



STATE BOARD OF EQUALIZATION

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TO COUNTY ASSESSORS:

SAFE HARBOR LEASE TRANSACTIONS

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No. 82/68

This letter discusses the recently created "safe harbor" leasing statutes and their effect on the assessment of property subject to such a lease.

Much publicity has been generated over recent months surrounding the ability of corporations to buy or sell certain federal income tax benefits. Specific benefits are the Investment Tax Credit (ITC) and the opportunity to claim Accelerated Cost Recovery System (ACRS) deductions. These tax benefits derive from acquisition of qualifying new business property.

Certain corporations acquire, or intend to acquire, new business property but have insufficient net income to realize any benefit from available ITC and ACRS benefits. Such a corporation (referred to as a "loser" corporation) may now effectively sell those federal income tax benefits through an agreement to lease the property. A profitable corporation acquiring the income tax credits through a lease or sale/leaseback agreement is said to have established a safe harbor -- sheltering of income from higher federal income tax.

The Economic Recovery Act of 1981 provides the legal framework for this new type of lease agreement. Internal Revenue Code provisions now allow qualifying corporations to enter into the sale and leaseback of tangible business property, where the sole economic purpose of the lease is to transfer property investment tax credits and accelerated cost recovery deductions.

Numerous safe harbor leases have been executed since passage of the Economic Recovery Act in August 1981, involving tangible property located in California costing millions of dollars. These leases may transfer rights of ownership of the property subject to the lease, in addition to specific federal income tax benefits.

Proper assessment of the leased property is complicated since classification and ownership is difficult to ascertain. Property must be sufficiently described within the lease document so that it can be identified, physically inspected as necessary, and classified based on recognized classification tests. To the extent that description is lacking, the assessor may have to obtain additional data to classify the property.

Determination of ownership is important because the true owner, whether the "lessee" or "lessor" in a safe harbor lease, is the preferred

May 7, 1982

assessee. Also, if the property is a fixture or other type of real property, it is important to determine whether or not a change in ownership occurred for purposes of assigning the proper base year and base year value.

Determining ownership of property subject to a safe harbor lease may be a difficult task. The language of safe harbor lease statutes and implementing regulations implies the creation of a new property ownership right equivalent to "tax title." Unfortunately, tax title is not a defined legal property right; the language stems from federal income tax law. Specific terms of each sale/lease must be analyzed to determine when transfer(s) of title to property occur(s). When title to property is not clearly stated, terms of the lease must be analyzed to ascertain the party with the most significant economic property interest.

Current ownership, plus contractually specified future transfer(s) of title to property, must be determined to assign the proper base year of safe harbor property classified as real property (fixture).

You may find it necessary to refer many of these original safe harbor leases to your county counsel for legal interpretation of ownership, based on specific language contained within a lease.

In most cases, historical cost is the apparent approach to use in determining market value for property subject to a safe harbor lease. Proposed Financial Accounting Standards Board regulations specify that property cost data should be retained by the seller-lessee and displayed on the seller-lessee's balance sheet.

Business property subject to a safe harbor lease may prove difficult to discover if neither lessee nor lessor claims ownership of the property. Conversely, both parties may report the property, increasing the risk of a double assessment. Since corporations participating in safe harbor leases will almost always be mandatory audits, an inquiry question addressing the existence of safe harbor leases is suggested for assessor audit programs.

Technical requirements for a transaction to qualify as a safe harbor lease are contained in Internal Revenue Code Section 168(f)(8) (enclosed) and related Internal Revenue Service Regulations.

If you have additional questions regarding safe harbor lease transactions, please contact the Technical Services (Business Property) Section at (916) 445-4982.

Sincerely,



Verne Walton, Chief
Assessment Standards Division

ATTACHMENT I
ECONOMIC RECOVERY ACT OF 1981
PUBLIC LAW 97-34

Sec 168(f)(8)--

(A)--In the case of an agreement with respect to qualified leased property, if all of the parties to the agreement characterize such agreement as a lease and elect to have the provisions of this paragraph apply with respect to such agreement, and if the requirements of subparagraph (B) are met, then, for purposes of this subtitle--

(i)--such agreement shall be treated as a lease entered into by the parties (and any party which is a corporation described in subparagraph (B)(i)(I) shall be deemed to have entered into the lease in the course of carrying on a trade or business), and

(ii)--the lessor shall be treated as the owner of the property and the lessee shall be treated as the lessee of the property.

(B)--The requirements of this subparagraph are met if--

(i)--the lessor is--

(I)--a corporation (other than an electing small business corporation (within the meaning of section 1371(b)) or a personal holding company (within the meaning of section 542(a))),

(II)--a partnership all of the partners of which are corporations described in subclause (I), or

(III)--a grantor trust with respect to which the grantor and all beneficiaries of the trust are described in subclause (I) or (II),

(ii)--the minimum investment of the lessor--

(I)--at the time the property is first placed in service under the lease, and

(II)--at all times during the term of the lease, is not less than 10 percent of the adjusted basis of such property, and

(iii)--the term of the lease (including any extensions) does not exceed the greater of--

(I)--90 percent of the useful life of such property for purposes of section 167, or

(II)--150 percent of the present class life of such property.

(C)--If the requirements of subparagraphs (A) and (B) are met with respect to any transaction described in subparagraph (A), no other factors shall be taken into account in making a determination as to whether subparagraph (A)(i) or (ii) applies with respect to such transaction.

(D)--For purposes of subparagraph (A), the term "qualified leased property" means recovery property (other than a qualified rehabilitated building within the meaning of section 48(g)(1)) which is--

(i)--new section 38 property (as defined in section 48(b)) of the lessor which is leased within 3 months after such property was placed in service and which, if acquired by the lessee, would have been new section 38 property of the lessee,

(ii)--property--

(I)--which was new section 38 property of the lessee,

(II)--which was leased within 3 months after such property was placed in service by the lessee, and

(III)--with respect to which the adjusted basis of the lessor does not exceed the adjusted basis of the lessee at the time of the lease, or

(iii)--property which is a qualified mass commuting vehicle (as defined in section 103(b)(9)) and which is financed in whole or in part by obligations the interest on which is excludable from income under section 103(a).

For purposes of this title (other than this subparagraph), any property described in clause (i) or (ii) to which subparagraph (A) applies shall be deemed originally placed in service not earlier than the date such property is used under the lease. In the case of property placed in service after December 31, 1980, and before the date of the enactment of this subparagraph, this subparagraph shall be applied by submitting "the date of the enactment of this subparagraph" for "such property was placed in service."

(E)

(i)--For purposes of subparagraph (A), the term "minimum investment" means the amount the lessor has at risk with respect to the property (other than financing from the lessee or a related party of the lessee).

(ii)--For purposes of clause (i), an agreement between the lessor and lessee requiring either or both parties to purchase or sell the qualified leased property at some price (whether or not fixed in the agreement) at the end of the lease term shall not affect the amount the lessor is treated as having at risk with respect to the property.

(F)--For purposes of this paragraph, any determination as to whether a person is a lessor or lessee or property is leased shall be made on the basis of the characterization of such person or property under the agreement described in subparagraph (A).

(G)--The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this paragraph, including (but not limited to) regulations consistent with such purposes which limit the aggregate amount of (and timing of) deductions and credits in respect of qualified leased property to the aggregate amount (and the timing) allowable without regard to this paragraph.