is considered in Part III of this Article.} would leasing be more desirable than owning. Matters get more complicated once one takes into account (a) low-tax and tax-exempt users, and (b) that the financing of a purchased machine is a mixture of equity and debt in a fixed ratio. Nevertheless, in most cases the tax advantages to the equity-financed portion of a purchased machine will exceed the tax advantages of leasing. Thus, the mistaxation of rent should not drive low-tax or no-tax users into leasing. This point of view might explain the relatively small notice taken of the problems in current...
law.\textsuperscript{46} This conclusion seems wrong, however. After all, tax-driven leasing does occur. Comparing leasing to buying using a fixed ratio of debt to equity seems to hide the real tax effect due to the different overall debt-to-equity ratios for the user in the lease and purchase transactions. It is possible to develop an intuitive explanation here. Portfolio theory suggests that one look to how taxpayers adjust their holdings in response to tax changes. Here, one quickly focuses on how low-bracket users respond to the tax benefits of leasing. While a tax-exempt does quite well if it 100\% equity-finances a machine, so that the economic return on an amount equal to the equity tied up in the building is tax-exempt, as noted in the preceding paragraph, the tax-exempt does even better if it changes its holdings: equity-financing interest-bearing obligations and leasing the machine. By doing so, the tax-exempt gets two tax benefits. First, its equity takes full advantage of the tax exemption. Second, the tax advantages of the lease should enable the tax-exempt to obtain the use of the machine for a low rent resulting from the mistaxation of rent.\textsuperscript{47} Portfolio adjustments that hold the user’s overall debt-to-equity ratio constant give the tax-exempt a double tax benefit if it leases rather than owns. Thus, current leasing tax law encourages low-bracket taxpayers to lease, making the tax problems with leasing transactions a considerable concern.

3. Reform

There are two helpful ways to think about these defects in current law. First, one can focus on rent, as has been done thus far in this Article, and view the problem as arising from taxing rent inconsistently with depreciation. Second, one can reverse the focus: examining depreciation so as to attribute the problem to current law improperly accounting for the return of capital in long-term leases. Depreciation under current law does not provide for a return of capital that is consistent with the economics of a long-term lease with level rent.\textsuperscript{48} The second way of thinking about current

\textsuperscript{46} Further explanations are considered infra notes 48, 72.

\textsuperscript{47} See Harvey Galper & Eric Toder, Owning or Leasing: Bennington College and the U.S. Tax System, 36 Nat’l Tax. J. 257, 258-60 (1983). This Article owes a considerable debt to Galper and Toder.

\textsuperscript{48} Marvin A. Chirelstein, supra note 16, at 143-45; Stewart C. Myers, David A. Dill &
law motivates a simple reform.

The theoretically correct way to tax any lease is to determine the economic rent, tax it, calculate any hidden economic lending, and tax it. This seems unacceptably complicated. Thinking about current law as providing a defective return of capital suggests that one compare the return of capital in a lease with that in a loan. After all, a loan is simply a special type of lease: one where the property being “leased” is money. The only fundamental difference between a loan and a lease, when present, is the nature of the final property payment — i.e., cash, or other property and cash.

Treating a lease as if it were a loan is only a little tricky. In the example in Table IV, the lessee is using a machine with a ten-year life for five years. Thus, an analogous loan would be for the entire value of the machine (30.72). The payments (principal plus interest) on this loan would be the 5.59 cash rent payments plus the value of the machine when it is returned after five years. This value of the machine at the end of a lease is referred to customarily as the “residual value.” Under the assumed economic depreciation, the machine is worth 15.36 after five years, as shown in Table I. Thus, the total payments on the loan in the last year are 20.95 (5.59 cash rent plus 15.36 residual value of the machine). The implicit loan resembles a loan with a balloon payment. This residual value loan analysis is customarily used in pricing lease transactions, and is required when a lessor accounts for a lease as a loan for financial accounting purposes. The loan based on these assumptions looks as follows:

Alberto J. Bautista, Valuation of Financial Lease Contracts, 31 J. Fin. 799, 813-14 (1976) ("[When] depreciation is accelerated relative to the principal repayments implicit in the lease, the government suffers a net loss in terms of present value."). This viewpoint might help explain why people view the problem as a depreciation problem, and not a rent mistsation problem.

Economic rent could be reverse engineered from economic depreciation, as in Table I.


Accounting for Leases, Statement of Financial Accounting Standards No. 13, ¶99 (Fin. Accounting Standards Board 1976) [hereinafter FASB 13].
TABLE VI

<table>
<thead>
<tr>
<th>Year</th>
<th>Balance</th>
<th>Interest</th>
<th>Payments</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>30.72</td>
<td>3.07</td>
<td>5.59</td>
</tr>
<tr>
<td>2</td>
<td>28.21</td>
<td>2.82</td>
<td>5.59</td>
</tr>
<tr>
<td>3</td>
<td>25.44</td>
<td>2.54</td>
<td>5.59</td>
</tr>
<tr>
<td>4</td>
<td>22.39</td>
<td>2.24</td>
<td>5.59</td>
</tr>
<tr>
<td>5</td>
<td>19.05</td>
<td>1.91</td>
<td>20.95</td>
</tr>
</tbody>
</table>

The payments in the fourth column are as assumed. Applying the assumed 10% interest rate to the balance of the loan in the second column gives the interest in the third column. The loan balance is assumed to start at 30.72. It then is increased by interest (column three) and decreased by payments (column four).

As can be seen in Table VI, the lessor's economic income on this loan is the same as in Table V. Loan treatment gives the correct economic answer and is simpler than determining the correct economic rent under lease treatment. This is not a surprising result — economic income does not come in flavors. The income inherent in a transaction does not depend on whether the transaction is viewed as a lease (the lessee using the lessor's machine) or a loan (the lessee using the lessor's money). In both cases, the lessor earns an economic return on its net investment. The lessee's total cost equals the lessor's return plus the economic decline in value of the property; under loan treatment, this is depreciation plus interest, and, under lease treatment, this is rent — which equals depreciation plus interest. In other words, since, under the instant assumptions, the lessor and lessee are indifferent between lending and leasing, the tax system also should be. A difference in the property used to make the last payment in the contract should not make a fundamental difference in the tax treatment of that contract.\footnote{Kripke makes this basic point persuasively: Chattel security law, accounting, and tax law have been most inept in letting the tail wag the dog, i.e., letting the question of treatment of the bulk of the property rights and a major portion of a total purchase price depend on . . . [the] residual. The fact is that the residual at the end of an eight, ten, or fifteen-year lease of equipment has so little present value at the inception of the lease . . . that it can make no sense for any determinations for legal, accounting, or tax purposes to turn on [the residual]. Kripke, supra note 37, at 728.}

In light of this analysis, rather than legislate the taxation of economic rent, an equivalent reform under the instant artificial as-
sumptions would be to tax the Table IV lessor like a lender. This treatment is shown in the third column of Table V. At the end of Year 5, the lessor would own the machine with a basis equal to the residual value of 15.36 (having “depreciated” 15.36 of the 30.72 cost as principal recovery against cash on the loan proxy). Loan treatment, in effect, takes the rent structure at face value but conforms depreciation to it in order to avoid the inconsistent treatment currently provided.

A similar result applies to the lessee. If the transaction were viewed as a lending, the lessee would be treated as borrowing 30.72 and buying the machine for 30.72. The lessee would deduct the amounts in the fourth column of Table VI as interest and also would deduct depreciation (straight-line, with the Table IV machine). This is the sixth column of Table V. Again, loan treatment is identical to economic treatment.

This reform deals with the mistaxation of rent without needing a determination of economic rent, a calculation of a hidden loan, or any of the other complex features of Table IV. Taxpayers are familiar with the underlying calculations, as the reform uses the time-value and related concepts that current law applies in the loan context. This reform has an additional benefit. The distinction between leases and loans has plagued the tax law for some time, and still results in considerable litigation between taxpayers and the Service. This Article’s proposal makes the distinction

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63 Indirect lease acquisition costs, such as legal fees, incurred by the lessor would be treated as an increase in the amount loaned for purposes of the lessor’s calculations, reducing its income, but not the lessee’s deduction, over the lease term. The lessee’s costs would be treated as prepaid rent for purposes of its calculations, but not the lessor’s, increasing the lessee’s deductions over the lease term. This treats the expenditures identically regardless of whether they are paid by the lessee directly, or by the lessor and reimbursed through higher rent. Current law provides straight-line amortization to the payor with no effect on the other party to the lease. Treas. Reg. § 1.162-11(a) (lessee deduction); Treas. Reg. § 1.167(a)-3 (lessee deduction).


65 There is a large and confused body of law that distinguishes true leases from loans for federal income tax purposes, summarized in B. Bittker & L. Lokken, Federal Taxation of Income, Estates and Gifts ¶¶ 4.4.2, 4.4.3 (2d ed. 1989). Basically, the law looks at a given transaction to see whether it more closely resembles a paradigmatic lease or a paradigmatic loan. A purported lease transaction is examined to see whether it contains loan-like features, such as a particularly small residual (so that the lessor has little current interest in the property), lessee investment, lessee benefits from residual appreciation (e.g., from a lessee purchase or lease renewal option), lessee risk of loss with regard to the residual (e.g., from a
rather unimportant, which is quite attractive.

lessor put option), and the like. Id. These features have little bearing on the real tax issues: mistaxation of rent and non-economic accelerated depreciation (discussed in Part III). See supra note 52. Thus, not surprisingly, the lease/loan distinction under current law misses the point and achieves unsatisfactory and arbitrary results. See, e.g., Saul D. Kronovet, Characterization of Real Estate Leases: An Analysis and Proposal, 32 Tax Law. 757, 763 (1979); Note, "Safe Harbor" as Tax Reform: Taxpayer Election of Lease Treatment, 95 Harv. L. Rev. 1648, 1666-68 (1982).

Financial accounting has its own rules for distinguishing leases from loans. See FASB 13, supra note 51. Basically, a lease of personal property will be respected unless it contains any of the following provisions:

1. The lease transfers ownership at the end of the lease term.
2. The lessee has a bargain purchase option.
3. The lease extends over 75% or more of the leased property's estimated economic life.
4. The present value of the lease payments is 90% or more of the value of the leased property.

Id. at ¶ 7. The principal concern underlying FASB 13 is whether to show the leased asset and the liability inherent in a long-term lease on the lessee's balance sheet. Id. at ¶ 60. Loan treatment is appropriate when the risks of the property have been transferred to the lessee. Id. Thus, the FASB 13 standards are of little relevance to the instant income measurement issues. There is evidence that the FASB’s lease/loan distinction interferes with economic decisions. James Ang & Pamela P. Peterson, The Leasing Puzzle, 39 J. Fin. 1055, 1063-64 (1984). Somewhat different rules apply to real estate transactions. See FASB 13, supra, at ¶¶ 24-28; Accounting for Leases: * Sale-Leaseback Transactions Involving Real Estate * Sale-Type Leases of Real Estate * Definition of Lease Term * Indirect Costs of Direct Financing Leases, Statement of Financial Accounting Standards No. 98, ¶¶ 7-13 (Fin. Accounting Standards Board 1988) [hereinafter FASB 98]. Special financial accounting rules limit the use of sale-leasebacks to trigger realization of gain, as discussed infra note 182.

Commercial law also distinguishes between leases and loans. U.C.C. §§ 1-201(37), 2A-103(1)(j) (1987). Basically, a lease is treated as a loan if the rent obligation extends over the term of the lease and any one of the following applies:

1. The lease term extends over the economic life of the property.
2. The lessee is required to re-lease the property for the rest of its life or to buy the property.
3. The lessee has an option to renew the lease for nominal consideration.
4. The lessee has an option to buy the property for nominal consideration.

U.C.C. § 1-201(37). The lease/loan distinction is relevant for two U.C.C. purposes: First, in order for a lessor/secured lender to be fully protected, it must record a loan but not a lease. UCC §§ 2A-307, 9-301, 9-302. Second, a lessor's rights and obligations with regard to goods are different than a seller's, although lessees and buyers are treated similarly. The principal differences are in remedies, warranties, and disclaimers. See Edwin E. Huddleson, Old Wine in New Bottles: U.C.C. Article 2A — Leases, 39 Ala. L. Rev. 615, 641-68 (1988). Bankruptcy law draws upon the commercial law lease/loan distinction and provides different results in a variety of contexts depending upon whether a transaction is characterized as a lease or a loan. See Ayer, supra note 33, at 690-98. As discussed supra note 33, a lessor generally is treated as well or better than a lender. The issues in the commercial law and bankruptcy contexts are so remote from the instant concerns, however, that this law is not considered further. For wonderful critiques of the commercial law and bankruptcy lease/loan distinctions, see Ayer, supra note 33; Kripke, supra note 37, at 726-30. (Ayer traces his critique as
The proposed reform uses a simple loan calculation, but does require two facts that might not be readily available: the fair market value of the machine at the beginning of the lease and the expected residual value at lease termination. As to the value at the outset, in many cases this should not present a problem, since many leases commence shortly after the lessor acquires the leased property. Used leased property is discussed in Part II. As to the value of the residual, if economic depreciation were provided by law, the expected residual value could be determined by applying the depreciation schedule for the period of the lease to the value of the leased property at lease commencement. Problems presented by statutory non-economic accelerated depreciation are dealt with in Part III.

The proposal makes the taxation of rent dependent on the depreciation of the underlying property. A lease can cover more than one kind of property, such as one lease that covers both a depreciable building and non-depreciable land. An allocation of rent between the various kinds of leased property is required in order to apply the proposal to the various leased properties. This allocation is not required currently and therefore makes the proposal somewhat more complicated than current law in this regard. The tax law frequently requires taxpayers to break a unified business transaction into its component tax pieces, however. For example, when a taxpayer acquires a business by buying the business' assets for a lump sum, this is treated as a separate purchase of each asset in the business, so that the purchase price must be allocated over all of the assets. Thus, the allocation required under the proposal is in line with this aspect of current law. Also, the allocation under the proposal should be required infrequently and primarily in large transactions where the costs of making the allocation (e.g., appraisers) are not unduly burdensome. This would not undermine the advantages of the proposal.

Another interesting question is whether the interest component

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56 The value of the residual in property best suited for use only by the lessor might be particularly difficult to determine. Current law, in determining depreciation of tangible property, does not worry about how property is going to be used. I.R.C. § 168. Thus, the problem that this special use property presents to the instant proposal is not developed further here.

57 See Williams v. McGowan, 152 F.2d 570, 572 (2d Cir. 1945).
of the rent proxy should be treated as interest (paid, incurred, or earned) for other tax purposes, such as the rules for capitalization of construction period interest \textsuperscript{58} and the special foreign tax credit limitation applicable to interest.\textsuperscript{59} The basic analysis above suggests that it should. This would further serve to reduce the significance of the lease/loan distinction, which is desirable. The specific policies underlying each of the other special rules for interest should be examined to verify that this treatment is appropriate, however, which is beyond the scope of this Article.

This suggested reform could be limited to long-term leases, as the size of the potential hidden loan — and, therefore, the amount of potential mistaxation — is necessarily smaller with loans that extend over a shorter period of years, measured without regard to the life of the underlying property. Also, this reform need not apply to leases of undeveloped land, as the mistaxation analysis above does not apply to nondepreciating property, such as land.

4. Accelerated or Excessive Stated Rent

Thus far, the discussion has focused on the most common lease transactions: where the stated rent has the same present value as economic rent, but the stated rent is less rapid than economic rent. It also is possible to structure transactions that involve accelerated or excessive rent. These transactions are not very common; in fact, current law discourages them.\textsuperscript{60} Nevertheless, it is helpful to note that the instant proposal could easily eliminate any benefit from such transactions.

The classic example of an excessive rent transaction involves above-market rent coupled with an option for the lessee to purchase the property at the end of the lease for a below-market price,\textsuperscript{61} or to renew for below-market rent. In this case, the stated rent actually contains hidden payments for an option.\textsuperscript{62} As option

\textsuperscript{58} I.R.C. § 263A(f).
\textsuperscript{59} I.R.C. § 904(d)(1)(B).
\textsuperscript{60} Rev. Rul. 55-540, 1955-2 C.B. 39, basically outlaws excessive rent transactions by requiring that the stated rent be reasonable. Stated prepaid rent (as compared to accelerated stated rent) is discussed infra Part IV.A.1.
\textsuperscript{61} See, e.g., Rev. Rul. 55-540, § 2.02(d), 1955-2 C.B. 39, 40 (basically outlaws excessive rent transactions by requiring that the stated rent be reasonable).
\textsuperscript{62} Since, at this point, the text assumes no risk, the option payments must reflect a below-market option price. A lessee option to buy for a fixed price or re-lease at a set rent

\[\text{Vol. 11:683} \]
payments, the amounts would be deductible later; as rent, the hidden option payments are deductible currently. If all leases were treated as loans, the lessee would only be allowed to deduct economic rent, while being taxed on hidden interest, thus eliminating this abuse.

This can be seen in the context of the ongoing example. Assume that the machine is rented for 14 per year for two years, at which time the lessee can purchase the property for 7.77 (the expected residual value of 24.58, reduced by the excess rent plus interest). If the proposal were applied, the yield on the loan proxy would be in excess of 37%. This is obviously absurd. The proposal deals automatically with accelerated, but not overstated, stated rent. Thus, to deal with excessive rent transactions, the proposal could provide that if the implicit interest rate in a lease with a lessee purchase or renewal option exceeds some ceiling on yields, the option is treated as exercised. A 10% ceiling would work here as follows:

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serves to reduce risk by assuring the continuing future availability of the leased property at a known cost. An interesting question is the economic accounting for the portion of the price of an option attributable to this risk reduction. In a sense, the risk reduction relates to the future, but has a current impact on the value of the business. Thus, only the cost of reduction of risk (value fluctuations) during the current year should be deductible currently. A tax problem is presented when rent contains a hidden premium for an option that relates to future risks. This problem is part of the general hardship of accounting for risk reduction devices, such as options, that relate to risk over multiple years. Since an analysis of the general problem is beyond the scope of this Article, the problem of misaccounting for risk reduction premiums hidden in rent is not considered further. Any resulting errors are probably small.

63 If the option is not exercised, its cost is allowed as a loss at that time. If the option is exercised, its cost is treated as a cost of the underlying property, probably recovered as the property is depreciated. Rev. Rul. 78-182, 1978-1 C.B. 265. It should be noted that these rules make the treatment of options that merely reallocate risk inconsistent with the treatment of other forms of risk allocation, such as insurance. If the hidden option payments in rent are viewed as insurance payments, their current treatment is objectionable only to the extent they do more than pay for the reallocation of risk, i.e., when the option price is below the expected market price of the property on the option exercise date, as in the types of transaction under consideration in the text. Alternatively, if one views option exercise as a sure thing, the excess rent is really prepaid purchase price or prepaid rent. This does not change the basic tax analysis, however. Current rent still is overstated.

64 The loan would provide a Year 1 payment of 14 (rent) and a total Year 2 payment of 38.58 (14 rent + 24.58 residual).

66 Current law requires some minimum interest in most deferred payment transactions. I.R.C. § 1274.
### TABLE VII

<table>
<thead>
<tr>
<th></th>
<th>(1) Balance</th>
<th>(2) Interest</th>
<th>(3) Payments</th>
<th>(4) Depreciation</th>
<th>(5) Total Ded.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>30.72</td>
<td>3.07</td>
<td>14.00</td>
<td>3.07</td>
<td>6.14</td>
</tr>
<tr>
<td>2</td>
<td>19.80</td>
<td>1.98</td>
<td>21.77</td>
<td>3.07</td>
<td>5.05</td>
</tr>
</tbody>
</table>

In Year 1, this loan treatment provides the lessee the deduction in the fifth column (interest plus depreciation), which equals economic rent. The lessor is taxed on the interest in the second column. In Year 2, the lessee has paid the lessor 14, consisting of economic rent of 6.14 and a loan of 7.86. Thus, in Year 2, while the lessee deducts economic rent (5.84), it must also be taxed on interest on the 7.86 loan (0.79), leaving the net effect of 5.05 seen in the fifth column. The lessor is taxed on the interest in the second column. At the end of Year 2, the lessee will have deducted only 11.19 of its 28 of stated rent. The remaining 16.81 is a loan. The loan is treated as exchanged along with 7.77 of cash for the leased property. Thus, the property is treated as sold for 24.58 (16.81 + 7.77), which is the expected market value at the end of Year 2. The lessee gets a basis of 24.58. Again, loan treatment has the effect of taxing economic rent and any hidden lending — although, here, the loan is from the lessee to the lessor; while, above, the loan was from the lessor to the lessee.

Note how elegantly the proposal applies here. The proposal, in effect, separates the use of the property (economic depreciation) from the financing of that use (payments for the use), and taxes each in accordance with their economics, so as to eliminate the abuse potential of manipulated payment streams. Use is accounted for with assumed economic depreciation, which is the same depreciation allowed any owner of depreciable property, and, thus, is readily available. The financing is accounted for using the lessee’s actual payments and economic depreciation, so that the interest component of rent is determined with respect to the lessor’s real

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66 If an option to renew the lease, rather than an option to buy, were involved, the 16.81 would be accounted for as a reduction of the implicit loan in the lease over the renewal period.

67 While the general problem of accelerated or excessive rent does not seem particularly significant at this time, a lessee purchase or lease renewal option, perhaps at a bargain price, is common; having a simple mechanism to deal with these options can be quite useful. See Shrank & Fritch, supra note 32, at 169-71.
net investment. Abuse is eliminated merely by putting a ceiling on yields, without any need to value rent, to value option prices, or to determine the "real" lease period.\textsuperscript{68} Rules that mirror these rules could apply to leases where the lessor has a sale or renewal option.

The proposal deals only with situations where the total payments (rent plus residual, or rent plus an option price) have a present value equal to the value of the leased property.\textsuperscript{69} Rent could be increased as hidden compensation to the lessor for property or services provided to the lessee not involving the use of the leased property. Similarly, rent could be decreased as hidden compensation to the lessee for property or services provided to the lessor not involving the use of the leased property. If this is done in either case, the proposal's loan calculations will not work properly. The other transaction reflected in the lease payments must be identified and priced. Then, the lease payments can be appropriately adjusted to eliminate any effect of the other transaction. Only after this adjustment will the present value of the lease payments equal the amount of the loan proxy, and the proposal work properly. Under current law, it is necessary to identify and separately account for such rent adjustments whenever they relate to nondeductible or capitalized payments.\textsuperscript{70} Thus, the separate accounting needed for the proposal is not substantially more burdensome than the separate accounting required currently.

5. Service and Non-Net Leases

The question arises as to the treatment of a lessor under a non-net lease that requires the lessor to maintain the property, to pay property taxes and insurance, to provide services, or the like. Rules to deal with such a lease materially complicate the proposal.

First, consider a lease that requires the lessor to repair and maintain the leased property. Under this lease, the lessor pays the expenses of repair and maintenance. The tax results of a lease

\textsuperscript{69} At this point, the stated rent does not pay for services associated with the use of the property. The situation where the stated rent pays for services is discussed infra Part I.B.5.
\textsuperscript{70} As to the lessor, it does not seem likely that there are any benefits from converting some other form of lessor income into immediately taxable rent. As to the lessee, when the adjustments relate to something currently deductible, a separate accounting would have no net effect, as the increased rent deduction would be offset by losing an equal non-rent deduction.
should not depend upon whether, as above, the lessee pays such expenses and deducts them or, as is the case here, the lessor pays the expenses, deducting them, and receives offsetting amounts as "rent."71 Under the proposal, this would be achieved by, when a lease requires the lessor to repair and maintain the property, (i) backing the expected repair and maintenance expenses out of the stated rent for each year, (ii) determining the proxy rent based on this adjusted stated rent, and, then, (iii) increasing this rent proxy each year by the expected expenses for that year. This methodology gives the lessee the same deductions as if it paid the expected expenses itself, and gives the lessor the correct amounts of income to offset those deductions. Failure to account separately for repairs and maintenance generally would result in the portion of the stated rent attributable to them being taxed in an accelerated fashion, which would overtax the lessor and undertax the lessee if the repairs and maintenance are level or increasing with time — which seems likely.72 Unfortunately, the correct calculation requires an expected amount, determined at the beginning of the lease, of all such expenses for each year of the lease. An updated version of the Treasury's annual asset guideline repair allowance percentages would provide an acceptable estimate.73

The same basic analysis applies to a lease that requires the lessor to pay property taxes and insurance or to bear the risk of theft or destruction, i.e., self-insure. Both are fairly common situations;

71 See supra note 3. Only expected expenses are priced into a non-net lease, however, so that the proposal need only account for expected expenses. Of course, when the lessor's or the lessee's actual current expenses vary from those priced into the lease, this should be reflected currently.72 The lessor's overtaxation on service payments partially offsets the undertaxation of economic rent. This means that service leases are not as mistaxed as net leases, which is an additional possible explanation of why current law's mistaxation of rent has received relatively little attention.

73 These are set out in Rev. Proc. 83-35, 1983-1 C.B. 745, obsoleted by Rev. Proc. 87-56, 1987-2 C.B. 674. Of course, it is the parties' expected expenses that are priced into the rent, not a third person's estimate or the actual expenses. Since these expected expenses are not determinable as a practical matter, an objective estimate is the best that can be done.

The Treasury repair allowances key off the now-repealed asset depreciation range system and no longer apply. Rev. Proc. 87-56, § 2.03, 1987-2 C.B. 674, 675. Consequently, using the Treasury repair allowances in the proposal would require the Treasury to update them. Presumably, they still monitor repairs in their supervision of depreciation under I.R.C. § 167(i)(1), since, as discussed supra note 9, repair patterns affect depreciable lives. Thus, any required update should not be particularly burdensome. The repair allowances are a fixed percentage of the nondepreciated basis of the property. Treas. Reg. § 1.167(a)-11(d)(2)(iii).
either requires an adjustment to the proposal. Insurance might be purchased under a long-term contract, so that a good estimate is available, otherwise, any estimate here seems problematic. The best that can be done might be to use a level annual estimate equal to the first year's expenses. Since insurance and taxes probably are expected to increase, such an estimate likely results in overstated accelerated rent. Some ad hoc increase, e.g., 5% per year, could be used for purposes of the estimate. In short, accounting for property taxes and insurance is a very real problem with the instant proposal. While this problem seems small compared to the problems with current law, further study clearly is indicated.

Finally, consider a lease that requires the lessor to provide services, such as training operators of the leased property. As with repairs and maintenance, under the proposal, any compensation for services must be split out of the rent and accounted for separately. It seems reasonable to simply require taxpayers to separately account for services provided under a lease of property. As noted above, such allocations are common in the tax law. Further requiring a taxpayer who buys services and the use of property for a lump sum, as is the situation here, to break down the lump sum does not seem particularly burdensome or unreasonable.

C. Rent, Risk, and Change

The economic analysis gets more complicated once one takes risk and change into account. A detailed analysis is beyond the scope of this Article. General principles suggest, however, that the two key conclusions reached above continue to be true.

First, under any realistic assumptions about risks and expectations, the basic analysis that current law mistaxes rent is valid. Since economic depreciation is straight-line or faster, and economic interest must be greater in the early years of an asset's life because the investment is greater then, accelerated rent must be the norm. Since current tax law respects level rent, while still providing level or more accelerated depreciation, current law conse-

74 This is required with regard to services not related to the property, as discussed supra notes 71-72 and accompanying text.
75 See supra note 57 and accompanying text.
76 The discussion of insurance, theft, and destruction in the preceding section of this Article dealt somewhat with risk.
quently undertaxes lessors and overtaxes lessees.\textsuperscript{77} This creates unjustified tax planning opportunities.\textsuperscript{78} Considerable revenue is lost. Economic behavior is distorted.

Second, loan treatment of long-term leases is likely to provide considerably more accurate accounting than current law. Once one allows that the residual in a lease involves different risks than cash payments under the lease, it becomes virtually impossible to find a loan that is a perfect proxy for a lease. This is not all that troubling, however. For example, the various payments (principal and interest) in a loan might involve different risks, yet current law, in effect, ignores this in its constant interest rate approach. Thus, while further analysis is needed, it seems that loan treatment, while not perfect, should provide better accounting than current law.

\section*{II. Used Leased Property and Realization}

Two problems are presented if leased property is not new at the commencement of the lease. First, as noted above, one must determine how to apply the proposal. Second, rules are needed to deal with any unrealized gain or loss in the leased property at the time the lease commences.

\subsection*{A. Realization Basics}

Current law generally does not tax fluctuations in the value of property until the gain or loss is realized in a transaction.\textsuperscript{79} The

\textsuperscript{77} For example, Miller and Upton generalize their basic analysis (which, except for the limitations discussed supra Part I.B.2. supports the instant conclusions) for all risks. Miller & Upton, supra note 3, at 774.

\textsuperscript{78} Once one relaxes the assumption that the tax law has no effect on prices, the market might reprice assets so as to redistribute the tax benefits of leasing. This repricing and related economic activity is an unjustifiable tax-induced distortion of economic behavior. Consequently, even allowing for tax shifting, mistaxation under current law is objectionable.

\textsuperscript{79} See generally David J. Shakow, Taxation Without Realization: A Proposal for Accrual Taxation, 134 U. Pa. L. Rev. 1111 (1986) (arguing, inter alia, that accrual taxation would be more efficient, more equitable, and simpler than the current system). For the sake of simplicity, the present discussion merges recognition notions into the idea of realization.

The realization concept originally was developed in financial accounting, but became solidified by early developments under the income tax. See James D. Cox, Financial Information, Accounting, and the Law: Cases and Materials 201-67 (1980); Ted J. Fiflis, Homer Kripke & Paul M. Foster, Accounting for Business Lawyers — Teaching Materials 154-230 (3d ed. 1984).
purposes underlying this rule of convenience are not well-defined. Perhaps the most widely-held view is that this requirement serves to avoid valuing property when there is no "realization" transaction, such as a sale, that provides evidence of the value. Such valuations would be burdensome and speculative.80

Realization is not an economic notion. In fact, the realization regime causes the tax system to have untoward economic effects.81 Most obviously, a tax burden on realizations generally discourages realizations. Although realization only goes to when income is to be taxed, not realizing gain sooner generally decreases the present value of the tax deduction, and, therefore, generally discourages sellers from engaging in realization transactions. Similarly, a tax benefit from realizations generally encourages realizations; realizing loss sooner increases the present value of the deduction and thus encourages realization transactions.82

Under these circumstances, the best that can be done in designing a realization regime is to choose rules that have the least troubling impact on behavior.83 This is important, as bad realization rules could have a substantial effect. For example, if sales always triggered an immediate tax on gain84 and leases did not, highly-taxed potential sellers would be encouraged to lease rather than to sell, which would be very troubling.85 Good realization rules avoid this kind of problem by treating similar transactions similarly. Unfortunately, there is no mechanical economic measure of similarity. A potential realization transaction frequently is similar both to a transaction that is treated as a realization event and to one that is not. In this case, judgment must be exercised in deciding which treatment, realization or non-realization, will have the least troub-

80 Mundstock, supra note 5, at 1220-28.
82 Deferring realization defers the tax, which, as long as the tax in the later year is not materially higher than the tax in earlier years, reduces the tax in present value terms.
83 Of course, revenues have an impact on the decision. It generally is better, however, to choose revenue-raisers that have less impact on behavior over those that have a more significant impact. Thus, this Article looks solely to achieve neutrality, leaving the quest for revenues to provisions that have a lesser impact on behavior.
84 Current Code provisions on installment reporting prevent this from happening. See I.R.C. § 453.
85 There are various scenarios where accelerating gain or deferring loss reduces the total tax of buyer and seller. This additional complexity would not change the instant conclusions and is not discussed further.
ling effect on behavior.

**B. Leasing and Realization**

Current law provides partial deferred realization in lease transactions. When a lessor leases used property with an adjusted tax basis (basically, the historic cost less accumulated depreciation) that differs from the property's fair market value, tax depreciation is determined using the adjusted tax basis, not the fair market value. Thus, if the property has a built-in unrealized gain so that the fair market value is greater than the tax basis, tax depreciation is smaller than economic depreciation. This has the effect of taxing a portion of the unrealized gain over the lease term through the understated depreciation. Similarly, when leased property has an unrealized loss at lease commencement, the built-in loss is partially realized over time through overstated depreciation, as compared to economic depreciation. The lessee is unaffected by the lessor's accounting for unrealized gain or loss.

This can be illustrated in the context of the ongoing example. Assume that the machine in Table V, while worth 30.72 at lease commencement, only has an adjusted basis of 20.72 at such time, i.e., that the machine has a built-in, unrealized, gain of 10, but still has ten years of life remaining over which the machine will depreciate on a straight-line basis with no salvage value. Under current law, each year the lessor has net income of 3.52 (5.59 rent less 2.07 depreciation), rather than the 2.52 in Table V. The additional 1.00 of annual net income spreads the unrealized gain pro rata over the ten remaining years in the life of the property. With the five-year lease, a total gain of 5 is taxed pro rata over 5 years. Note that half of the total gain, 5, is taxed, because the depreciation schedules allow 50% depreciation over the lease. The portion of the total gain taxed is a function of these schedules with no adjustment for present values and therefore usually is less than the portion of the total value of the property represented by the leasehold. In the example, the leasehold is worth 21.18 (the present value of the economic rent), while the property is worth 30.72, so that the leasehold represents 68.9% of the total value, yet only 50% of the gain

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*I.R.C. §§ 167, 168, 1012, 1016(a)(2). At this point, the text still assumes that the tax code's depreciation schedules represent an economic rate if applied to current values. Part III, infra, looks at non-economic accelerated depreciation.*
is taxed.

The proposal can be applied to the lessor similarly to current law. All calculations would assume that the property is worth its adjusted tax basis at lease commencement. In the example, the loan proxy would be of 20.72 with payments (principal and interest) of 5.59 for the first four years and 15.95 in the fifth year (5.59 stated rent plus an expected residual of 10.36 determined by applying five years of ten-year straight-line depreciation to the 20.72). This loan provides an annual yield of 20.29%. The higher yield is required to tax a portion of the unrealized gain. Table VIII looks as follows:

<table>
<thead>
<tr>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
<th>(4)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year</td>
<td>Balance</td>
<td>Interest</td>
<td>Payments</td>
</tr>
<tr>
<td>1</td>
<td>20.72</td>
<td>4.20</td>
<td>5.59</td>
</tr>
<tr>
<td>2</td>
<td>19.34</td>
<td>3.92</td>
<td>5.59</td>
</tr>
<tr>
<td>3</td>
<td>17.67</td>
<td>3.59</td>
<td>5.59</td>
</tr>
<tr>
<td>4</td>
<td>15.67</td>
<td>3.18</td>
<td>5.59</td>
</tr>
<tr>
<td>5</td>
<td>13.26</td>
<td>2.69</td>
<td>15.95</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>17.58</td>
</tr>
</tbody>
</table>

At the end of the lease, the lessor would have a basis of 10.36. This is the expected residual used in the loan proxy, which necessarily equals the basis at lease commencement reduced by the return of capital (depreciation) applied against cash in the loan proxy.

In Table VIII, the total interest is 17.58, compared to 12.58 in Table VI. The extra 5 of interest taxes 5 of the unrealized gain, just as under current law. The 5 is taxed more rapidly here than under current law, as current law spreads the 5 pro rata (1 each year, as reduced depreciation), while Table VIII taxes the 5 more quickly (as hidden interest): 1.13, 1.10, 1.05, 0.94, and 0.78 in Years 1 through 5, respectively.

This regime is attractive. It adapts the proposal to used leased property without requiring a valuation of the property. In fact, the calculations work identically with new and used property. As to realization, this regime parallels current law, so that it would not

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87 William Andrews suggested that I consider this basic approach.

88 Obviously, the ceiling on interest rates suggested in Part I.B.4 would have to apply differently with used property.
cause much disruption. Realization is accelerated somewhat, but this is desirable because it reduces, although does not eliminate, the significance of the lease/loan distinction.

The suggested approach for dealing with unrealized gain or loss in used leased property is conceptually inconsistent with the loan proxy mechanism. The loan proxy treats a lessor as if it transferred the property to the lessee in exchange for a debt (payable partly in kind). Extending this view, any lease should result in immediate taxation of the lessor at lease commencement on all built-in gain or loss in the leased property at such time. At lease termination, the lessor would be taxed on all gain or loss in the residual accruing during the lease term. This approach is not adopted here for a number of reasons. It is a far more radical departure from current law than the loan proxy as applied to rent. It also would increase the tax cost of leasing used property in a troublesome way. The conceptual inconsistency is not particularly bothersome, since realization and rent taxation are very different kinds of issues, which present such different kinds of policy concerns. Part IV.A.3 considers a more complicated alternative to the approach just suggested, which provides for partial immediate realization to the lessor at lease commencement in all leases of used property.

As to the lessee, current law provides a deduction for the stated rent, so that the lessee is not affected by the lessor's gain or loss taxation. The Table VIII regime builds gain or loss realization into the loan proxy in a way that makes it unacceptable to use the Table VIII loan as the basis for taxing the lessee. For example, using the Table VIII calculations as the starting point for the lessee's rent proxy under the proposed reform would allow the lessee an artificially accelerated deduction because the reduced depreciation used in calculating economic rent from depreciating the tax basis rather than the value would be taken into account more slowly than the increased interest deduction in Table VIII. Specifically, the lessee's deductions would be 6.28, 6.00, 5.66, 5.25, and 4.76 in Years 1 through 5, respectively, the same 27.94 total amount as in Table V, but on an accelerated basis. Similarly, if the lessor has an unrealized loss, the lessee would have an analogous artificially deferred rent proxy deduction. These rent mistaxations are inconsistent with current law and generally unacceptable. Additionally, the lessee might not have the information required to apply the lessor's treatment.
The basic problem in applying the loan proxy to a lessee of used property is that one does not know the principal of the loan (the value of the machine) or the total last payment (the contribution to the last payment from the property's expected residual value). Current law has a rule to deal with the problem of not knowing the principal of a loan: section 1274. It can be expanded to help with the somewhat more difficult problem here.

Section 1274 reverse engineers a principal for a loan when a loan is incurred to pay for property which has an uncertain value. When the payments (i.e., interest and repayments of principal) on a loan are known, if one assumes an interest rate, regardless of whatever interest is stated, it is possible to apply present value concepts to determine the principal of the loan. When section 1274 applies to a loan, the principal amount that results in the loan providing constant rate interest at the "applicable federal rate" set by statute (the yield on U.S. Treasury obligations of similar duration) is treated as the principal for tax purposes. This amount is simply the present value, at the applicable federal rate, of all loan payments.

In the current example, in addition to not knowing the principal, the total last payment is not known. However, if one knows the ratio of the residual value to the principal, it still is possible to perform the calculations. This residual value ratio follows from the depreciation schedules. For example, if a machine is going to lose one-third of its value over the lease term, the residual value is two-thirds of the original value and the residual value ratio is two-thirds. Once one has determined the residual value ratio, a simple formula gives the leased property's value:

I.R.C. § 1274. Walter Blum suggested a section 1274 approach. This Article, like current law, ignores the term structure of interest. See generally Joseph Bankman & William A. Klein, Accurate Taxation of Long-Term Debt: Taking into Account the Term Structure of Interest, 44 Tax L. Rev. 335 (1990) (discussing the term structure of interest). Reflecting this complexity would not change the conclusions.

Id.

I.R.C. § 1274(b).

This formula is derived simply. Assume the following abbreviations:

\[
\begin{align*}
\text{PV} & = \text{Present Value} \\
\text{SR} & = \text{Stated Rent} \\
\text{RVR} & = \text{Residual Value Ratio}
\end{align*}
\]

The property is worth the present value of all rent payments plus the present value of the residual:

\[
\text{VALUE} = (\text{PV of SR}) + (\text{PV of the value of the residual}).
\]
Value = \frac{\text{Present Value of Stated Rent}}{(1 - \text{Present Value of Residual Value Ratio})}

All present values are determined using the applicable federal rate. The present value of the residual value ratio is determined on the basis of the lease term. For convenience, this formula will be referred to as the “Value Formula.” This value is then used in applying the loan proxy to the lessee.

It is easy to use the Value Formula with regard to the Table VIII transaction. The residual value ratio is 0.5 and the applicable federal rate is 10%. Therefore:

\[
\text{Value} = \frac{21.1848}{(1 - 0.3105)} = 30.72
\]

30.72 is the value of the machine. Because here the applicable federal rate provides economic interest, the formula works perfectly to reverse engineer a value for the machine. The basic proposal can therefore be applied using this value so as to allow the lessee a deduction for economic rent, exactly as in Table VI.

This way of dealing with a lessee of used property seems advisable. It requires only one calculation, although a rather non-intuitive one, in order to tax lessees of new and used property similarly. Indeed, in this example, lessees of new and used property are taxed identically. To the extent the applicable federal rate is different from economic interest, the formula does not work perfectly. The applicable federal rate will almost always be less than economic interest, so that using this formula overstates the property’s value, understates the rent in present value terms, and overtaxes the lessee. This inaccuracy does not seem particularly troubling in light of the associated simplicity and improvement over current law.

But, the value of the residual = VALUE x RVR, so that:

\[
\text{VALUE} = (\text{PV of SR}) + [\text{PV of (VALUE x RVR)}].
\]

\[
\text{PV of (VALUE x RVR)} = \text{VALUE} \times (\text{PV of RVR}), \text{ so that:}
\]

\[
\text{VALUE} = (\text{PV of SR}) + [\text{VALUE} \times (\text{PV of RVR})].
\]

Solving for VALUE gives the formula in the text.

** Overstating the machine’s value increases depreciation’s contribution to rent. Depreciation generally is slower than interest. Thus, in general, overstating the value causes the rent to be accounted for too slowly.
C. Lease Cancellations, Transfers, and Defaults

The market rent for leased property probably varies over the term of the lease as market conditions change. Nevertheless, current law and the instant proposal determine rent at the outset of the lease, as required by realization notions. The parties’ tax treatment is not affected by market changes. However, it is necessary to reflect a change in market conditions when a lease is cancelled, when the lessor or lessee transfers the benefits and burdens of the lease prior to the termination of the lease, or when the lessee defaults. A reader with little interest in these esoteric transactions can skip ahead to Part III.

1. Transfers of Properties Subject to Leases

A transfer by a lessor of its rights under a lease without also transferring the underlying property, the residual, seems unusual and is not considered here. Property subject to an outstanding lease, including the rights of the lessor under the lease, frequently is transferred, however. Current law has problems dealing with this situation, whereas the proposed reform deals with it easily.

Even if the rent in long-term leases generally were accounted for properly, current law would have problems with the purchase of property subject to a lease. If there has been any change in market rent between the commencement of the lease and the time the leased property is purchased, the rent stated in the lease does not provide economic rent at the time of purchase. When rents have gone down, the purchaser pays a premium for the now-above-market rent. Current law has trouble deciding whether this premium is a cost of the lease or a cost of the leased property. When rents have gone up, the purchaser gets a discount for taking property with a value that is reduced by a now-below-market lease. Under current law, that discount probably should be accounted for over the term of the lease, but there is no legal authority for this

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95 The treatment of the purchaser of a remainder without the rights of the lessor is discussed in Part IV. A lessee that buys out its lessor is considered in Part II.C.4.
97 See Surrey, supra note 96.
98 The purchaser/lessor would be treated as purchasing the property for fair market
The proposed reform's basic loan proxy views property subject to a lease as a loan with payments consisting of the rent in the lease and the residual. It does not matter whether the lease provides market rent. Thus, the loan proxy would apply readily to a purchaser of property subject to a lease. The new economics of the purchaser will be reflected through the new loan proxy, which is based on the new value of the property, as if not subject to the lease. Unfortunately, the Value Formula cannot be used to determine this value here, as the formula assumes market rent.100

Applying the proposed reform to property subject to a lease eliminates another issue that has presented problems for current law: purchaser depreciation of lessee improvements.101 Under the proposal, lessee improvements are relevant to the taxation of the purchaser only to the extent that they have an expected residual value.102 The purchaser gets a basis in the improvements at lease termination equal to their expected value at lease end; determined at the time of purchase.

The transferor of property subject to a lease would be taxed on the difference between its adjusted basis in the property transferred and the amount realized. Part VI considers whether any of

value, subject to the liability to provide use to the tenant for less than market rent. Over the term of the lease, the purchaser/lessor would be taxed as if it received market rent, determined at the time of purchase, each year, and used the difference between this deemed rent and the stated rent to pay off the liability, including imputed interest.


100 See supra note 93.

101 See Robinson, supra note 99, at ¶ 5.12. This issue is closely related to the issue of the treatment of holders of remainders. See discussion infra Part IV.A.2.

102 To elaborate, lessee improvements should not be depreciated twice by a purchaser/lessor: once through an explicit depreciation allowance, and a second time due to the stated rent being lower because the lessee, and not the original seller/lessor, made the improvements. The proposal avoids this problem. In other words, the purchaser/lessor really is buying a remainder in lessee improvements, and, over the term of the lease, the remainder increases in present value as the time for enjoyment comes closer. The remainder does not begin to depreciate until vested. See infra Part IV.A.2.

The question arises as to a lessor's treatment of lessee improvements. Current law, basically, taxes the lessor when tenant improvements are in lieu of rent, but not otherwise. See generally Robinson, supra note 99, at ¶¶ 5.06-5.08. At the termination of the lease, the lessor has no income, but is allowed no basis in the improvements. I.R.C. §§ 109, 1019; see also Robinson, supra note 99, at ¶ 5.09. This regime is defective, but the problems seem sufficiently small that they are ignored in this Article.
the amount taxed should be treated as capital gain or loss.

2. *Lessee Transfers and Subleases*

A lessee can be paid to transfer a lease to a new lessee, presumably because the lease reflects then below-market rent, or can pay another to take over a lease, presumably because the lease provides then above-market rent. Current law provides that amounts received for transferring a lease are taxable immediately, and there seems to be no ready alternative to this regime. Deferring the prior lessee's tax seems impractical, since, generally, the prior lessee no longer has any interest in the leased property or any continuing relationship with the lessor or the new lessee. Part VI considers whether these amounts should be treated as capital gain, and how that might affect the conclusions here. The new lessee could treat the amounts paid to the prior lessee as prepaid rent, subject to the reform. This would treat the new lessee the same regardless of whether it buys a lease or enters into a new lease. Unfortunately, this regime taxes the transaction more than a new lease with identical terms that is subject to the proposal, so that the lessor is taxed on a deferred basis, as illustrated in Table VIII, rather than immediately, as here with the prior lessee. Giving the new lessee an immediate deduction that would offset the prior lessee's tax so as to eliminate the overtaxation might be advisable, but would create tax avoidance possibilities when the new lessee is in a higher tax bracket than the prior lessee.

Amounts paid by a prior lessee to be relieved from a lease present similar problems. The prior lessee would have an immediate deduction. It would be possible to treat the payment received by the new lessee as a downward adjustment to future overstated rent under the instant proposal. This would result in the transaction being undertaxed, much in the same way the transaction in the preceding paragraph was overtaxed if the new lessee were required

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103 For simplicity, this Article treats the benefits and burdens under a lease on a net basis. One also can view a lease transfer as a sale of the benefits in exchange for an assumption of the burdens, with an appropriate adjustment for any cash changing hands, as argued by Crane v. Commissioner, 331 U.S. 1 (1947).

104 The "right" regime might be to deduct these amounts, adjusted for hidden interest, over the term of the lease to which the prior lessee was a party. This seems unreasonable for the same reasons that deferring the lessee's income when it sells a lease seemed unreasonable.
to defer its deduction. Again, it seems best to tax the payment immediately, although this creates tax avoidance opportunities. Part VI considers whether this income should be treated as capital gain, and how that might affect the conclusions here.

A sublease is similar to the transfer of a lease by a lessee. The sublessee would be taxed under the proposal just as if it entered a new lease with the owner. The lessee/sublessor would be taxed on the same gross rent, continuing to deduct rent under the original loan proxy. Any gain or loss in the lessee/sublessor's lease from the owner/lessor would be reflected through the lessee/sublessor continuing to determine its rent deduction with regard to the original lease under the old loan proxy.

Alternatively, if the sublease extends over the remaining term of the original lease so that the lessee/sublessor no longer has an interest in the leased property, the lessee/sublessor could just be taxed using two new, simpler, loan proxies — first, a borrowing of the present value, at the yield of the original lease, of the remaining rent under the original lease; second, a lending of this present value in exchange for the payments in the sublease. However, this simplified calculation would defer the lessee's realization somewhat compared to true sublessor treatment.

3. Lease Cancellations and Defaults

Lease cancellations, as transactions similar to the lease transfers just discussed, merit some discussion. A lessee can buy its lessor out of a lease or a lessor can buy its lessee out. Under current law, when a lessee buys its lessor out of a lease, the lessee has an immediate deduction and the lessor has immediate income. This is unobjectionable. Under current law, when a lessor buys its lessee out, the lessee has immediate income. The lessor has a capitalized item — capitalized either as a cost of the leased property or as a cost of a new lease, and depreciated accordingly. The lessee's capital gain treatment is discussed in Part VI. This treatment of the parties makes sense to the extent the payment merely pays the lessee for the costs of moving and the like. A somewhat different analysis applies when the payment compensates the lessee for giv-

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105 See Robinson, supra note 99, at ¶ 5.03, 5.04.
106 Id. at ¶ 5.03.
107 Id. at ¶ 5.04.
ing up a right to below-market rent. Below-market rent would have been reflected through increased lessee net income from a smaller rent deduction, and less lessor rent income, if the lease had not been cancelled. An immediate lessee tax coupled with a deferred lessor deduction overtaxes the cancellation and, thus, interferes with economic behavior. Since it seems hard to tax the lessee over time, eliminating the overtaxation by giving the lessor an immediate deduction might be appropriate. Immediate-income/immediate-deduction treatment would tax a lease that is terminated at a premium or a discount analogously to current law's treatment of the retirement of a bond at a premium or a discount.108

A closely-related transaction is a default by one of the parties to the lease. Lessor default seems unusual, since it would involve removing the lessee from possession of the leased property in violation of the lease, and is not considered further. Lessee default would have various tax consequences. With regard to rent taxation, the lessor would have a bad debt deduction and the lessee would have discharge-of-indebtedness income to the extent the accrued rent under the proposal exceeded the rent actually paid. These items would be appropriately adjusted by any termination penalties and similar lessee payments to the lessor. This treatment basically conforms the taxation of lessee default to the treatment of debtor default. As to realizing gain or loss, the lessor's hidden taxation on unrealized gain or loss would terminate, just as under current law. Its basis in the property returned upon the default would be its basis in the property at the outset reduced by any basis amounts applied against rent, also as under current law.

4. Lessee Acquisitions of the Leased Property

Part II.C.1 concluded that the law should reflect the reality of any discount or premium reflected in a purchase of property subject to a lease. When a lessee buys its lessor out, however, the purchaser is wearing three hats: purchaser, lessor, and lessee. This should not affect the lessee in its role as purchaser, however. It still should be treated as buying the property for market value. Any premium/deduction or discount/hidden income would be taken

108 Treas. Reg. § 1.163-3(c)(1) (borrower deduction upon retiring obligation at a premium); United States v. Kirby Lumber Co., 284 U.S. 1 (1931) (borrower income on retiring obligation at a discount).
into account immediately under the general rules for lease termi-
nations described in the preceding section.

III. LEASING AND NON-ECONOMIC ACCELERATED DEPRECIATION

The discussion thus far has assumed that current tax law pro-
vides economic depreciation. In fact, for most tangible assets, cur-
rent law provides non-economic accelerated depreciation. This tax preference is allowed in the hope that it will have a social ben-
efit, such as encouraging investment. Some are particularly trou-
bled by leasing of property subject to non-economic accelerated de-
preciation. This Part shows that, once one takes into account the mistaxation of rent, such leasing presents few problems that are not inherent in the preference itself. Thus, the proposal provides
the foundation for an improved non-economic accelerated depreci-
ation regime for leased property. Conversely, the proposal suggests a ready way to eliminate preference benefits in leasing transac-
tions, if that is desired. Leveraged leasing and sale-leasebacks also are discussed.

A. Leasing: Bifurcated Benefits

Current law provides a deduction for depreciation with respect
to many types of assets. When an asset is expected to lose value through use in a business due to exhaustion, wear and tear, or ob-
solence, the cost of that asset is deducted over time. The cur-
rent rules generally provide deductions in the early years of a de-
preciable tangible asset’s life that exceed those that would be allowed if depreciation tracked the asset’s expected decline in mar-
ket value. In other words, current law’s deductions generally are accelerated compared to economic depreciation. Current law only provides a fast, not an excessive, write-off over the life of an asset. The total deduction is the cost of the asset under both economic

109 The discussion in this Article, as is customary in the literature, assumes that actual economic depreciation is the economic depreciation expected when the property is acquired. This assumption is consistent with the notion that depreciation is only appropriate for ex-
pected value changes, since the effects of market changes on values generally are not re-
flected until a realization event. See supra Part II.A.

110 I.R.C. §§ 167, 168. See also Mundstock, supra note 5, at 1193.

accounting and current law. Non-economic accelerated depreciation, nevertheless, generally provides a net reduction in the present value of taxes, as earlier deductions generally are more valuable in present value terms.

Unlike the mistaxation of rent, current law's non-economic accelerated depreciation is intentional. While taxes generally should not interfere with economic decisions, the Congress has determined that non-economic accelerated depreciation is appropriate to encourage investment, capital formation, savings, U.S. international economic competitiveness, and the like.

Some analyses of the taxation of leasing attribute the benefits from being an owner of leased property to the benefits from accelerated depreciation. After all, if the tax system has had no effect on prices and an owner of leased depreciable property gets extra tax benefits from depreciation, such ownership is taxed more favorably than alternate investments, such as stocks and bonds.

The analysis above, however, shows that the current law's rules for the taxation of rent alone provide a significant tax benefit to being a lessor. These benefits are in addition to the benefits from non-economic accelerated depreciation. The basic analysis is fairly obvious. Assume perfect markets on which taxes have had no net effect, lessors are allowed non-economic accelerated depreciation, and the current rules for the taxation of rent apply. Under these

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112 The text oversimplifies matters a bit. Economic depreciation reflects salvage value, while current law does not. Id. This means that, under economic accounting, the income on disposition of the asset will be lower by the amount of the nondepreciated salvage value. I.R.C. §§ 1001, 1012, 1016(a)(2). Thus, taking taxation on disposition into account, the total capital recovery is the same under current law and economic accounting.

113 This ignores small errors (unintentional benefits and burdens) when the current law's objective approach to depreciation does not reflect the subjective use and maintenance of a given asset, as discussed supra note 9 and infra note 135.

114 This might not be the case, for example, if the taxpayer is in a higher tax bracket in the later years.


116 E.g., Macan & Umbrecht, supra note 42, at 313-14; Shrank & Fritch, supra note 32, at 103-104. The leading article, Miller & Upton, supra note 3, concludes that limits on utilization of depreciation tax benefits and the now-repealed investment tax credit are the only explanation of why users prefer leasing, as lower user tax rates would cause the user to buy with equity and not lease. Miller & Upton, supra note 3, at 785. As discussed supra notes 42-48 and accompanying text, this analysis assumes that the relevant decision is whether to lease or buy with some equity, when the real decision is whether to lease or buy with debt.
circumstances, the lessor receives two benefits compared to economic treatment: deferred taxation of rent and accelerated depreciation. The lessee is unaffected by the accelerated depreciation, and, thus, is still overtaxed through a non-economic deferred rent deduction.

This can be seen in an example. Consider how Table V would look if the subject machine, which has an economic straight-line depreciation over ten years with no salvage value, was subject to the 150% declining balance switching to straight line when more favorable over a ten year depreciable life with no salvage value or averaging convention tax depreciation method.\(^\text{117}\)

\[
\begin{array}{cccc}
\text{Year} & \text{L'or Econ. Inc.} & \text{L'or Tax Inc.} & \text{L'ee Econ. Deduct.} & \text{L'ee Tax Deduct.} \\
1 & 3.07 & 0.98 & 6.14 & 5.59 \\
2 & 2.82 & 1.67 & 5.89 & 5.59 \\
3 & 2.54 & 2.26 & 5.62 & 5.59 \\
4 & 2.28 & 2.76 & 5.31 & 5.59 \\
5 & 1.90 & 2.93 & 4.98 & 5.59
\end{array}
\]

The total tax effect to the respective taxpayer (the differences between the second and third columns and between the fourth and fifth columns) can be exactly bifurcated into the effect from mistaxation of rent and mistaxation of depreciation, as follows:

\[
\begin{array}{cccc}
\text{Year} & \text{L'or Dep. Tax Ben. Effect} & \text{L'or Rent Ben. Tax Rent Dep. Effect} & \text{L'ee L'ee} & \text{L'ee L'ee} \\
1 & 0.55 & 1.54 & 0.55 & 0.55 & 0 \\
2 & 0.30 & 0.85 & 0.30 & 0.30 & 0 \\
3 & 0.02 & 0.26 & 0.02 & 0.02 & 0 \\
4 & -0.28 & -0.24 & -0.28 & -0.28 & 0 \\
5 & -0.62 & -0.40 & -0.62 & -0.62 & 0
\end{array}
\]

\(^{117}\) The depreciation would be 4.61, 3.92, 3.33, 2.83, and 2.67 in Years 1 through 5, respectively.
Column three is the difference between the preferential depreciation and economic depreciation. The total effect of the mistaxation of rent shown in the second and fifth columns is derived from Table V (by subtracting the second column of Table V from the first and the fifth from the fourth, respectively). Columns one and four show that the sum of these two effects (rent mistaxation and non-economic depreciation) to the respective taxpayers equals the total effect to the taxpayers shown in Table IX. The only difference between the taxation of Tables V and IX is the extra benefit to the lessor from accelerated depreciation.

B. Lessor or Lessee Benefits?

Under the analysis in the preceding section, the only issue presented with respect to non-economic accelerated depreciation in lease transactions is whether the preference should be provided to lessors (which is the current law result), to lessees, or to neither. Unfortunately, given the ill-defined purposes of the current non-economic accelerated depreciation, this question is unanswerable. If one assumes the most reasonable purpose, to encourage investment, lessee or lessor benefits might be appropriate.

In order to analyze the economics of non-economic accelerated tax depreciation in lease transactions, it is necessary to know the purposes of the preference. There are nearly as many purposes articulated for non-economic accelerated depreciation as there are taxpayers that benefit from the preference. It is possible to formulate a purpose for accelerated depreciation that requires lessor benefits. For example, lessor benefits would make sense if one wanted to reward the legal owners of machinery, and one believed that lessors are not forced to pass through most of the tax benefits through reduced rent. Conversely, there are purposes that are not consistent with lessor benefits. For example, benefits for non-corporate lessors make little sense if the purpose of the preference is to reduce the corporate tax burden on the return on capital used by corporations, since, due to the rent deduction, the return on the capital invested in property leased by corporations from non-corporate lessors is not subject to the corporate tax. When the Con-

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gress last visited the accelerated depreciation issue, in its consider-
ations that lead to the Tax Reform Act of 1986, it seemed to
view the preference primarily as an investment incentive. This
probably is the best view of the preference. Consequently, the
instant discussion focuses on non-economic depreciation as an in-
vestment incentive.

In order to evaluate accelerated depreciation benefits in leasing
transactions from an investment incentive perspective, it is neces-
sary to decide who makes the investment decision with regard to
leased property. In the case of a very long-term lease, it seems
clear that the lessee makes the investment decision. The lessee de-
cides whether to use the machine in business; leasing is merely a
financing choice. As leases get shorter, the issue seems more dif-
cult. Consider a short-term lessor of dictating equipment. The
lessor can be viewed as engaging in a leasing business and investing
in dictating equipment. Each lessee, however, is ultimately using
the equipment. The lessee could just buy the equipment and resell
the equipment when it no longer has a use for it. Thus, again, the
better view is that the lessee makes the investment decision.

Under these circumstances, lessees should get the benefit of the

120 "Investment" is used in this context to mean the acquisition of a real asset. This usage
is customary in the economics literature. See, e.g., David F. Bradford, Issues in the Design
of Savings and Investment Incentives, in Depreciation, Inflation, and the Taxation of In-
come From Capital 13, 16 (Charles R. Hulten ed. 1981).
121 S. Rep. No. 313, 99th Cong., 2d Sess. 96 (1986). The Senate Finance Committee Re-
port is cited because the final act closely resembled the Finance Committee's bill. H.R. Rep.
Interestingly, in 1981 Congress enacted special "safe-harbor" leasing (now-repealed) dis-
cussed infra notes 129-131 and accompanying text, to facilitate lessee benefits from non-
economic accelerated depreciation and the investment tax credit. S. Rep. No. 144, 97th
now-repealed investment tax credit was not allowed to most long-term non-corporate les-
sees, but this was an anti-tax shelter rule, not a rule intended to assure that lessors not
making investment decisions not receive tax benefits. I.R.C. § 46(e)(3)(B); S. Rep. No. 437,
92d Cong., 2d Sess. 43 (1971).
123 See Miller & Upton, supra note 3.
124 Leasing to consumers presents special problems. For example, one has to take into
account that an equity-financed acquisition of consumer goods avoids tax. See, e.g., Miller &
Upton, supra note 3, at 783-84. Consideration of these issues is beyond the scope of this
Article, however. See supra note 4.
125 See Miller & Upton, supra note 3.
Taxation of Business Rent

preference. Denying the preference in leasing transactions would undermine the efficiency of the preference by discriminating against investment in leased assets. Denying preference benefits also is not acceptable as a rough justice way of dealing with the mistaxation of rent because, as illustrated in Table X, there is likely to be little relationship between the amount of benefits from rent mistaxation and the amount of benefits from accelerated depreciation.

This does not mean that the preference must appear on lessee returns. Lessees enjoy benefits on lessors' returns when these benefits are passed through to lessees through reduced rent. This might even be a more desirable way to provide preference benefits to some lessees. Some lessees might have tax losses or otherwise might not be in a position to enjoy benefits on their returns. Passed-through lessor benefits assure that such lessees are not discriminated against by being denied preference benefits.

This suggests that it might be appropriate to have the preference generally appear on lessor returns if one believes that the benefits are passed through. Before considering the incidence of lessor benefits, however, it is helpful to consider who generally benefits from non-economic accelerated depreciation. The preference makes sense as an investment incentive only if one believes that owner/users of depreciable property generally enjoy the benefits.

Even in a world where owner/users generally enjoy most of the benefits of non-economic accelerated depreciation, it seems likely that lessors pass a large portion of their benefits through to lessees. Under the owner/users-keep-the-benefits assumption, depreciable

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126 Perfect pass-through would take into account not only the tax effects of non-economic accelerated depreciation, but also the tax effects of the resulting change in the stated rent. This could happen only if all lessors and lessees are in the same marginal tax bracket and the only effect of the preference was on pre-tax rent. In this case, the rent would be reduced each year by the tax savings, or, similarly, increased each year by the tax increase, from accelerated depreciation for the year, grossed-up by the tax rate to reflect that the lessor is saving tax on the reduced rent and that the lessee is losing deductions because of the reduced rent.


128 This is not necessarily the case — for example, the tax preference might make owners of depreciable property willing to pay more for the property, pushing up the price so that sellers and manufacturers capture some of the benefits — but since the preference is a viable investment incentive only if most of the benefits generally are enjoyed by owners, this is assumed.
property provides an above-market after-tax return. Potential lessors as a class do not have unlimited access to investments providing this return. Thus, as potential lessors compete for this most desirable investment, potential lessees will be able to demand lower rents. These lower rents will result in lessees capturing more of the tax benefits.

In 1981, the Congress enacted "safe-harbor" leasing (but repealed it the following year): 129 Leases with absurd rent streams were treated as leases and not as loans, permitting the wholesale creation of tax benefits in low tax bracket lessee transactions that were not available to mere owner/users of property. 130 There is evidence that lessors captured a large portion — in the neighborhood of 20% — of the total tax benefits, i.e., non-economic rent and non-economic accelerated depreciation. 131 This does not prove that lessors capture a large portion of the accelerated depreciation benefits, however. Accelerated depreciation benefits, although perhaps less valuable benefits, would be available to the lessee if the lessee purchased the property outright. In contrast, the benefits of rent mistaxation exist only if a lessor is involved. Thus, it is possible that lessors and lessees share the benefits from non-economic accelerated depreciation differently from the way they share rent mistaxation benefits.

In short, while accelerated depreciation benefits should be allowed in leasing transactions, it is not clear whether they should be allowed on lessee or lessor returns, as both treatments present problems. Providing benefits on lessee returns would cause some lessees to get inadequate benefits, would effect a change from current law, and might end up indirectly benefitting lessors anyway. Providing benefits on lessor returns seems to make it more likely that lessors inappropriately capture benefits. The next section shows how the proposal can reach either result.

This analysis does not defend non-economic accelerated depreciation for leased assets. I oppose the preference for reasons beyond the scope of this Article. The point is that lessor benefits make

130 Warren & Auerbach, supra note 29, at 1764-69.
nearly as much sense as benefits to an owner/user. If one is bother-
ered by lessor benefits, one should be bothered by benefits to any
taxpayer.

Some lessees are perceived as inappropriate objects of an invest-
ment incentive. For example, investment by governments might need no incentive. Some believe that tax-exempt organizations should receive no tax benefit in addition to their exemption, such as an indirect accelerated depreciation benefit from leasing. On the other hand, a reduction in the tax benefits available in leasing transactions in which the lessee is a government or a tax-exempt organization could have the effect that these entities face a higher relative risk-adjusted cost of capital with regard to leasing than with regard to alternate means of securing the use of capital, which might be troubling. Any judgment here requires an analysis of the investment decisions of these entities that is beyond the scope of this Article. The proposal will apply in the same way regardless of the identity of the lessee.

C. Application of the Proposal

The question arises whether the proposal makes any sense in a world with tax non-economic accelerated depreciation. After all, if depreciation is mistaxed, why care about rent mistaxation? The answer is suggested in Table X. Without reform of the taxation of rent, lease transactions have more benefits than other financings of depreciable property. This undermines the efficiency of the preference. Only with rent taxation rules working properly will the preference work properly.

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133 See Galper & Toder, supra note 47, at 258-60.
134 Boris Bittker called this concern to my attention.
135 A given property's depreciation depends on how it is used and maintained by the tax-
payer. See supra note 9. Current law ignores this subjective aspect of depreciation as to most tangible property and provides objective depreciation that is independent from the use and maintenance of the property. I.R.C. § 168. This means, for example, that taxpayers that use property more than the typical owner of the same type of property get inadequate de-
preciation. The proposal also works objectively, which accomplishes the same simplicity de-
sired for current law. Moreover, any unintended benefits or burdens from the current objec-
tive approach would be reduced in leasing transactions, as the proposal would match excess statutory depreciation with extra rent, and inadequate depreciation with inadequate rent. Eliminating these benefits and burdens is attractive. It would leave some vitality in the
With a few modifications, the proposal adapts to a non-economic accelerated depreciation regime. Moreover, the proposed reform facilitates improvements in the application of non-economic accelerated depreciation in leasing transactions, regardless of one’s views of the desirability of, and purposes for, the tax preference.

The most obvious way to deal with accelerated depreciation is to adopt the basic approach used to deal with unrealized gain or loss in Table VIII: take the tax accounts for the leased property at face value. There, the tax basis was used even though it was not the value of the leased property, while, here, the tax accounts can be used even though, as to the residual, they do not reflect economic depreciation. This can be illustrated with the ongoing example. Consider how the proposal would apply to the transaction in Table IX. The loan proxy would be for 30.72 and provide payments of 5.59 for the first four years and of 18.95 for the fifth (5.59 cash plus 13.36 residual determined using the accelerated depreciation). This loan provides interest of 8.69%, the lower interest reflecting the benefits of the accelerated depreciation. Then, the loan proxy looks as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Balance</th>
<th>Interest</th>
<th>Payments</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>30.72</td>
<td>2.67</td>
<td>5.59</td>
</tr>
<tr>
<td>2</td>
<td>27.80</td>
<td>2.42</td>
<td>5.59</td>
</tr>
<tr>
<td>3</td>
<td>24.63</td>
<td>2.14</td>
<td>5.59</td>
</tr>
<tr>
<td>4</td>
<td>21.18</td>
<td>1.84</td>
<td>5.59</td>
</tr>
<tr>
<td>5</td>
<td>17.44</td>
<td>1.51</td>
<td>18.95</td>
</tr>
</tbody>
</table>

The lessor would have a basis of 13.36 in the residual at lease termination.

Unfortunately, the income figures in the third column of Table XI are troubling. Comparing these numbers to the economic income (the second column in Table IX) shows that the Table XI regime provides roughly 0.40 of extra depreciation a year. This both eliminates rent mistaxation and provides the extra 2.00 of deductions over five years that are built into the statutory depreciation schedule. The level nature of the benefit in table XI is a coin-lease/loan distinction, however, as the benefits and burdens would still arise outside the leasing context.
This 2.00 extra benefit is provided much more slowly in Table XI than in the depreciation schedule (the third column of Table X), however. Table XI treats the 2.00 as a reduction in interest that reduces income much less in Years 1 through 3 than under the depreciation schedule. In fact, the deferral of the depreciation in Table XI is so great that Table XI provides less generous treatment than the second column of Table V, which merely reflects current law’s mistaxation of rent. If non-economic accelerated depreciation is to be allowed, there seems to be little reason to have it so cut back in some leasing transactions. Also, in other leasing transactions, the opposite happens — treating the accelerated depreciation as interest has the effect of speeding up the extra depreciation. In short, while treating unrealized gain or loss as an adjustment to interest was acceptable in Part II because realization is such an inaccurate art and because current law’s treatment as reduced depreciation is so arbitrary, treating non-economic accelerated depreciation as interest here changes the benefit in lease transactions arbitrarily and seems unacceptable.

In light of this analysis, if the tax code generally provides non-economic accelerated depreciation, special economic depreciation schedules would be required in order to determine the expected residual value used in applying the proposal. This should not be too burdensome. Current law’s accelerated schedules are derived from economic schedules, so that assets of various economic lives receive roughly the same amount of preference. The proposal merely would require that these economic depreciation schedules be made public. Alternatively, the slower depreciation allowed for minimum tax or earnings and profits purposes could be used as a proxy for economic depreciation.

The reform then can be adapted to any approach to non-economic accelerated depreciation. For example, if one is opposed to accelerated depreciation in leasing transactions, the proposal makes it easy to eliminate any benefits, since, with no further ad-

\[136\] An example is set out in Mundstock, supra note 1, at 357.

\[137\] Also, as with Table VIII, the Table XI regime could not apply to the lessee, creating further problems.

\[138\] A rather unsatisfactory way to avoid economic depreciation schedules is discussed in Mundstock, supra note 1, at 358.


\[140\] I.R.C. §§ 56(a)(1), 168(g), 312(k).
adjustments, it would automatically eliminate lessor benefits. Lessee benefits would be eliminated by requiring lessees to use the same economic depreciation schedules that are used in determining the residual for purposes of the economic loan proxy.

It is easy to give the benefits of non-economic accelerated depreciation directly to lessees. Lessors would simply determine their economic income under the economic loan proxy. Lessees would calculate interest under the economic loan proxy, but use the non-economic accelerated depreciation as their depreciation. This would be a considerable improvement over current law. Extra benefits from rent mistaxation in leasing transactions would be eliminated. Lessees would be allowed to claim benefits on their returns. Thus, lessees who can benefit from the preferential deductions no longer would need to rely on negotiating reduced rent to receive an investment incentive. The lease/loan distinction would have little significance.

This lessees benefit regime can be illustrated with the ongoing example. The lessor would be taxed as in Table VI. The lessee's tax would be as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Proxy Loan Interest</th>
<th>Accelerated Depreciation</th>
<th>Total Deduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>3.07</td>
<td>4.61</td>
<td>7.68</td>
</tr>
<tr>
<td>2</td>
<td>2.82</td>
<td>3.92</td>
<td>6.74</td>
</tr>
<tr>
<td>3</td>
<td>2.54</td>
<td>3.33</td>
<td>5.87</td>
</tr>
<tr>
<td>4</td>
<td>2.24</td>
<td>2.83</td>
<td>5.07</td>
</tr>
<tr>
<td>5</td>
<td>1.91</td>
<td>2.67</td>
<td>4.58</td>
</tr>
</tbody>
</table>

At the end of the lease, the lessee has only expended 27.94, but has deducted 29.94. It would recapture as taxable income the 2.00 of excess depreciation at that time.

In Table XII, the total deduction exceeds the economic deduction in Table V by 1.54, 0.85, 0.25, -0.25, and -0.40 in Years 1 through 5, respectively. The total extra 2.00 of depreciation is given to the lessee in exactly the same fashion that it is given to an

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141 Issues presented when there are multiple lessees are beyond the scope of this Article.
owner of property (as shown in the third column of Table X).

Matters are only somewhat more difficult if it is desired to give preference benefits to lessors in the first instance. The proposal would be modified to provide one additional adjustment to a lessor's income — it would be adjusted by the difference between the preferential depreciation and economic depreciation. This adjustment would be easy to calculate from the non-economic accelerated depreciation schedules and the economic schedules provided to implement the reform, as shown in the third column of Table X.\(^\text{142}\)

If this regime is applied to the Table XII lessor, matters are as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>(1) Proxy Loan Interest</th>
<th>(2) Excess Depreciation</th>
<th>(3) Net Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>3.07</td>
<td>1.54</td>
<td>1.53</td>
</tr>
<tr>
<td>2</td>
<td>2.82</td>
<td>0.85</td>
<td>1.97</td>
</tr>
<tr>
<td>3</td>
<td>2.54</td>
<td>0.25</td>
<td>2.29</td>
</tr>
<tr>
<td>4</td>
<td>2.24</td>
<td>-0.25</td>
<td>2.49</td>
</tr>
<tr>
<td>5</td>
<td>1.91</td>
<td>-0.40</td>
<td>2.31</td>
</tr>
</tbody>
</table>

At the end of the lease, the lessor's basis would be 13.36 (reflecting the 2.00 of extra depreciation). The lessee would be taxed as in Table V.

In Table XIII, the total net income is the same as under current law (the third column of Table IX). Here, however, the lessor only gets the deferral of income resulting from accelerated depreciation, while current law gives that deferral as well as the deferral from the mistaxation of rent (as shown in Table X).

\section*{D. Used Property and Realization}

The presence of non-economic accelerated depreciation does not
materially change the basic analysis of realization.\footnote{See Alan J. Auerbach, Inflation and the Tax Treatment of Firm Behavior, 71 Am. Econ. Rev. — Papers and Proceedings 419, 420 (1981); Gerard Brannon & Emil Sunley, Jr., The “Recapture” of Excess Tax Depreciation on the Sale of Real Estate, 29 Nat’l Tax J. 413 (1976); Roger H. Gordon, James R. Hines, Jr., & Lawrence H. Summers, Notes on the Tax Treatment of Structures, in The Effects of Taxation on Capital Accumulation 223, 228-37 (Martin Feldstein ed. 1987).} Under any reasonable purpose for the preference, the amount of tax benefits should not be affected by whether or when the ownership of the property changes hands.\footnote{See supra Part III.B.} Unfortunately, it is difficult to achieve this. Current law does not even come close.\footnote{See Mundstock, supra note 5, at 1210-14.} For example, under current law, the sale of a relatively new piece of property that has been subject to non-economic accelerated depreciation will trigger a tax to the seller that reduces the benefits of the preference. The buyer will get more tax benefits than the seller would have, which probably is reflected in a somewhat higher price that compensates the seller somewhat for its tax. However, the current tax on the seller usually will be greater in present value than the buyer’s benefits. Realization reduces the tax preference. Consequently, current law’s realization regime prevents the proper functioning of the accelerated depreciation preference in rather arbitrary ways. Under these circumstances, it seems best to just design realization rules here that interfere with economic decisions as little as possible, and not pay too much attention to the tax preference. The approaches in Parts II and III should be used simultaneously with used property subject to accelerated depreciation: As to the lessor, the adjusted tax basis at lease commencement is used to determine loan proxy. Excess depreciation also can be allowed the lessor if that is desired. As to the lessee, the interest component of the loan proxy is based on the value determined using the Value Formula and on economic depreciation. The lessee then claims economic or accelerated depreciation, depending upon whether the lessee is to get preference benefits.

\subsection*{E. Leverage and Sale-Leasebacks}

Long-term lease transactions frequently have one or both of two additional features: (1) the lessor debt-financing much of its in-
investing (a leveraged lease)\textsuperscript{146} and (2) the lessor acquiring the
leased property from the lessee (a sale-leaseback). The presence of
these additional features does not materially change the analysis
above.

1. Leverage

Leverage presents two issues: First, since in a leveraged lease the
lessor resembles a conduit between the lender and the lessee,
should this resemblance change the lessor's tax treatment? Second,
does leverage present particular problems with respect to non-econo-
mic accelerated depreciation of leased property? The answer to
both questions is "no."

Consider the most extreme example of leveraged leasing: a lessor
finances its entire investment in the leased property on a non-re-
course basis, with the lease extending the entire economic life of
the property and with the rent exactly servicing the debt. All the
lessor does is collect rent and promptly turn it over to the lender
as debt service. This lessor looks very much like a conduit between
its lender and the lessee.

This transaction is no more troubling from a rent mistaxation
perspective than any other long-term lease. Assume that the rate
of the implicit interest in the lease mirrors the rate of interest on
the loan, that the tax law provides economic depreciation, and that
the tax law has had no effect on prices. As noted above, a good
proxy for economic accounting would treat the lessor as a lender,
so that, under economic accounting, the lessor would be treated, in
effect, as borrowing and relending the same amount. The interest
in the two loans would be equal, and would offset. Consequently,
there would be no net effect on the lessor's taxes. In other words,
the transaction provides the lessor no economic profit or loss, so
that each year the lessor has no income or loss under economic
accounting. Consequently, if the lessor gets material benefits under
current law, they must be attributable either to current law's mis-
taxation of rent or to non-economic accelerated depreciation, or
both. Lessor benefits in a leveraged lease are the same benefits
available to any lessor. It merely is easier to see the current defects

\textsuperscript{146} See Shrank & Fritch, supra note 32, at 106-109.
with regard to a leveraged lease.  

A number of commentators believe that non-economic accelerated depreciation with regard to leveraged assets is particularly troubling. As discussed above, assuming that non-economic accelerated depreciation is an investment incentive, one is troubled by the preference appearing on lessor tax returns to the extent one believes that the benefits do not flow through to lessees through reduced rent. It is hard to see how the presence of a lender makes it less likely that the lessor passes the tax benefits through. The concern for leveraged leasing seems misdirected.

One important qualification to this analysis must be noted. Leveraged non-economic accelerated depreciation property is most troubling when the lessor’s investment is a package that the lessor would not put together itself, so that the packaging causes the lessor to take special risks. It might be easier to package a leveraged lease than an equity-financed lease, since a smaller lessor investment is required. If so, special restrictions on at least some leveraged leasing might be appropriate. This in no way reduces the need to reform the taxation of rent, however.

2. Sale-Leasebacks

When the lessor acquires the leased property from the lessee, the resemblance between a long-term lessor and a long-term lender is particularly obvious. The instant analysis of rent taxation concludes that long-term lessors generally should be taxed like lenders. Sale-leasebacks do not present a special case.

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147 Thus, any limits on leveraged leasing are inappropriate, as they would provide an implicit tax penalty on transactions that are indistinguishable from nonpenalized transactions, which would undesirably distort economic behavior.

148 For a summary of this controversy and the most thoughtful analysis, see Alan J. Auerbach, Should Interest Deductions Be Limited?, in Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax 195 (Henry J. Aaron, Harvey Galper & Joseph A. Pechman eds. 1988).

149 Auerbach, supra note 148, at 210-14.

150 The rise of the leveraged tax shelter certainly suggests this.

151 There is one very real tax problem presented by sale-leasebacks, particularly a lessee/seller-financed leveraged sale-leaseback. The lessee/seller/lender and lessor/buyer/borrower play many roles. If the lessee and lessor are in different tax postures, they might be able to reduce their total taxes even more than is normally possible with a long-term lease by blurring the lines between the roles. For example, if the lessor can benefit from deductions more than the lessee can, they have an incentive to overstate the purchase price so as to increase lessor depreciation deductions. The increased price would increase the lessee’s income, but
concerns with regard to sale-leasebacks are discussed in Part IV.B below.

IV. TERMS FOR YEARS AND REMAINDERS

The sale of a term for years closely resembles a long-term lease. An example: REMAINDER owns a machine, and Possessory Interest Holder ("PIH") buys a term for years in the machine from REMAINDER. PIH resembles a lessee, while REMAINDER resembles a lessor. Nevertheless, current law taxes this transaction quite differently from the parallel lease transaction. Compared to economic treatment, REMAINDER is overtaxed, while PIH is undertaxed, but not as much as REMAINDER is overtaxed. In the parallel lease transaction, the lessor is undertaxed, while the lessee is overtaxed by the exact amount that the lessor is undertaxed. Both the mistaxation of sales of terms for years, as compared to economic treatment, and the different treatment of these transactions and the similar lease transactions are troubling. The reform suggested above for long-term leases facilitates reform here.\(^\text{153}\)

A. Sales of Terms for Years

1. Taxation of the Possessory Interest Holder

Current law inadvertently provides tax benefits to PIH, as compared to a regime that exactly taxes economic income. In order to see this, it is necessary to consider the economics of PIH's term for years. To simplify exposition, this section assumes that there is no

\(^{153}\) This transaction usually is seen in real estate transactions, but, for consistency, is discussed here in the context of a machine.

\(^{153}\) The discussion here does not consider other types of interests in property that are similar to those discussed, such as life estates, production payments, and interests created through trusts and estates. See Kenneth F. Joyce & Louis A. Del Cotto, The AB (ABC) and BA Transactions: An Economic and Tax Analysis of Reserved and Carved Out Income Interests, 31 Tax L. Rev. 121 (1976); Jeffrey L. Kwall, The Income Tax Consequences of Sales of Present Interests and Future Interests: Distinguishing Time from Space, 49 Ohio St. L.J. 1 (1988). It can be noted, however, that the instant methodology should apply. If economic accounting were applied, regardless of whether these arrangements are viewed as loans or as property interests, the tax results should be the same.
unrealized gain or loss in the property at the time the term for years is sold or terminates. Realization issues are considered later in this Part.

The cost of a term for years should equal the present value of economic rent over the term.\textsuperscript{154} In a given year, the economic depreciation of the term is the decline in the value of the term equal to the difference between the present value of the remaining economic rent at the beginning of the year and this present value at the end of the year. This net loss of value can be viewed as resulting from two partially offsetting effects. First, each year, the term for years loses value because the value of the rent for the current year has been enjoyed, so that there are fewer years left to the term. Second, this gross loss in value is offset in part by an increase in value, because the present value of the remaining years increases as a result of becoming closer in time. Under this view, economic depreciation of the term for years for a given year equals the economic rent for that year reduced by the increase in the present value of future years' rent; that increase, in effect, is economic interest on the investment in the future years' rent.\textsuperscript{155}

This makes sense. PIH's deduction should be smaller than that of a lessee for economic rent. PIH has an investment in the term for years that earns implicit interest which reduces the net cost. To look at the transaction the other way, PIH's deduction should be greater than an owner's economic depreciation. PIH's property loses all of its value over the term, while an owner benefits from an increasing residual value.

The facts of Table I can be used to illustrate these economics. Assume that PIH buys a five-year term in a new machine for 21.18 (the present value at 10% of five years' economic rent). Matters are as follows:

\textsuperscript{154} This assumes, of course, no tax effect on prices. The discussion of the term for years transaction owes much to comments from Daniel Halperin.

\textsuperscript{155} See George Mundstock, Eleventh Circuit Affirms Accelerated Depreciation of Land?, 47 Tax Notes 737, 737-39 (May 7, 1990). The text oversimplifies matters somewhat to facilitate exposition in that the current year's rent also increases in value during the year. For example, the last month's rent increases in value during the first eleven months.
TABLE XIV

<table>
<thead>
<tr>
<th>Year</th>
<th>Value of TfY</th>
<th>EcDep. of TfY</th>
<th>Econ. Rent</th>
<th>Int. on TfY</th>
<th>Rnt-Int</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>21.18</td>
<td>4.03</td>
<td>6.14</td>
<td>2.12</td>
<td>4.03</td>
</tr>
<tr>
<td>2</td>
<td>17.16</td>
<td>4.12</td>
<td>5.84</td>
<td>1.72</td>
<td>4.12</td>
</tr>
<tr>
<td>3</td>
<td>13.04</td>
<td>4.23</td>
<td>5.53</td>
<td>1.30</td>
<td>4.23</td>
</tr>
<tr>
<td>4</td>
<td>8.81</td>
<td>4.34</td>
<td>5.22</td>
<td>0.88</td>
<td>4.34</td>
</tr>
<tr>
<td>5</td>
<td>4.47</td>
<td>4.47</td>
<td>4.92</td>
<td>0.45</td>
<td>4.47</td>
</tr>
</tbody>
</table>

Table I supplies the economic rent in the fourth column. The present value of the total amount of rent for the remainder of the term for years at the beginning of each year is shown in the second column. This value drops each year, as shown in the third column. Each year’s interest (the fifth column) is simply 10% (the assumed interest rate) of the value of the term at the beginning of the year (the second column). Note that the sixth column (economic rent from the third column less the interest in the fourth column) equals the third column (decline in value of the term), as just suggested.

Table XIV shows that the economic depreciation of a term for years is slower than the depreciation of the underlying property, so that when the underlying property has level economic depreciation — and frequently even when the underlying property has accelerated economic depreciation — the economic depreciation of a term for years is slower than straight-line. This might be the most surprising result in this Article.

Compare Table XIV with Table I. As Table I shows, the economic depreciation of the underlying property allows for the loss of the value of the current year’s rent, but also implicitly taxes the increase in the value of future years’ rent by reducing the deduction from the economic rent by the economic interest. After all, if rent equals depreciation plus interest, depreciation must equal rent minus interest. In Table I, the second column minus the fourth\(^5\) equals the third. The depreciation of a term for years also equals the economic rent minus the economic interest\(^5\), but the interest subtracted is smaller with a term for years than with out-

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\(^5\) The net income figures in Table I are interest on the net investment, which necessarily equals the increase in value of the remaining rent.

\(^5\) See supra note 155 and accompanying text.
right ownership, since there are fewer future years — less capital — earning interest. The term for years does not contain the remainder. Thus, not only will the amount of depreciation of a term for years for a given year be greater than the amount of depreciation of the underlying property, but also, due to compounding effects, the term for years depreciates more slowly, since the smaller reduction for interest with the term for years falls off more rapidly than the larger reduction with outright ownership falls off. In other words, in getting from the rent for the underlying property to its depreciation, economic interest on the remainder, which grows with compounding, must be subtracted, whereas this subtraction is not taken into account in getting from the rent to the depreciation of the term for years, so that the depreciation of the term for years is slower. This is considered further in the next section of this Article.

Current law allows PIH to depreciate the term for years on a straight-line basis. On the facts of Table XIV, this would be 4.23 per year. Current law can be quite generous to PIH compared to economic accounting.

This point can be reinforced by viewing a term for years as a loan by PIH to REMAINDER that is to be repaid with interest by rent-free use of the property. With this characterization, under economic accounting, PIH would deduct economic rent and be taxed on interest on the loan. Table XIV shows that this is equivalent to economic depreciation of the term for years. Since PIH's loan is greatest up front, the reduction in the rent deduction is greatest in the early years. Thus, as long as the economic rent is not extraordinarily accelerated, depreciation of the term for years will be quite slow.

There is yet another way to look at the current defects. A term for years resembles coupons (payable in kind) stripped from a bond. Current law treats stripped coupons as if they were a new zero-coupon (no-interest) loan with an issue price (tax principal) equal to the cost of the coupons. This provides for slow recovery of the cost, because of the constant rate accounting for interest. In

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156 Treas. Reg. § 1.162-11(a). There is an untenable argument that the owner of the term for years depreciates the entire property, and not just the term for years. See Kwall, supra note 153, at 49-50.

158 I.R.C. § 1286(a).
contrast, current law provides straight-line depreciation for terms for years. The insights reflected in the coupon-stripping rules are not reflected in the taxation of terms for years.

The slower the depreciation of the underlying asset, the worse current law works. Under these circumstances, current law is particularly troublesome with regard to nondepreciable land. Consider a five-year term in land worth 30.72 under the economic assumptions underlying Table I. Each year, the rent would be 3.07, so that the term would cost 11.65 (the present value at 10% of five annual payments of 3.07). Then, matters are as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>EcDep. of TfY</th>
<th>Econ. Rent</th>
<th>Int. on TfY</th>
<th>Rnt-Int</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>1.91</td>
<td>3.07</td>
<td>1.16</td>
<td>1.91</td>
</tr>
<tr>
<td>2</td>
<td>2.10</td>
<td>3.07</td>
<td>0.97</td>
<td>2.10</td>
</tr>
<tr>
<td>3</td>
<td>2.31</td>
<td>3.07</td>
<td>0.76</td>
<td>2.31</td>
</tr>
<tr>
<td>4</td>
<td>2.54</td>
<td>3.07</td>
<td>0.53</td>
<td>2.54</td>
</tr>
<tr>
<td>5</td>
<td>2.79</td>
<td>3.07</td>
<td>0.28</td>
<td>2.79</td>
</tr>
</tbody>
</table>

Current law allows a level annual deduction of 2.33, providing quite a non-economic tax benefit.

The proposal deals nicely with the depreciation of the term for years. All that is required is to treat PIH like a lessee and to treat the cost of the term for years as prepaid rent. On the facts of Table XIV, PIH is treated as buying the property for 21.18 plus an obligation to pay 15.36 (the expected residual value) at the end of Year 5. The current purchase price is 30.72, the 21.18 plus the 9.54 present value of 15.36 (the amount loaned). The loan then accrues interest (discount) at 10% for five years until its balance is 15.36 at the end of Year 5. Each year, the total deduction is economic depreciation plus interest (current accrued discount), as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Loan Balance</th>
<th>Interest</th>
<th>Depreciation</th>
<th>Deduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>9.54</td>
<td>0.95</td>
<td>3.07</td>
<td>4.03</td>
</tr>
<tr>
<td>2</td>
<td>10.50</td>
<td>1.05</td>
<td>3.07</td>
<td>4.12</td>
</tr>
<tr>
<td>3</td>
<td>11.55</td>
<td>1.15</td>
<td>3.07</td>
<td>4.22</td>
</tr>
<tr>
<td>4</td>
<td>12.70</td>
<td>1.27</td>
<td>3.07</td>
<td>4.34</td>
</tr>
<tr>
<td>5</td>
<td>13.97</td>
<td>1.40</td>
<td>3.07</td>
<td>4.47</td>
</tr>
</tbody>
</table>
Note that the deduction in the fifth column of Table XVI is the same as in Table XIV. A purchaser of the term for years from PIH would be taxed similarly.\textsuperscript{160}

Thus far in this Article, it has not been necessary to apply the proposal with regard to land. Table XV demonstrates that when there is a hidden loan in a land transaction, such as in a term for years transaction, the proposal would be a considerable improvement over current law. The remainder of the discussion in this Part also applies to land.

2. Taxation of the Holder of the Remainder

Current law overtaxes REMAINDER more than it undertaxes PIH. Fortunately, reform with regard to REMAINDER is as easy as above with regard to PIH.

There is no income-relevant event at the instant when the term for years is sold. The transaction does have the effect of generating income subsequently, however. REMAINDER is left holding only a remainder, and there is income hidden in it. The remainder increases in value with time as the day when the remainder ripens into outright ownership comes closer. As noted above, a term for years transaction resembles a stripping of coupons off a bond, where the principal (remainder) is effectively a zero coupon obligation that is payable in kind. Under this view, REMAINDER has economic income each year equal to the increase in the value of the obligation.\textsuperscript{161} Thus, economic accounting would not tax REMAINDER at the time of sale, but would tax it each year on the income hidden in the remainder.

This can be illustrated by looking at the facts of Table XIV from the point of view of REMAINDER. REMAINDER owns property worth 30.72. It sells a term for years for 21.18, retaining a remainder worth 9.54. At the end of Year 5, the machine will be returned,

\textsuperscript{160} Transfers of leases between new and old lessees is discussed supra Part II.C.2.
\textsuperscript{161} Joyce & Del Cotto, supra note 153, at 123-26; Kwall, supra note 153, at 22. Taxing this income would not violate the realization notion discussed in Part II.A. The realization notion is that gain or losses from changes in market conditions are not taxed as they accrue, but at an appropriate event. Depreciation does not violate this notion, because depreciation is for expected, not actual, loss in value. The current original issue discount rules do not violate this notion because they are based on expected, not actual, increases in value. 1982 Bluebook, supra note 129, at 158-61. Similarly here, the economic accounting is based on expected increases in value and is consistent with realization notions.
when it will be worth 15.36. Thus, the remainder increases in value 5.82 (from its Year 1 value of 9.55 to its Year 5 value of 15.36), as follows:

**TABLE XVII**

<table>
<thead>
<tr>
<th>Year</th>
<th>Rem.Disc</th>
<th>EconRent</th>
<th>TfY Int</th>
<th>EconDep</th>
<th>Rnt-Int-Dep</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>0.95</td>
<td>6.14</td>
<td>2.12</td>
<td>3.07</td>
<td>0.95</td>
</tr>
<tr>
<td>2</td>
<td>1.05</td>
<td>5.83</td>
<td>1.71</td>
<td>3.07</td>
<td>1.05</td>
</tr>
<tr>
<td>3</td>
<td>1.15</td>
<td>5.53</td>
<td>1.30</td>
<td>3.07</td>
<td>1.15</td>
</tr>
<tr>
<td>4</td>
<td>1.27</td>
<td>5.22</td>
<td>0.88</td>
<td>3.07</td>
<td>1.27</td>
</tr>
<tr>
<td>5</td>
<td>1.40</td>
<td>4.91</td>
<td>0.45</td>
<td>3.07</td>
<td>1.40</td>
</tr>
<tr>
<td></td>
<td>5.82</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The second column is the hidden interest (accruing discount) in the remainder, calculated by applying the assumed 10% interest to the original 9.54 cost plus previously accrued interest. This interest income is relatively small because the table reflects a relatively small remaining investment by REMAINDER (9.54 at the outset). Such small interest income is not troubling, since it merely reflects that 15.36 (five years' economic depreciation) was applied against the 21.18 payment, leaving 5.82 taxed. Note that the hidden interest income to REMAINDER each year exactly equals the extra deduction to PIH from allowing a deduction for economic depreciation of the term for years rather than for the smaller economic depreciation of the underlying property (the third column of Table XVI). Thus, under economic accounting, the total effect to the two taxpayers is a deduction for economic depreciation of the underlying property.

Table XVII makes an additional point. REMAINDER can be viewed as borrowing 21.18, to be repaid, plus interest, in rent. The fourth column is the interest on the unpaid balance of this loan. Under this view, REMAINDER would be taxed on economic rent and deduct interest on the loan and economic depreciation. This is the sixth column. The third and fifth columns are taken from Table I and used to calculate the sixth column. Note that the sixth column equals the second column (hidden interest on the remainder).

---

162 REMAINDER also has the 21.18 it received for the term for years in the bank, plus interest.
Current law takes a different tack. It treats the sale of the term for years as a receipt of prepaid rent that is immediately taxable, with no immediate basis recovery, but, presumably, with depreciation deductions over the term. No tax results when the remainder vests. This regime effects an overtaxation. The economic income is taxed well before it is earned. Moreover, the overtaxation of REMAINDER always exceeds the undertaxation of PIH: PIH gets a small speed-up of part of its deduction, while REMAINDER gets a complete acceleration of all gross income into Year 1, which is offset in part by depreciation in later years.

Reform here is not difficult, as shown in Table XVII. All that is needed is to inform the treatment of the term for years transaction with the ideas underlying the current rules for coupon stripping. REMAINDER would be taxed as if it held a zero coupon bond with an issue price equal to the market value of the remainder at its creation and with a redemption price at maturity equal to the expected value of the remainder at the end of the term for years. In order to do this calculation, it is necessary to determine only one fact that is not obvious: the market value of the entire property at the time the remainder is created, which can be done by using the Value Formula. Then, the current value of the remainder

\[163\text{ See Kwall, supra note 153, at 17-19 (There apparently is an argument that there is a taxable event when a remainder vests in possession, but this is not the better view of the law).}\\
\[164\text{ Since the amount taxed currently is the present value of the future rent using a pre-tax discount rate, the current tax necessarily equals the pre-tax present value of all taxes, at the same rate as the tax on the immediate inclusion, on the future rent using the same pre-tax discount rate. Thus, at first glance, current law seems correct. This is the wrong way to analyze the transaction, however. At the beginning of the lease, REMAINDER would need to set aside an amount equal to the after-tax present value of future taxes on rent, which is larger than the pre-tax present value, in order to set aside enough money to pay the future taxes on the rent. Looking solely at taxes on rent, the term for years transaction is taxed more favorably than long-term lease treatment. However, this analysis is incomplete. REMAINDER is also paying taxes on its money in the bank. The term for years transaction results in less rent, but more interest, as REMAINDER gets the rent earlier in the term for years transaction, so that the rent is in the bank longer, generating more interest. In fact, the term for years transaction results in the identical amount of taxable income (in pre-tax present value terms) as the long-term lease, but that income is taxed earlier in the term for years transaction, so that the term for years transaction results in a greater total after-tax present value of taxes.}\\
\[\text{This net overtaxation can be avoided if PIH and REMAINDER buy their interests simultaneously from a third party, although the mistaxation of income as between the parties cannot. See Kwall, supra note 153, at 27-28. The instant proposal would eliminate this silly benefit to tax planning.}
can be calculated easily by subtracting the price for which the term for years was sold from the current value of the entire property; the expected value of the remainder at the end of the term can be calculated by adjusting the current value of the entire property for expected economic depreciation over the term. Thus, this regime really just applies the proposal above to the "prepaid rent" in the term for years transaction. It does not seem unwieldy. At the end of the term, REMAINDER's basis in the property would be its expected value (15.36 in the example). A purchaser of the remainder from REMAINDER would be taxed similarly.

Overtaxation of REMAINDER under current law might be defended as an in terrorem rule that prevents the creation of hard-to-tax remainders. This might have been a valid argument ten years ago. Recent legislation has applied the basic loan concepts used here to so many transactions, including the coupon stripping transactions that so closely resemble the sale of a term for years transaction, that adding one more application of these concepts does not seem beyond the pale. Reform of the taxation of REMAINDER and any recipient of prepaid rent seems appropriate. This also would eliminate any question of whether the purchaser of a remainder should be allowed any depreciation, with no offsetting income, during the period of the term for years.

3. Realization

Current law, as noted above, treats the sale of a term for years by the owner of the entire property as a prepaid rent transaction that does not involve a realization. The proposed reform rejects this view and adopts a carve-up-of-the-property approach for depreciation and related purposes. While it frequently is advisable to

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3. Many prepayments, not just prepaid rent, are overtaxed compared to economic and financial accounting. Surrey, supra note 96, at 621-31. Thus, an argument can be made that reform of the taxation of prepaid rent should be deferred pending reform of the taxation of all prepayments. Cf. supra note 2.


5. See supra Part IV.A.2.
take different views of a transaction for realization and other pur-
poses, as above with regard to leases, adopting the same view for
these purposes makes sense here. In particular, current law's no-
realization approach would be unjustifiably generous here in light
of the basis recovery, as opposed to immediate taxation of rent,
provided in the proposal. A carve-up view seems appropriate for
realization purposes.

Under a carve-up approach, a seller of a term for years would be
treated as dividing the property into two properties: the term for
years and the remainder. The total basis in the entire property
would be allocated between the newly-created properties propor-
tionately to their respective then fair market values. Gain or loss
on the term for years equal to the amount realized less the basis
allocated it would be recognized. There would be no immediate
realization with respect to the remainder. At the outset, the re-
mainder would have a basis equal to the portion of the total basis
allocated to it, so that its basis would be less than its value by the
unrealized portion of the total gain. Applying the basic proposal,
the basis of the remainder would be increased as the owner is
taxed on hidden interest. This merely reflects the increase in
value of the remainder as the time of outright ownership comes
closer. No tax event will occur at the end of the term for years.
Consequently, when the term for years ends and the remainder be-
comes outright ownership, the property's basis at the outset plus
taxed hidden interest (i.e., adjusted basis) still would be less than
its value at the outset plus hidden interest (i.e., the expected value
at such time) by exactly the amount of gain or loss not taxed when
the term for years was sold. Thus, the gain or loss not taxed when
the term was sold can be taxed when the now-vested remainder is
disposed of or depreciated. This regime makes sense.

These carve-up rules suggested for sales of terms for years result
in partial immediate realization in the covered transactions,

170 See supra Part II.B.
171 Treas. Reg. § 1.61-6(a). The basic calculations are done with regard to Table XVIII. See infra Table XVIII and associated discussion. The only unclear fact, the property's value, can be estimated with the Value Formula.
172 This basis would be increased over time to reflect the taxation of hidden interest, as discussed in connection with Table XVII.
173 This regime was described in more detail in connection with Table XVII. See supra Part IV.A.2.
whereas in the proposed reform for the parallel lease transactions suggested above a different amount of gain is taxed on a deferred basis.\textsuperscript{174} This is troubling, as the realization rules for all of these transactions should be similar. Nevertheless, the realization rule for leases set out above is attractive, as it is not a radical departure from current law and is workable. The proposal does do somewhat better than current law in treating leases and sales of terms for years similarly, as the proposal speeds up realization in leases compared to current law,\textsuperscript{175} and therefore somewhat reduces the difference between the realization rules for leases and sales of terms for years.

If one is troubled by the difference between the realization rules for leases and sales of terms for years, the proposal can be modified to radically reduce the difference. There does not seem to be any reason to treat sales of terms for years like leases for realization purposes. It is possible to conform the rules for leasing to those for terms for years. Such rules would tax the lessor on the portion of the total gain that the current value of the leasehold is of the current value of the entire property.\textsuperscript{176} The stated rent could be treated as payments on an installment obligation to which the installment reporting rules could apply, after converting an appropriate portion of the rent/principal to interest, as current law does with deferred payment transactions that do not state adequate interest.\textsuperscript{177} Tough rules for determining the real lease term would be required.\textsuperscript{178} The lessor’s basis in the remainder at the end of the

\textsuperscript{174} See supra text accompanying notes 86-88.

\textsuperscript{175} See supra text accompanying notes 86-88.

\textsuperscript{176} This is recommended in Joyce and Del Cotto, supra note 153, at 185-89. For an interesting early work that concludes that this bifurcation generally is the better view, see Frank M. Keesling, Conflicting Conceptions of Ownership in Taxation, 44 Cal. L. Rev. 866, 869-70 (1956). The Value Formula can be used to approximate the value of the carved up property.

\textsuperscript{177} I.R.C. §§ 453, 483, 1272-75; see also Halperin, supra note 54, at 535-38. The installment obligation implicit in this gain proration does not reflect the value of the residual as in the general loan proxy. The loan proxy had to reflect the residual in order to assure that the total economic interest on the total investment in the machine was taken into account. Using that loan proxy here would have the effect of taxing all of the gain. The recommended allocation by cash payments is consistent with taxing only part of the gain and is in the spirit of installment reporting — spreading the tax out over the cash payments. An even simpler rule is possible: prorating gain by stated rent. This, in effect, prorates gain without regard to the actual sale price, but is otherwise no more arbitrary than the proration suggested in the text.

\textsuperscript{178} The proposed reform avoided this problem with regard to rent taxation with an inter-
lease would be the expected fair market value reduced by any unrealized gain. For purposes of applying the reforms of the taxation of rent proposed above, market values would be used. Thus, the lessee would be unaffected by the lessor’s tax treatment. The lessee’s depreciation would be determined on the basis of the property’s fair market value at lease commencement.

This is best illustrated with an example. Consider the basic facts and assumptions of Table VIII. The applicable federal rate can be used to value the property and the interests created in the property. At the beginning of Year 1, the leasehold represents 68.9% of the property’s value. The present value at 10% of the stated rent of 5.59 per year for five years, is 68.9% of the total value of 30.72. The lessor would be treated as selling 68.9% of the machine, realizing 68.9% of the total gain, or 6.89 of gain out of the total gain of 10.00, leaving the 3.11 gain attributable to the residual unrealized. If installment reporting is available, the lessor would be treated as follows:

\[
\begin{array}{cccc}
\text{Year} & \text{Lease Income} & \text{Prncpal of Instll.Obl} & \% \text{ of Principal} & \text{Gain} \\
1 & 3.07 & 3.47 & 16.4\% & 1.13 \\
2 & 2.82 & 3.82 & 18.0 & 1.24 \\
3 & 2.54 & 4.20 & 19.8 & 1.36 \\
4 & 2.24 & 4.62 & 21.8 & 1.50 \\
5 & 1.90 & 5.08 & 24.0 & 1.65 \\
\hline
 & 21.18 & 100.0\% & & 6.89 \\
\end{array}
\]

The lessor would be taxed on the second column, from Table VI, as a proxy for rent plus interest less depreciation. The gain would

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est rate ceiling, as discussed in Part I.B.4. Unfortunately, because of the elusive nature of realization, no reform deals perfectly with all the realization problems presented by options. These problems arise in many transactions not involving leases. See, e.g., 1984 Bluebook, supra note 24, at 301-24 (stock options). Fortunately, rules are required here only with regard to lessor or lessee options to renew. Leases coupled with options to buy also present realization problems. These problems are little different from the normal realization problems presented by an option, however, and thus are beyond the scope of this Article. Consequently, realization rules for leases coupled with options to buy are not considered here.

This is the basis allocated to the residual at the outset plus the discount on the residual implicitly taxed through the rent tax regime. See supra note 172.
be taxed by treating the stated rent (5.59 per year) as payments on an installment obligation that provides for no interest. Thus, it is necessary to determine the tax principal payments in this obligation by backing out hidden interest; since interest already is taxed in the rent proxy, the back-out here is solely for purposes of taxing gain. As shown in the third column, this tax principal portion of a payment for a given year is determined by subtracting 10% interest on the balance of the entire obligation (21.18 plus 10% interest less payments) from the stated rent of 5.59 per year. The total gain of 6.89 would be reported proportionately to these payments of tax principal, as shown in the fifth column. At the end of the lease, the lessor would have property worth 15.36 with a basis of 12.25 (15.36-3.11), so that the 3.11 of gain not realized as a result of the lease will be realized in the future. The lessee is unaffected by the lessor's accounting.

This regime is attractive. The seller is taxed on the portion of the value to which it has transferred market risk. Installment reporting softens any liquidity problems from accelerated realization. Long-term leases and sales of terms for years are treated similarly.

Loss realization in leasing transactions presents additional concerns. The stakes are reversed between the taxpayer and the government. With gain, the taxpayer usually wants nonrealization, while, with loss, the taxpayer usually wants realization. Current law contains rules that provide non-recognition of loss on transactions driven by a desire to trigger the tax loss without really changing the investment. A sale-leaseback clearly raises such concerns.

More broadly, loss realization concerns also arguably

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160 The 12.25 also can be viewed as the 6.43 of basis allocated to the residual in Year 1 (31.1% of the original basis of 20.72) increased by the 5.82 of discount taxed in Years 1 through 5.
161 Most prominently, I.R.C. § 1031.
162 Current law contains byzantine rules that limit losses by seller/lessees in sale-leasebacks. See Louis A. Del Cotto, Sale and Leaseback: A Hollow Sound When Tapped?, 37 Tax L. Rev. 1, 10-14 (1981). If the rules suggested above for gain realization were applied to loss realization, the seller/lessee would realize only the loss attributable to the remainder immediately. The loss attributable to the lease term would be spread over the term through extra “rent” deductions under the loan treatment proxy. No loss would be allowed in installment-sale sale-leasebacks. If this regime is viewed as overly generous, no loss need be allowed until the end, of the lease term, with perhaps an exception for de minimis leasebacks. Cf. Accounting for Sales with Leasebacks, Statement of Financial Accounting Standards No. 28, ¶¶ 3, 10, 12 (Fin. Accounting Standards Board 1979) (de minimis exception from general rules for financial accounting for personal property sale-leasebacks).
require that the realization rules suggested above that treat a lease like a sale of a term for years not apply to loss realization, since, otherwise, these rules would allow a lessor to realize any loss attributable to the lease term immediately. The immediate partial realization rule could be limited to gains.

4. Application of Accelerated Depreciation

The regime suggested above for sales of terms for years can be adapted easily to take account of non-economic accelerated depreciation. If lessors generally are allowed the preference, as under current law, it might be appropriate to give similar benefits to holders of remainders, since they resemble lessors. Under the proposal, this would be done by allowing the holder of a remainder in property to which the preference applies a depreciation deduction each year equal to the amount by which the preferential depreciation exceeds economic depreciation for that year. However, it might be inappropriate to give the preference to holders of remainders, even in a world where lessees generally enjoy a depreciation preference, since lessees, or at least non-leveraged lessees, usually have a greater investment than holders of remainders. In a world where lessees generally enjoy the preference, it seems pretty clear that holders of terms for years should. Under the proposal, a term for years holder simply would use the preferential method of depreciation, with a recapture, if needed, at the end of the term.

B. Sale of Remainder

It is interesting to consider a transaction similar to the sale of a term for years just considered: the sale of a remainder interest by an outright owner. The basic rules for sales of terms for years just described also should apply to these additional transactions. This would eliminate the question under current law of whether an owner of nondepreciable land that sells a remainder is allowed to

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The parallel issue under financial accounting is the use of sale-leasebacks to create a realization event so that the seller can book profit. See FASB 13, supra note 51, at ¶ 107. Basically, financial accounting follows a pro rata rule. See FASB 13, supra note 51, at ¶ 33. Different rules apply to real estate transactions. See FASB 98, supra note 55, at ¶¶ 7-13.

Installment reporting could not apply. I.R.C. § 453(a).

Cf. I.R.C. § 311 (gain, but not loss, taxed to corporation on dividend-like distribution of property to shareholders).
As to realization, the current treatment of sales of remainders is unclear. Rules similar to those proposed for sales of terms for years seem advisable. The seller would allocate basis between the sold remainder and the retained term and recognize gain or loss on the remainder, with the remaining gain or loss taxed through the operation of the proposal, much like in Table VIII.

A seller/lessee in a sale-leaseback resembles a seller of a remainder. It might be desirable to conform the treatment of such a seller to the treatment of an owner that sells a remainder, even if the treatment of leases generally does not conform to the treatment of sales of terms for years. Under this approach, the total purchase price and the property’s basis would be allocated between the present value of the sold remainder and the retained term (the present value of the rent), with only the gain attributable to the remainder realized immediately. The unrealized gain attributable to the lease term would be taxed through proportionately reduced seller/lessee depreciation deductions.

C. Sales with Retained Use

Consider an owner of a property that sells the property, but retains the right to use it for some period. This transaction can be viewed as either the sale of the remainder or as a sale of the entire property with a leaseback, with the implicit rent being prepaid through a hidden reduction in the sale price. Current law respects

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185 When an outright owner sells a remainder to a related person, the owner is allowed no depreciation or amortization. I.R.C. § 167(r). Otherwise, the law is unclear, particularly with regard to term interests in depreciable property. See Rolf Auster, Amortizing Life Estates After the Revenue Reconciliation Act of 1989, 68 Taxes 459, 459-69 (1990); Walter J. Blum, Amortization of a Retained Terminable Interest After Transfer of a Remainder, 62 Taxes 211, 211-19 (1984).

186 See supra note 185.

187 A sale-leaseback frequently involves payment of the sale price with an installment obligation of the buyer/lessor that the seller/lessee accounts for under the installment method. In order to apply installment reporting under sale-of-the-remainder treatment, the note must be allocated between the sold remainder and the retained possessory interest. The easiest way to do this would be to prorate each payment proportionately to the respective interest’s fair market value on the sale day; all this while the gain with regard to the term also is being spread over the same payments. Perhaps it is best to treat a sale-leaseback involving installment reporting just in accordance with its terms for gain realization purposes.
both views. Sale-leaseback treatment generally results in higher taxes: an immediate tax on the buyer/lessor on the deemed prepaid rent, offset somewhat by depreciation over the period of retained use, and an immediate tax to the seller/lessee on all gain.

A confused body of law demarcates the line between the two treatments. Under the instant analysis, the two treatments should — and would — be taxed essentially the same, eliminating the significance of this line. Sale of the remainder treatment would result in the seller having a depreciable term and in the buyer having an appreciating remainder. A sale-leaseback would be treated essentially the same. The seller would have deductible economic rent offset by implicit interest, which difference would equal economic depreciation of the term for years. The buyer would have economic rent reduced by implicit interest and economic depreciation, which difference would equal economic appreciation of the remainder. The realization rules would be similar.

V. Inflation

The discussion thus far has assumed that there is no inflation. Inflation complicates matters considerably, but with little change in the conclusions.

Inflation represents a decline in economic value of the dollar. It causes the tax system to mismeasure income, as compared to economic income, to the extent that any item on the current return is not measured in current dollars. For example, income is overstated when gross income measured in terms of a large number of the current cheap dollars is offset by depreciation deductions measured in terms of fewer, but more valuable, old dollars. Inflation poses a problem for the taxation of income from capital throughout the tax system. Here, it affects how one determines economic rent, economic interest, and economic depreciation. Current law

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189 Also, there are arguments that depreciation is available to both the buyer and the seller under sale of remainder treatment, making that treatment even more attractive. See supra notes 168, 185.
190 See supra notes 168, 185.
191 See supra Part IV.A.1 (specifically, Table XIV and associated discussion).
192 Id.
193 See supra Part IV.A.3.
takes little explicit account of the mismeasurement of income attributable to inflation.\textsuperscript{194} 

Any reform that fine-tunes the tax law for inflation across the board should apply to the taxation of rent and related concerns discussed here. The suggested reforms are no more difficult to index for inflation than is current law. For example, whatever method is devised for indexing borrowings would apply to the loan treatment suggested above for long-term leases. This would not provide a preference for leased property, as any broad-based reform also would provide parallel indexation for depreciation on assets that are not leased.

Problems are presented if indexation is not provided across the board. The purposes underlying the limited indexation must be scrutinized to determine how they affect the instant analysis. For example, current law's non-economic depreciation can be viewed as an ad hoc inflation adjustment for depreciable property.\textsuperscript{195} This indexation does not apply to loans, notwithstanding that loans are every bit as affected by inflation as investments in depreciable property. Thus, under an ad hoc inflation adjustment view of non-economic accelerated depreciation, the instant loan proxy for taxing economic rent could be troubling if no adjustment for accelerated depreciation for the lessor is provided, since this regime would deny the ad hoc indexation to an owner of depreciable property. Conversely, if one views a long-term lease as a loan, such a denial of accelerated depreciation benefits for the lessor would be preferable to current law, as it would treat leases like loans. Similar analyses apply to accelerated depreciation for lessees. These possibilities are not worth much consideration, since a limited inflation adjustment does not improve the accuracy of the tax system, but merely provides a preference for covered assets, and, thus, is misguided.\textsuperscript{196}


VI. THE CAPITAL GAINS PREFERENCE

The Omnibus Budget Reconciliation Act of 1990\(^7\) had the effect of enacting a small capital gains preference for individuals.\(^8\) While the statutory marginal rate of tax on individuals can be as high as 31%, net long-term capital gains are taxed at a maximum marginal statutory rate of 28%.\(^9\) The questions arise as to (a) what income involved in the transactions discussed in the Article should be allowed this special treatment,\(^{100}\) and (b) whether the presence of this preference affects any of the conclusions reached above.

It is most difficult to demarcate the scope of the preference, since Congress only vaguely articulated its purposes.\(^{201}\) The best that can be done is to allow the preference with regard to items vaguely economically similar to items for which the preference clearly is allowed.

Since rent generally is ordinary income, the rent proxy under the proposal also should be so treated. While, in theory, any unrealized gain or loss that is taxed through the loan proxy\(^2\) should be capital, it seems prudent to follow current law and not break this gain or loss out of the basic rules for rent taxation in order to give it


\(^{198}\) Id. at § 11101. Prior law had provided a 28% maximum capital gain rate if the highest explicit rate, ignoring surtaxes, phase-outs, and the like, was above 28%, but the highest explicit rate was 28%, so this provision had no effect. I.R.C. § 1(j) (1989). It was only when the highest rate was raised to 31% that this provision began having an impact.

\(^{199}\) I.R.C. § 1. The real marginal rate can be higher, as capital gains increase adjusted gross income, which can have the effect of reducing the amount of certain deductions, including some deductions that otherwise would be allowed against income taxed at 31%. I.R.C. §§ 62, 67, 68, 151(d)(3), 165(h)(2), 213(a).

\(^{200}\) Issues also are presented as to what losses should be treated as capital losses, the deductibility of which is limited for both individuals and corporations. See I.R.C. §§ 165(f), 1211, 1212. These issues seem so remote from the focus of this Article that they are not considered here.

\(^{201}\) The legislative history of the House version of the 1990 legislation expresses an intent to encourage realizations by lowering the tax on such transactions. Ways and Means Democratic Alternative Budget Reconciliation Agreement, CCH Std. Fed. Tax Rep. No. 46, 16 (1990), but the House bill and the final act do not apply to all realizations or even to all realizations of assets held for some time. Thus, it is hard to make much use of this Congressional purpose. The legislative history of the latent 28% maximum rate also suggests a concern to encourage realizations. S. Rep. No. 313, 99th Cong., 2d Sess. 169 (1986); H.R. Rep. No. 426, 99th Cong., 1st Sess. 196 (1985).

\(^{202}\) This is discussed in Part II.
separate treatment, as the associated complexity would undermine
the simplicity that motivated taxing gain or loss through the proxy
in the first place. The income hidden in a remainder described in
Part IV is not realized gain for which the preference is appropriate.

The realization transactions discussed in Part IV are better can-
didates for the preference. A seller of a term for years or a remain-
der would be treated as selling part of the property. Presumably,
this partial sale should be allowed any capital gain treatment that
would be allowed on a sale of the entire property. Similarly, the
gain (but only such gain) that is taxed if a long-term lease is
treated like a part sale, as explained in connection with Table
XVIII, should be allowed whatever capital gain treatment would
be allowed on a sale of the entire property. In both cases, the rele-
vant holding period would be the holding period of the entire
property.

A lessee that sells its lease or is paid to cancel the lease is al-
lowed capital gain treatment under current law. This does not
seem clearly wrong. Any such preference reduces the potential
over taxation of lease sale transactions if the buyer is not allowed
an immediate deduction, as discussed in Part II.C, above, and
makes deferred deduction treatment more attractive. The question
then arises as to payments received by a new lessee to assume a
lease or by a lessor to cancel a lease. Under current law, these
amounts are treated as ordinary income. In the case of a new
lessee, capital gain treatment might make it easier to defer the
payor's deduction. As to a lessor's receipt of a lease cancellation
payment, it is hard to accept current law's capital gain treatment
when a lessee is bought out without also allowing capital gain
treatment to a bought-out lessor.

The presence of non-economic accelerated depreciation does not
change matters. With a capital gains preference, it is possible to
devise rules for the taxation of realizations that work with the de-
preciation preference somewhat better than above in Part III, i.e.,
that cause realizations to impact less on the value of the deprecia-
tion preference. The sale of an asset need not increase the tax on
the asset, since the low capital gains tax need not exceed the pre-

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203 I.R.C. § 1241.
204 Treas. Reg. § 1.61-8(b).
205 This discussion is based on the articles cited supra note 143.
sent value of the buyer's new deductions. Current law does not do this, however. It taxes gain on the sale of depreciable personal property that might otherwise be capital gain as ordinary recapture income to the extent of past depreciation, so that only gain over the historical cost is allowed the capital gains preference.\textsuperscript{206} This recapture assures that an asset sale does not effect a net reduction in taxes because the seller's low capital gains tax is smaller than the buyer's future new depreciation deductions. Unfortunately, current law's recapture probably generally results in a tax on the seller that exceeds the present value of the buyer's new deductions, which is overkill. Thus, since current law's rules for taxing realizations and capital gains work so poorly, there is no real guidance on how to tax the transactions of interest here. The rules most consistent with the tough spirit of current law would provide that a taxpayer (allowed an accelerated depreciation method under the proposal\textsuperscript{207}) who otherwise would realize a capital gain is subject to ordinary income recapture of all prior depreciation up to the gain realized. The same tough spirit suggests that, in the case of a sale of a remainder or a term for years by an outright owner, all depreciation should be subject to recapture, and not just some share of the total recapture allocated somehow to the portion of the property viewed as sold, but this is problematic.

In short, the presence of a capital gains preference does not materially complicate the operation of the reforms suggested in this Article. Unfortunately, it is hard to evaluate whether the proposal improves the operation of the preference.

\textbf{VII. Conclusion}

This Article has discussed how an understanding of the mistaxation of rent in long-term leases motivates insights into various related tax issues, particularly the lease/loan distinction and related realization problems.

From an economic perspective, rent should be greater when a depreciating asset is new, but current law respects level rent stated in long-term leases. The resulting mistaxation distorts economic behavior and loses revenue. Reform requires applying the present

\textsuperscript{206} I.R.C. § 1245. The text oversimplifies matters somewhat. See Mundstock, supra note 5, at 1205-14.

\textsuperscript{207} See supra Part III.C.
value, compounding, and related concepts used in the taxation of loans to the taxation of long-term leases. Taxing a lease in the same way as a loan which provides the same payments would drastically reduce the current mistaxation.

Although the problem of when gain or loss should be realized is virtually intractable, since there is no economic notion of realization to use as a benchmark in evaluating tax realization rules, and since the loan proxy suggested for taxing rent makes little sense as a realization rule, the loan proxy proposal is adjustable to include realization rules that do not differ much from current rules, and also do not undermine the economic correctness of the loan proxy proposal's results.

While much attention has been paid in the past to non-economic accelerated depreciation used by the lessor, when rent mistaxation is considered, leases of property subject to that tax preference are not particularly problematic. Indeed, under this proposal, the benefits from the preference can be improved in the context of leases, sale-leasebacks, and leveraged leases.

Like the long-term leases they resemble, terms for years are mistaxed under current law. This Article's proposal also repairs this mistaxation. Similarly, inflation and the recently resuscitated capital gains preference pose tractable problems for this proposal.

In short, current law is in need of reform. This Article's proposal provides a workable means to achieve the necessary, and more economically correct, end.