Practitioner Notes Misstatements In Sheppard's REIT Article

To the Editor:

I have been reading Lee Sheppard's articles since she was writing about the check-the-box regulations in their proposed form. Her articles often cover a large swath of the tax law, which can be challenging to do under a deadline. This letter is to correct three misstatements in her article ''Can Any Company Be a REIT?'' (*Tax Notes*, Aug. 19, 2013, p. 755).

The article suggests that the renewable energy industry has made a strategic decision to trade sun-setting tax credits for inclusion of income from renewable energy projects in the eligibility test for master limited partnerships (MLPs) in section 7704. Specifically, the article provided:

> What about all those green energy tax credits Congress so enthusiastically passes? Those are too ephemeral to justify sustained investment (e.g., sections 40A, 45, 45K, 54, 54C). The renewables crowd has concluded it is better off with a permanent tax-free vehicle. It has also looked at master limited partnerships. Sen. Christopher A. Coons, D-Del., sponsored S. 795, the Master Limited Partnerships Parity Act of 2013, to enable renewable energy producers to use this form of organization.

Statements from the renewable energy industry's proponents make it clear that the industry has not decided ''it is better off'' with MLP expansion than tax credits. For instance, Dan Reicher, formerly a Google executive responsible for renewable energy and before that a Department of Energy official, who is currently a professor at Stanford, testified on July 31 to a Senate subcommittee: ''*I want to emphasize strongly that my support for MLPs and REITs should in no way signal that I endorse an immediate phase-out of PTC or any weakening of the current ITC. The PTC and ITC have been critical catalysts in the growth of U.S. renewables*'' (emphasis in the original).[1] This statement is important as Reicher coauthored a *New York Times* editorial that led to the idea of MLP for renewables entering Washington's consciousness.[2]

On April 24, the American Council on Renewable Energy (ACORE) along with a host of companies involved in renewable energy submitted a letter to senators and representatives that provided:

> *Supplementing* the existing federal investment tax credit (ITC) and production tax credit (PTC) with MLPs could work for renewable energy and other clean energy technologies as it has for oil and gas. The ITC and PTC have been foundational to spurring private sector investment, creating jobs, and driving down costs significantly, to the point where some renewable technologies are approaching cost competitiveness. [Emphasis added.]

It would appear likely that the word ''supplementing'' was selected carefully to avoid the impression that MLP was preferable to tax credits.

Further, a wind industry publication quotes Peter Kelley of the American Wind Energy Association (AWEA) as saying that ''AWEA supports the MLP Parity Act to allow everyday Americans to invest in renewable energy, as they are able to do with other energy sources. Extending the PTC is the industry's top priority; given its effectiveness in driving renewable energy development in the U.S., MLPs can complement the PTC.''[3]

Finally, another article quotes Joseph Condo, the general counsel of a major developer of energy projects, as saying, ''some folks that aren't especially fond of the PTC sort of took it upon themselves to state publicly that their opinion was that this is a trade-off. And again, that's not coming from the supporters and drafters of the legislation.''[4]

Sheppard's article contained a separate tangent about leasing in which there were misstatements of U.S. generally accepted accounting principles and of federal tax law. As to GAAP, the article provided:

> Financial accounting generally considers a long-term ''capital'' lease to be a transfer of

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[1]Dan W. Reicher, Written Testimony to the Senate Finance Committee, Subcommittee on Energy, Natural Resources, and Infrastructure, Hearing on Principles for Energy Tax Reform (July 31, 2013).

[2]*See* Felix Morgan and Reicher, ''How to Make Renewable Energy Competitive,'' *The New York Times* (June 1, 2012).

[3]Mark Del Franco, ''Controlling the Message,'' North American WindPower (June 2013).

[4]Darren Goode, ''Will MLP Campaign Put Wind Tax Credit at Risk?'' *Politico* (June 6, 2013).

> real property ownership, provided the term is 75 percent of the useful life of the property, and the present value of rent payments is 90 percent of its value. A capital lease is booked as a balance sheet asset and an obligation representing the present value of lease payments. Basically, this is loan treatment (ASC Topic 840).

First, ASC 840 contains a four-part test[5] to distinguish between an ''operating lease'' and what is referred to as a ''capital lease'' with respect to a lessee or a ''direct finance lease'' with respect to a lessor. Capital lease treatment results from the lease not satisfying *any* one of the four tests. Therefore, it is a disjunctive test, while the use of ''and'' in the first quoted sentence improperly suggests it is a conjunctive test.

As to federal tax law, the article provided: ''Any lease that is not a capital lease is an operating lease. A short-term 'operating' lease is classified as a lease with payments expensed on the income statement. *But to the IRS, a lease is a lease*.'' This appears to suggest that the federal income tax law does not distinguish between a lease that vests ownership in the lessor, which is known as a true lease, and lease that is treated as a loan from the putative lessor.

The distinction between a true lease and a disguised loan has been addressed in published guidance for almost 60 years.[6] Further, two Supreme Court cases have addressed the issue.[7] And just this month the Tax Court opinion found certain sale-in, lease-out and lease-in, lease-out transactions to not be leases as their form suggested but to rather be loans; thus, reminding us that to the IRS a lease is not always a lease.[8]

Possibly, the quoted language was intending to make the point that the tax law has a different test than GAAP for distinguishing between a lease and a loan. It is worth noting that the accounting standard setters are apparently displeased with the current GAAP test for leases and would like to put in place a completely different and complex set of rules.[9] Such gyrations in the financial accounting world make the federal income tax ''true lease'' doctrine appear rather sensible.

Thank you for your consideration.

Sincerely,

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Aug. 21, 2013

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[5]The four tests are the two referred to in Sheppard's article, plus tests about bargain purchase options and automatic transfer of ownership of the leased property at the end of the term.

[6]Rev. Rul. 55-540, 1955-2 C.B. 239.

[7]*Helvering v. F.R. Lazarus & Co.*, 308 U.S. 252 (1939) (a 99-year lease of a retail store is a sale to the ''lessee''); *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978) (the lessor was the owner of a building acquired in a sale-leaseback, despite the lessee having multiple fixed price purchase options and the lessor borrowing much of the cost of the building).

[8]*John Hancock Life Insurance Co. v. Commissioner*, 41 T.C. No. 1 (2013) (''we find that John Hancock did not acquire the benefits and burdens of ownership. . . . [T]he transaction resembles a loan from John Hancock'').

[9]The Financial Accounting Standards Board and the International Accounting Standards Board have an on-going project to eliminate this standard and replace it with a complex regime that results in every transaction generating an asset *and* a liability on the books of *each* of the lessor and the lessee. FASB Exposure Draft Leases (Topic 842) (May 16, 2013).