§ 5c.168(f)(8)–6 Qualified leased property.

(a) *Basic rules*—(1) *In general.* An agreement shall be treated as a section 168(f)(8) lease only if the property which is leased is qualified leased property. Qualified leased property is recovery property as defined in section 168(c) and is either—

(i) Except as provided in subparagraph (2), new section 38 property of the lessor which is leased no later than 3 months after the date the property was placed in service (or prior to November 14, 1981, if the property was placed in service after December 31, 1980, and before August 14, 1981) and which, if acquired by the lessee, would have been new section 38 property of the lessee, or

(ii) 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 proceeds from an issue of obligations the interest on which is excludable from income under section 103(a).

(2) *Sale and leaseback arrangement.* (i) Where the leased property is purchased, directly or indirectly, by the lessor from the lessee (or a party related to the lessee), the property will not be qualified leased property unless the property was (or would have been) new section 38 property of the lessee and was purchased and leased no later than 3 months after the date the property was placed in service by the lessee (or prior to November 14, 1981, if the property was placed in service by the lessee after December 31, 1980 and before August 14, 1981) and with respect to which the lessor's adjusted basis does not exceed the adjusted basis of the lessee (or a party related to the lessee) at the time of the lease. If the lessor's adjusted basis in the property exceeds the seller's adjusted basis with respect to the property at the beginning of the lease, the property will not be qualified leased property.

(ii) For purposes of this paragraph (a)(2) and paragraph (b)(3)(ii) of this section, transactional costs with respect to a sale and leaseback arrangement that are not currently deductible shall be allocated to the lease agreement (and not included in the lessor's adjusted basis with respect to the property) and amortized over the term of the lease. These costs include legal and investment banking fees and printing costs.

(iii) The application of this paragraph (a)(2) may be illustrated by the following examples:

Example (1). X, an airline, contracts to have an airplane constructed for a fixed price of $10 million. Prior to completion of construction of the airplane, the value of the airplane increases to $11 million. X buys the airplane at the contract price of $10 million and, before it is placed in service, sells the airplane at its fair market value of $11 million to Y and then leases it back. The lease will not qualify for safe harbor protection under section 168(f)(8) because the lessor's adjusted basis in the airplane exceeds the lessee's adjusted basis. This result obtains even though the airplane qualifies as new section 38 property of X airline.

Example (2). Assume the same facts as in example (1) except that, prior to completion of the construction of the airplane, X assigns its contract to Y for $1 million, and Y thereafter buys the airplane at the contract price of $10 million. The acquisition by Y is treated as an indirect purchase from the lessee. Because Y's adjusted basis in the airplane would exceed the lessee's adjusted basis, the lease will not qualify under section 168(f)(8).

(b) *Special rules*—(1) *New section 38 property.* (i) New section 38 property is section 38 property described in subsection (b) of section 48 and the regulations thereunder other than a qualified rehabilitated building (within the meaning of section 48(g)(1)). Qualified leased property must be new section 38 property at the beginning of the lease and must continue to be section 38 property in the hands of the lessor and the lessee throughout the lease term. The fact that the lessee used the property within the 3-month period prior to the lease will not disqualify the property as new section 38 property of the lessee.

(ii) The application of this paragraph (b)(1) may be illustrated by the following examples:

Example (1). N is a hospital exempt from Federal income tax and wishes to purchase certain equipment for use in furtherance of its exempt functions (*i.e.*, other than for use in an unrelated trade or business). O, a qualified lessor as defined in § 5c.168(f)(8)–3(a), acquires the property and leases it to N. Since the equipment would not be new section 38 property of N if N had acquired it by virtue of section 48(a)(4) (relating to exception from definition of section 38 property for certain property used by certain tax-exempt organizations), the equipment is not qualified leased property and the lease does not qualify under section 168(f)(8). Whether O is considered the owner of the property for Federal tax law purposes will be determined without regard to the provisions of section 168(f)(8).

Example (2). P Corp. is constructing progress expenditure property as defined in section 46(d)(2) for R Corp. Progress expenditure property is property which it is reasonable to believe will be section 38 property in the hands of the taxpayer when it is placed in service. Before the date that the property is placed in service (as defined in § 5c.168(f)(8)–6(b)(2)(i)), the property is not new section 38 property. Accordingly, progress expenditure property cannot be qualified leased property.

Example (3). R Corp., a foreign railroad, acquires new rolling stock and enters into a sale and leaseback transaction with B Corp., a domestic corporation. R uses the rolling stock within and without the United States, but predominantly outside the United States within the meaning of section 48(a)(2)(A). Section 48(a)(2)(B)(ii) is inapplicable to R because R is neither a domestic railroad corporation nor a United States person; therefore, the rolling stock cannot be section 38 property to R. The property is not qualified leased property.

(2) *Placed in service.* (i) Property shall be considered as placed in service at the time the property is placed in a condition or state of readiness and availability for a specifically assigned function. If an entire facility is leased under one lease, property which is part of the facility will not be considered placed in service under this rule until the entire facility is placed in service. If the lessee claims any investment tax credit or ACRS deductions with respect to any component which is part of an entire facility that is subsequently leased, the lessee must file an amended return within the time prescribed in paragraph (b)(2)(ii) of this section in which it foregoes its claim to the investment tax credit and ACRS deductions. If such amended return may not be filed because the time for filing a claim for refund with respect to any component under section 6511 has expired, each component of the facility will be considered as placed in service at the time the individual component is placed in a condition or state of readiness and availability for a specifically assigned function and not when the entire facility is placed in service.

(ii) For purposes other than determining whether property is qualified leased property, property subject to a lease under section 168(f)(8) will be deemed to have been placed in service not earlier than the date such property is used under the lease. If the lessee claims any investment tax credit or ACRS deductions with respect to property placed in service under a lease, the lessee must file an amended return within 3 months following the execution of the lease agreement in which the lessee foregoes its claim to the investment tax credit and ACRS deductions with respect to the leased property or the election under section 168(f)(8) will be void.

(iii) The application of this paragraph (b)(2) may be illustrated by the following examples:

Example (1). X Corp. acquires equipment on December 31, 1982, and places the equipment in service. X's taxable year ends December 31. On March 20, 1983, X sells the equipment to Y Corp. and leases it back in a transaction that qualifies under section 168(f)(8). The property is considered to be new section 38 property to X under paragraph (b)(1). X is not allowed any investment tax credit or ACRS deductions with respect to the property in 1982 because the property is not considered to have been placed in service for purposes other than determining whether it is qualified leased property until it is used under the lease under subdivision (ii) of this subparagraph (2). If X has claimed credits or deductions on its 1982 return, it must file an amended return for 1982 within 3 months following the execution of the lease agreement or the election will be void.

Example (2). In March 1985, K Corp. completes reconditioning of a machine, which it constructed and placed in service in 1982 and which has an adjusted basis in 1985 of $10,000. The cost of reconditioning amounts to an additional $20,000. K would be entitled to a basis of $20,000 in computing its qualified investment in new section 38 property for 1985. In May 1985, K enters into a sale and leaseback transaction with L Corp. with respect to the reconditioned parts of the machine that are new section 38 property to K. K and L elect to have section 168(f)(8) apply. Assuming that the adjusted basis of the leased property is the same to L as it is to K, the property qualifies as qualified leased property under section 168(f)(8)(D)(ii) and L is considered the tax owner of the property. Since, for purposes other than determining whether property is qualified leased property, the property is deemed originally placed in service not earlier than the date the property is used under the lease, the property is new section 38 property to L and L may claim the investment tax credit (and ACRS deductions) with respect to the leased property.

(3) *Qualified mass commuting vehicle.* (i) A qualified mass commuting vehicle as defined in section 103(b)(9) will constitute qualified leased property for purposes of section 168(f)(8)(D)(iii) and this section provided all of the following requirements are met:

(A) At least part (as, for example, 5 percent) of the financing for the purchase of such vehicle must be derived from proceeds of obligations the interest on which is excludable from income under section 103(a)(1) (whether or not such obligations are described in section 103(b)(4)(I));

(B) The vehicle must be recovery property (*i.e.*, it must have been first placed in service by the lessee after December 31, 1980); and

(C) The vehicle must not have been previously leased under a section 168(f)(8) lease by the lessee.

A qualified mass commuting vehicle that is qualified leased property may be leased under section 168(f)(8) at any time after December 31, 1980. The requirement of paragraph (b)(3)(i)(A) of this section may be satisfied where the vehicles leased under a section 168(f)(8) lease are refinanced with proceeds of an obligation the interest on which is excludable from income under section 103(a)(1).

(ii) Where the leased property is purchased, directly or indirectly, by the lessor from the lessee (or a party related to the lessee), the property will not qualify under this subsection unless the lessor's adjusted basis in the property does not exceed the adjusted basis of the lessee (or related party) at the time of the execution of the lease. The adjusted basis of property to a lessee (or related party) shall be determined under Part II of Subchapter O of Chapter I of the Code for purposes of determining gain, except that the adjustment described in section 1016(a)(3) and §1.1016–4 need not be made for property acquired during calendar year 1981 and leased no later than March 1, 1982.

(iii) In a transaction characterized as a lease under section 168(f)(8), the lessor's adjusted basis may not include that portion, if any, of the cost of the vehicle to the lessee (or related party) that is financed, directly or indirectly, with an Urban Mass Transportation Administration (UMTA) grant (excluding a grant under the interstate transfer provision of the Federal-Aid Highway Act (FAHA)), a FAHA grant, or any other Federal grant. Where a vehicle is included as part of an UMTA-funded project, 80 percent of the vehicle's cost will be deemed to be financed with an UMTA grant and 20 percent will be deemed to be financed from non-Federal sources without regard to whether the UMTA funds or the non-Federal funds are traceable to any particular vehicle included within the project. For purposes of this subparagraph and paragraph (b)(3)(ii) of this section, amounts originating from non-Federal sources which are paid or incurred with respect to leased property by a State or political subdivision of the State (or political subdivision created by the joint authorization of two or more States) shall be taken into account in computing the lessee's adjusted basis in the leased property as if the lessee had paid or incurred such amounts.

(iv) If a vehicle is purchased pending approval of an UMTA grant, the lessor's unadjusted basis in the vehicle may equal the lessee's unadjusted basis unreduced by any subsequently approved UMTA grant; however, if an UMTA grant is later approved and the vehicle is included as part of an UMTA-funded project, except as provided hereinafter in this subparagraph, the lease shall terminate with respect to an undivided 80 percent interest in the vehicle. For the Federal income tax consequences of the termination of a lease, see §5c.168(f)(8)–8. If such a subsequently approved UMTA grant is used to purchase additional qualified mass commuting vehicles, the portion of each vehicle deemed to be allocable to non-UMTA financing (*i.e.*, 20 percent) may be leased under section 168(f)(8). If a vehicle is purchased pending approval of an UMTA grant and leased under section 168(f)(8), the lease will not be deemed to have terminated with respect to 80 percent of the vehicle when the UMTA grant is later approved if the total interest leased before the grant is approved did not exceed 20 percent of the lessee's adjusted basis in the vehicle (unadjusted basis prior to March 1, 1982) unreduced by any subsequently approved UMTA grant. For purposes of this subparagraph and paragraph (b)(3)(iii) of this section, the allocation principles applicable to UMTA grants shall apply in the case of FAHA grants except that 85 percent and 15 percent shall be substituted for 80 percent and 20 percent, respectively. Similar allocation rules shall also apply to other Federal grants used to finance the acquisition of qualified mass commuting vehicles.

(v)(A) Notwithstanding the provisions of § 5c.168(f)(8)–2(a)(3)(iii), the lessee in a transaction to which this paragraph (b)(3) applies is not required to file an information return or a statement concerning its election under section 168(f)(8).

(B) Notwithstanding the provisions of § 5c.168(f)(8)–2(a)(5), if the transfer of a qualified mass commuting vehicle is not otherwise a disqualifying event, the transferee is not required to file the statement mentioned therein.

(C) The fact that a qualified mass commuting vehicle is not section 38 property because it is used by an exempt entity will not disqualify the lease under § 5c.168(f)(8)–8(b)(4); however, a disqualifying event will occur, and the agreement will cease to be characterized as a lease under section 168(f)(8), with respect to a vehicle which (*1*) ceases to be a qualified mass commuting vehicle or (*2*) would cease to be section 38 property if used by a taxable entity as, for example, a vehicle used predominantly outside the United States. For the Federal income tax consequences of a disqualifying event, see § 5c.168(f)(8)–8.

(vi) The lessor of a qualified vehicle will not be allowed an investment tax credit with respect to it under section 38.

(vii) The application of this paragraph (b)(3) may be illustrated by the following examples:

Example (1). On July 1, 1981, a unit of city X, X Transit Authority (XTA), purchases 100 buses after receiving an UMTA grant for 80 percent of their purchase price. Fifteen percent of the purchase price is financed with a combination of State and local governmental grants and 5 percent is financed with proceeds from an issue of tax-exempt obligations described in section 103(b)(4)(I). Because UMTA financed an 80 percent interest in the 100 buses, XTA may lease under section 168(f)(8) only a 20 percent interest in each bus. If XTA were to lease 100 percent of 20 buses, only 20 percent of such buses would be deemed to be leased under a safe harbor lease.

Example (2). The facts are the same as in example (1) except that UMTA has not yet approved XTA's application in 1981. Pending the UMTA approval, XTA purchases and places in service 20 buses in July 1981. The 20 buses are financed with tax-exempt obligations described in section 103(b)(4)(I). On December 15, 1981, XTA sells a 100 percent interest in these 20 buses to Corporation M and leases them back under a lease in which the parties elect to have the provisions of section 168(f)(8) apply. M is a calendar-year taxpayer and claims an ACRS deduction with respect to the buses on its return for taxable year 1981. On July 1, 1982, UMTA approves XTA's grant application, thus enabling XTA to purchase an additional 80 buses. Because 80 percent of the original 20 buses are deemed to have been financed by UMTA beginning on July 1, 1982, the safe harbor lease terminates with respect to an undivided 80 percent interest in the 20 buses. If XTA would be considered the owner of the buses without regard to section 168(f)(8), the termination will result in a deemed sale of an undivided 80 percent interest in the 20 buses by M to XTA. The amount realized by M on the sale will include a proportionate part of the outstanding amount of M's debt plus the sum of any other consideration received by M. M will realize gain or loss, depending upon its basis, with applicable section 1245 recapture. However, XTA may lease the 20 percent interest in the 80 new buses it purchased in 1982 which is deemed to have been financed with non-Federal funds.

Example (3). The facts are the same as in example (2) except that the grant approved by UMTA is used to purchase and renovate a bus garage facility. Eighty percent of the original 20 buses are deemed to have been financed by UMTA beginning on July 1, 1982. The lease would still terminate with respect to an undivided 80 percent interest in the vehicles. XTA cannot lease the garage facility under 168(f)(8) because it does not constitute a qualified mass commuting vehicle.

Example (4). The facts are the same as in example (2) except that on December 15, 1981, XTA sells and leases back only a 20 percent interest in the 20 buses acquired in July 1981.

When the UMTA grant is later approved, the lease will not terminate with respect to any portion of the 20 buses. In addition, XTA may lease the 20 percent interest in the 80 new buses purchased in 1982 and deemed to have been financed with non-Federal funds.

Example (5). On August 1, 1982, UMTA approves a grant for a major 5-year capital expenditure program to improve city Y's rapid rail transit system. None of the funds relating to this UMTA-funded project, provided either by UMTA or by city Y, will be used to purchase qualified mass commuting vehicles. Instead, a number of rapid rail cars and buses will be purchased entirely with funds provided with a combination of grants by the State and city governments and of proceeds from an issue of tax-exempt obligations described in section 103(a). Because none of the rapid rail cars and buses are included as part of the UMTA-funded project, no part of them is deemed to be financed by UMTA. If at least 5 percent of the cost of the qualified mass commuting vehicles is provided by tax exempt obligations under section 103(a), the vehicles will be qualified leased property in their entirety.

Example (6). City Z has a mass transit agency (ZTA) which purchases on July 1, 1982, 10 buses for which it pays $1,000,000, 95 percent of which is derived from grants from city Z and 5 percent from tax exempt obligations described in section 103(a). The buses have a useful life within the meaning of §1.167(a)–1(b) of 10 years and their salvage value is zero. On July 1, 1983, ZTA sells these buses to corporation P and leases them back in a transaction which the parties elect to have treated as a lease under section 168(f)(8). At the time of the sale and leaseback, ZTA's adjusted basis in the 10 buses under section 1016(a)(3) and §1.1016–4 is $900,000 ($1,000,000 cost less $100,000 of depreciation sustained, computed on a stright-line basis). Before the transaction will qualify under section 168(f)(8) and §5c.168(f)(8)–6(b)(3)(ii), P's adjusted basis in the vehicles may not exceed ZTA's basis, or $900,000. Assuming that the transaction qualifies under section 168(f)(8) and that corporation P is a calendar year taxpayer, P may claim ACRS deductions for 1982 of $135,000 (15 percent of $900,000).

Example (7). The facts are the same as in example (6) except that the sale and leaseback transaction is closed on December 31, 1982. P's adjusted basis in the vehicles may not exceed ZTA's basis, or $950,000 ($1,000,000 cost less $50,000 of depreciation sustained, computed on a straight-line basis).

Example (8). The facts are the same as in example (6) except that ZTA purchases the buses on June 1, 1981, and enters into the sale and leaseback transaction with corporation P on December 31, 1981. Under §5c.168(f)(8)–6(b)(3)(ii), no adjustment is made to ZTA's basis in the buses for depreciation sustained. Therefore, P's basis in the buses may equal ZTA's cost of $1,000,000.

Example (9). On July 1, 1981, a unit of city W, W Transit Authority (WTA), purchases 100 buses with local grants derived entirely from a city W sales tax. The buses do not constitute qualified leased property under §5c.168(f)(8)–6(b)(3) because no part of the financing for their purchase was derived from the proceeds of tax exempt obligations.

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 leasee) 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