

*Example (10).* The facts are the same as in example (9) except that on November 1, 1981, WTA borrows 5 percent of the cost of the buses and pledges them as security. The interest on WTA's obligation is excludable from income under section 103(a)(1). On December 31, 1981, WTA sells to T Corp. all 100 buses and leases them back. Under § 5c.168(f)(8)-6(b)(3)(i), each bus is deemed to be financed with the proceeds of tax exempt obligations. Therefore, if the vehicles otherwise meet the definition of qualified leased property, all the vehicles will be qualified leased property under this section.

(4) *Foreign lessees.* In addition to the other provisions of this section, property which is leased under a section 168(f)(8) lease to a foreign person shall not be qualified leased property unless the gross income attributable to the property from all sources (determined without regard to section 872(a) or 882(b)) is effectively connected with a trade or business within the United States, and the taxable income, if any, attributable to the property is subject to tax under section 871(b)(1) or 882(a)(1). For this purpose, if income attributable to the property is not included in gross income of a foreign lessee, and is exempt from taxation, under sections 872 or 833, or if the income is otherwise exempt from taxation under any income tax convention to which the United States is a party, then the property shall not be qualified leased property.

(5) *Other rules.* (i) Qualified leased property may include undivided interests in property or property regardless of whether or not it is considered separate property under State or local law. If property subject to a section 168(f)(8) lease is later determined not to be qualified leased property, disqualification of the lease under section 168(f)(8) will apply only as to that property.

(ii) The application of this paragraph (b)(5) may be illustrated by the following examples:

*Example (1).* On July 1, 1981, X Corp. contracts to have a manufacturing facility constructed for use in its business. Construction of the facility is completed on July 1, 1982, and the facility is deemed to be placed in service as of that date under § 5c.168(f)(8)-6(b)(2)(i). The facility is comprised of a mixture of new section 38 property and buildings that do not qualify as section 38 property. On August 1, 1982, X sells the new section 38 property in the facility to Y and leases it

back under an agreement in which the parties elect to be treated as a lease described in section 168(f)(8). Assuming that the other requirements of this paragraph are met, the new section 38 property contained in the facility will be qualified leased property. If it is later determined that property subject to the section 168(f)(8) lease is not new section 38 property (and thus not qualified leased property), the safe harbor protection will be lost only as to that property.

*Example (2).* X Corp. acquires a certain piece of equipment (which is new section 38 property) for use in its business. Within 3 months, X sells a 70 percent undivided interest in the property to lessor A and a 10 percent undivided interest in the property to lessor B and leases both portions back under separate section 168(f)(8) leases. The investment tax credit and ACRS deductions associated with the property will be divided among X, lessor A, and lessor B, on a basis of 20 percent, 70 percent, and 10 percent, respectively.

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#### § 5c.168(f)(8)-7 Reporting of income, deductions and investment tax credit; at risk rules.

(a) *In general.* The fact that the lessor's payments of interest and principal and the lessee's rental payments under the lease are not equal in amount will not prevent the lease from qualifying under section 168(f)(8). However, see paragraph (b) for special requirements in sale and leaseback transactions. In determining the parties' income, deductions, and investment tax credit under the lease, the rules in paragraphs (c) through (g) of this section shall apply regardless of the overall method of accounting otherwise used by the parties.

(b) *Requirements for sale and leaseback transaction.* If the property leased is financed by the lessee (or a related party of the lessee) in a sale and leaseback transaction, the lease will not qualify under section 168(f)(8) unless—

(1) The term of the lessor's purchase money obligation is coterminous with the term of the lease, and

(2) The lessor's obligation bears a reasonable rate of interest. For this purpose, a rate of interest shall be presumed to be reasonable if, on the date the agreement is executed, it is within 3 percentage points of (i) the rate in effect under section 6621, the prime rate in effect at any local commercial bank,

or the most recent applicable rate determined by the Secretary under § 1.385–6 (e)(2)(i), or (ii) an arm's-length rate as defined in § 1.482–2, or (iii) any rate between any two of the rates described by subdivisions (i) and (ii) of this paragraph(b)(2).

(c) *Interest deductions and income*—(1) *Deductibility from income.* In determining the amount of interest that a lessor may deduct in a taxable year with respect to its purchase money obligation given to the lessee or to a third party creditor, the lessor may not claim a deduction that would be—

(i) Greater than a deduction that would be allowed to an accrual basis taxpayer under a level-payment mortgage, amortized over a period equal to the term of the lessor's obligation, or

(ii) Less than a deduction that would be allowed to an accrual basis taxpayer under a straight line amortization of the principal over the term of the lessor's obligation.

In cases in which the property is not financed by the lessee or a party related to the lessee, the computation of the interest deduction may take into account fluctuations in the interest rate which are dependent on adjustments in the prime rate or events outside the control of the lessor and the third party creditor.

(2) *Includibility in income.* The lessee shall include interest on the lessor's purchase money obligation in income at the same time and in the same amount as the lessor's interest deductions, as determined under paragraph (c)(1).

(d) *Rental income and deductions*—(1) *Deductibility from income.* The amount of the lessee's rent deduction under a section 168(f)(8) lease with respect to any taxable year shall be a pro rata portion of the aggregate amount required to be paid by the lessee to the lessor under the terms of the lease agreement. If the lessee is required to purchase the leased property at the end of the lease term, of if the lessor has an option to sell the property to the lessee, rent shall not include the lesser of—

(i) The amount of the lessee's purchase obligation, whether fixed by the terms of the lease agreement or conditioned on the exercise of the lessor's

option to sell the property to the lessee, or

(ii) The fair market value of the property at the end of the lease term determined at the beginning of the lease term.

For this purpose, fair market value shall be determined without taking into account any increase or decrease for inflation or deflation during the lease term. Rent deductions may be adjusted pursuant to the terms of the lease agreement to account for fluctuations which are dependent on events outside the control of the lessor and lessee, such as a change in the interest rate charged by a third party creditor of the lessor on the debt incurred to finance the purchase of the leased property.

(2) *Includibility in income.* The lessor shall include rent in income as follows:

(i) In the case of prepayments of rent, the earlier of when such rent is paid by the lessee or accrued under the lease, and

(ii) In the case of other rent, at the same time and in the same amount as the lessee's rent deductions, as determined under paragraph (d)(1).

(e) *ACRS deductions.* The deductions that the lessor is allowed under section 168(a) with respect to property subject to a section 168(f)(8) lease shall be determined without regard to the limitation in section 168(f)(10)(B)(iii). The recovery class of qualified leased property in the hands of the lessor shall be determined by the character of the property in the hands of the owner of the property without regard to section 168(f)(8). Any elections under section 168(b)(3) by the lessor with respect to the class of recovery property to which the qualified leased property is assigned shall apply to the leased property. However, with respect to RRB replacement property, the transitional rule of section 168(f)(3) shall be inapplicable to the lessor.

(f) *At risk requirements.* The amount of the investment credit and ACRS deductions that a lessor shall be allowed with respect to the leased property shall be limited to the extent the at risk rules under the investment tax credit provisions and section 465 apply to the lessee or to the lessor. In determining the amount the lessee would be

at risk, the at risk rules will be applied as if the lessee had not elected to have section 168(f)(8) apply. Thus, for example, if, without regard to section 168(f)(8), an individual lessee would be treated as the owner of the leased property for Federal tax law purposes, the lessor under a section 168(f)(8) lease would be allowed ACRS deductions or investment tax credits with respect to the property only to the extent that the lessee may have claimed them had the parties not elected treatment under section 168(f)(8). In addition, the ACRS deductions and investment tax credits that a lessor is allowed with respect to the property are further limited to the extent that the at risk rules apply to the lessor as owner of the property under the section 168(f)(8) lease. If the lessor and the lessee are subject to the at risk rules, the lessor is allowed only the lesser of the ACRS deductions and investment tax credits allowable to the lessor and the lessee.

(g) *Limitation on section 48(d) amount.* If in a sale and leaseback transaction the lessor elects pursuant to section 48(d) to treat the lessee (which is the user of the property) as having acquired the property for purposes of claiming the investment tax credit, the lessee shall be treated as acquiring the property for an amount equal to the basis of the property to the lessor (and not for an amount equal to its fair market value). The investment tax credit allowable to the lessee is further limited to the extent the at risk rules apply to either the lessor or to the lessee. See paragraph (f) of this section.

(h) *Examples.* The application of the provisions of this section may be illustrated by the following examples.

*Example (1).* Y, a qualified lessor, acquires a piece of equipment which is qualified leased property for \$1 million and leases it to X under a lease which the parties properly elect to have characterized as a lease described in section 168(f)(8). The equipment has a 10-year economic life and falls within the 5-year ACRS class. Under the terms of the lease, X, the lessee-user, is obligated to pay Y nine annual payments of \$10,000 and, at the end of the lease term, Y has the option to sell the property to X for \$2,160,000. Under § 5c.168(f)(8)-7(d), the aggregate payments required to be made by X under the lease are \$2,250,000 (\$90,000 rent plus \$2,160,000 option price) and are treated as rent to Y (less a reasonable estimate for the residual value of

the property) and taxable as such. Assuming a reasonable estimate of the residual value is zero, the full \$2,250,000 will be treated as rent, and under § 5c.168(f)(8)-7(d), such amount is deductible by X and includible in Y's income ratably over the term of the lease, *i.e.*, at a rate of \$250,000 per year (\$2,250,000 divided by 9).

*Example (2).* The facts are the same as in example (1) except that under the terms of the lease X is obligated to make rental payments of \$100,000 for each of the first 5 years of the lease and \$300,000 for each of the 4 remaining years under the lease. Further, X has an option to purchase the equipment for \$1.00 at the end of the lease term. Pursuant to § 5c.168(f)(8)-7(d), X's aggregate rental payments are deductible by X and are includible in Y's income ratably over the term of the lease. Thus, the annual rental payments are deemed to be \$188,000 per year (\$1,700,000 divided by 9).

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#### § 5c.168(f)(8)-8 Loss of section 168(f)(8) protection; recapture.

(a) *In general.* Upon the occurrence of an event that causes an agreement to cease to be characterized as a lease under section 168(f)(8), the characterization of the lessor and lessee shall be determined without regard to section 168(f)(8).

(b) *Events which cause an agreement to cease to be characterized as a lease.* A disqualifying event shall cause an agreement to cease to be treated as a lease under section 168(f)(8) as of the date of the disqualifying event. A disqualifying event shall include the following:

(1) The lessor sells or assigns its interest in the lease or in the qualified leased property in a taxable transaction.

(2) The failure by the lessor to file a copy of the information return (or applicable statement) with its income tax return as required in § 5c.168(f)(8)-2(a)(3)(iii).

(3) The lessee (or any transferee of the lessee's interest) sells or assigns its interest in the lease or in the qualified leased property in a transaction not described in § 5c.168(f)(8)-2(a)(6) and the transferee fails to execute, within the prescribed time, the consent described in § 5c.168(f)(8)-2(a)(5), or either the lessor or the transferee fail to file statements with their income tax returns as required by that paragraph.