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Safe-Harbor Leasing: Separating the Wheat from the Chaff

by Amy L. Kerka and Owen F. Humpage

In August 1981 the U.S. Congress enacted the Economic Recovery Tax Act (ERTA) to stimulate investment in plants and equipment through expanded investment tax credits and a more rapid method of depreciation. Before this legislation, firms that did not generate sufficient taxable income could not take full advantage of tax incentives for investment. Consequently, these firms faced an effective cost of capital some 10 percent to 30 percent higher than their more profitable counterparts.[1] The 1981 tax-law revisions allowed low-profit or profitless firms to sell their tax benefits to more profitable firms. The intent of these new rules, called the safe-harbor leasing provisions, was to equalize the cost of capital for all firms, that is, to allow a more even distribution of tax incentives for investment under the U.S. corporate-income-tax code.[2]

Since their introduction, the safe-harbor provisions have been under constant attack. Critics argue that safe-harbor leasing creates a large drain on the U.S. Treasury at a time when this country faces triple-digit budget deficits. Critics also charge that the program is not well targeted, that it gives benefits to highly profitable firms and middlemen as well as to firms that otherwise could not fully benefit from the investment incentives in the corporate-tax code. Safe-harbor leasing also has been criticized for not increasing investment. Many critics view it simply as a dole to profitless firms. Because of such outcries, Congress included measures in the Tax Equity and Fiscal Responsibility Act enacted in August 1982 to curtail many of the benefits derived from safe-harbor leasing and to eliminate safe harbor by the end of 1984.

This *Economic Commentary* discusses the criticisms of safe-harbor leasing that led to the demise of the program. Despite very real problems, however, safe-harbor leasing raises some important issues

1. Michael A. Verespej, "The Assault on 'Safe Harbor' Leasing," *Industry Week*, vol. 213, no. 6 (June 14, 1982), pp. 84–88.

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NOTE: No issues of the *Economic Commentary* were published in August or September.

2. Firms that participate in these tax-benefit sales are free from IRS prosecution—hence, the term ***safe harbor***. See Verespej, "The Assault on 'Safe Harbor' Leasing."

the transaction costs for small-lease arrangements appear to be no greater, relative to the size of the transactions, than they are for large-lease transactions.[5] This suggests that small companies can participate in the program as easily as large companies. More small-company participation would be expected as familiarity with safe-harbor leasing grew and companies that specialized in arranging safe-harbor transactions between prospective buyers and sellers developed.

Has Safe Harbor Spurred Investment?

The real evaluation of safe-harbor leasing rests largely on its ability to spur investment. Unfortunately, detailed analysis of this aspect of the program is impossible because of insufficient data; most studies have concentrated on the revenue and targeting issues. A study conducted by the Joint Committee on Taxation and based on a hypothetical model of firms generally concludes that safe-harbor leasing provides investment incentives for temporarily nontaxable firms equal to the incentives for fully taxable firms; that is, the after-tax rate of return on investment among firms equalizes with the introduction of safe-harbor leasing. The committee also finds that safe-harbor leasing provides firms that remain nontaxable for a long period of time a greater incentive to invest than a fully taxable firm. Having surveyed 31 tax-benefit sellers and 11 buyers, Arthur Andersen & Co. concludes that safe-harbor leasing does not offer much of a spur to investment.[6] According to the report, 71 percent of the firms surveyed indicated that past investments were not affected by the safe-harbor leasing provisions and 45 percent of the firms would still go ahead with their capital-spending plans without the safe-harbor leasing provisions.[7] Nevertheless, the report indicates that 29 percent of the respondents altered past investments because of safe-harbor leasing and that 42 percent would delay or trim future capital spending if the safe-harbor leasing program were repealed.

Unfortunately, these findings on the investment response to safe-harbor leasing are inconclusive. The program is relatively new, and many firms probably have not become fully acquainted with it. Moreover, because of the recently legislated changes in safe harbor and the phasing out of the program, an adequate test of its investment incentive is unlikely. It is impossible to tell how the effects of recent high interest rates and the recession are reflected in the responses of the surveys. Ultimately, holding all such factors constant, any program that lowers the cost of capital would spur investment.

The Wheat vs. the Chaff

Safe-harbor leasing has been portrayed as an expensive, poorly targeted program that functions more as a tax loophole for profitable firms and a dole for unprofitable firms than a significant spur to investment. Although a detailed analysis of these contentions is lacking, available information provides some rather ambiguous support for these views. On the other hand, if the government is going to use the tax system to encourage investment, should the benefits be offered in such a way as to allow firms not generating sufficient taxable income to be able to benefit equally? Should not the investment incentives contained in the tax code be available to all firms?

Although the Joint Committee on Taxation's analysis suggests that safe harbor benefits firms experiencing long-term losses, it is doubtful that safe harbor alone can prevent dying firms from going bankrupt. Safe harbor is more likely to provide a boost to the cash flow of firms that are temporarily generating insufficient income to benefit fully from the investment incentives in the U.S. tax code. Often such firms are new and/or rapidly growing with potential for steady longer-term growth and profitability. Safe harbor enables such firms to face a cost of capital similar to their older, highly profitable counterparts. Often firms experience temporary losses because of recessions; safe-harbor provisions could enable such firms, especially hard-pressed manufacturers such as automobile and steel, to avoid cutting or postponing investment in capital equipment. These additional investments would immediately raise the profits of other firms. Because the trough in investment spending often lags the trough in general economic activity, sluggish investment tends to retard recoveries. If the safe-harbor program had been continued, it might not have altered this lag; yet, it might have provided significant countercyclical advantages in limiting the trough in investment. Safe-harbor benefits might not be sufficient to encourage investment in additional capital equipment during recessions, but they should help firms maintain investment in replacement capital.

Although safe-harbor leasing seems to be a dead issue, the concept is likely to re-emerge in the future when business activity again weakens and the federal budget deficit does not present its current constraints. Economists and legislators might consider alternatives to safe-harbor leasing that would preserve its useful elements while correcting its faults. Indeed, why discard the wheat with the chaff?

5. "Preliminary Report on Safe Harbor Leasing Activity in 1981" (Department of the Treasury, Office of Tax Analysis, March 26, 1982; processed).

6. Verespej, "The Assault on 'Safe Harbor' Leasing."

7. When safe-harbor leasing was introduced in August 1981, purchases made from the beginning of that year could be converted into safe-harbor leasing transactions. This did nothing to encourage capital investment in those months, as the investment had already taken place.

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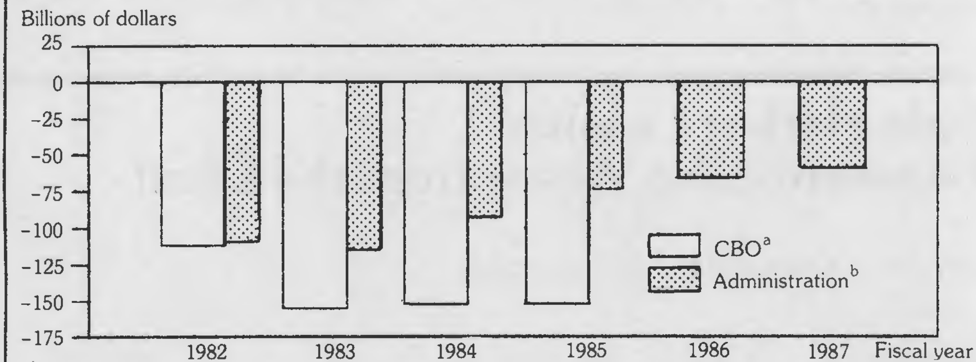

Chart 1 Federal Budget Estimates
Unified budget basis

a. Data from Congressional Budget Office, Analysis of First Concurrent Budget Resolution, September 1982.
b. Data from Office of Management and Budget, Mid-Session Review of the FY 1983 Budget, July 30, 1982.

worthy of further consideration. Foremost among these is whether *all* firms should benefit from the use of corporate tax incentives for investment.

The Mechanics

Safe-harbor leasing permits financial transactions in which firms with insufficient taxable income sell tax benefits to more profitable firms. In a typical safe-harbor lease, a firm with little or no profit—the seller—sells its newly acquired capital equipment to a profitable firm—the buyer—with income in excess of its allowable tax credits and deductions. The seller receives a cash payment plus a note for the balance of the value of the property but retains possession of the capital, which is now leased from the buyer. This transaction is called a ***sale leaseback.*** As nominal owner of the property, the buyer claims the accelerated cost recovery system (ACRS) deductions and the investment credit for the property. The seller incurs an annual rental fee for use of the property but receives credits for interest and principal on the purchaser's note. In most sale leasebacks, the rental and debt charges are equal so that no money except the initial cash payment is actually exchanged between seller and buyer. The equal rental and debt payments are said to ***wash,*** and these transactions are called ***wash leases***.[3]

The initial cash payment is effectively a payment from the buyer to the seller for the tax benefits associated with the capital equipment. It equals the share of the current value of these benefits going to the seller as negotiated between the two firms. The payment improves the cash flow of the seller firm, possibly avoiding layoffs and delaying cuts in investment projects.

Revenue Impact

The congressional decision to scale down and eventually end safe-harbor leasing occurred at a time when the administration was attempting to reduce huge budget deficits (see chart 1). Opponents of safe-harbor leasing argue that the program's provisions cause an unnecessary revenue drain on the Treasury (see table 1). Without any change in the safe-harbor-leasing program, both the Joint Committee on Taxation and the Treasury estimate that resultant net losses to the Treasury would grow from $3.2 billion in fiscal year (FY) 1982 to approximately $9.5 billion in FY 1986. Using Congressional Budget Office estimates of the federal budget deficit, the revenue loss would equal 2.9 percent of the deficit in FY 1982 and 4.7 percent in FY 1985. According to administration budget estimates, the loss could grow to 20 percent of the deficit in FY 1987.

3. Safe-harbor rules guarantee lease treatment for several types of financing arrangements in addition to those involving tax-credit and depreciation-allowance sales. The others are known as "leveraged" or "straight" leases and involve transactions where a third party owns the leased property. According to the Treasury, 2,120 of the 12,036 leases drawn up in 1981 were of the tax-credit sale, or wash, variety. In dollar terms, wash leases accounted for 80 percent of the $19.3 billion in leased property for that year.

As both the Treasury and the Joint Committee on Taxation observe, such revenue losses are very difficult to measure. Recent changes in the investment tax credit and the method of calculating depreciation deductions, together with the sharp decline in business activity, greatly complicate the task of isolating the impact of safe harbor on revenues. The above figures represent the *net* revenue loss to the Treasury. They attempt to measure directly the tax reduction gained by the firms buying the tax incentive and to account indirectly for additional tax generated from the firms producing and serving the capital equipment. The latter element in the calculations is as important as the former element, but it is also the most difficult to measure accurately. Other factors also account for the rapid rise in estimated revenue losses through FY 1987. Because safe-harbor leasing is a new type of financial arrangement, it would have become more popular as it became better known. The revenue-loss projections assume that, with depreciation allowances accelerating in 1981, 1985, and 1986, more firms would sell the deductions, resulting in additional tax-revenue losses. There is also some build-up in tax write-offs, because tax credits and depreciation allowances in 1983 are made for equipment purchased in 1983, 1982, and 1981; deductions in 1984 are made for equipment purchased in 1984, 1983, 1982, and 1981.

Table 1 Reduction in Revenue to Treasury
Fiscal year, billions of dollars

Year	Joint Committee on Taxation[a]	Treasury Department[b]
1981	na	<0.05
1982	-3.2	-3.2
1983	-4.0	-3.8
1984	-5.7	-5.4
1985	-7.1	-7.3
1986	-9.5	-9.4
1987	-12.1	na

a. *Analysis of Safe-Harbor Leasing,* Joint Committee on Taxation, 97 Cong. 2 Sess. (GPO, 1982), p. 35.

b. "Preliminary Report on Safe Harbor Leasing Activity in 1981" (Department of the Treasury, Office of Tax Analysis, March 26, 1982; processed), p. 13.

Safe-harbor leasing results in a large revenue loss at a time when the federal budget can scarcely afford it, and when the projected financial requirements of the federal budget deficit threaten to keep interest rates high. Certainly, if there were *no* safe-harbor leasing, there would be no corresponding revenue loss; but, any nonrevenue benefits also would be foregone. The evaluation of safe-harbor leasing should rest on a comparison of the costs with the benefits, although these may be difficult to measure.

The Matter of Targeting

A frequent criticism of safe-harbor leasing is that the program is not well targeted. In large part, the targeting criticism centers on the complaint that the seller of the tax break receives payment for less than the full value of that tax break. Both the Joint Committee on Taxation and the Treasury Department have attempted to determine what percentage of the tax break accrues to the seller, the buyer, and the third parties (lawyers and investment bankers) who arranged the transaction. Largely because of differences in estimation techniques, the Treasury's estimate of the share of tax benefits accruing to the seller is greater than the Joint Committee's.[4] Both estimates, however, follow the same trend. The Treasury finds that 84.5 percent of the tax break goes to the seller and 15.5 percent to the buyer and third parties. The Joint Committee finds that 76.5 percent of the break goes to the seller, 21.5 percent to the buyer, and 2.0 percent to third parties. Both estimates show the lion's share of the tax benefits accrues to those firms that otherwise had insufficient income to benefit from the investment incentives contained in the U.S. corporate tax code; they also showed that profitable, tax-paying firms required a hefty share of the benefits to become involved.

The safe-harbor provisions allow one firm to sell its tax benefits to another. By its very nature, the transaction implies that both parties would benefit. The share received by the buyer is tantamount to a finance charge that a bank might assess on a loan. The buyer, after all, is providing financial capital to the seller; a 15 percent to 22 percent fee does not seem unusual given the high interest rates of recent years. The fee accruing to the middlemen is similar to fees paid to third parties in most other financial transactions.

A second targeting criticism is that the program has provided one more loophole through which profitable firms can avoid paying corporate income taxes. Indeed, there have been instances where profitable firms have purchased enough tax breaks to eliminate their corporate tax liability completely, and cases where profitable firms generated tax reductions in excess of their tax liabilities and sold the excess tax credits. In its June 1982 report on safe-harbor leasing, the Joint Committee on Taxation presents data indicating that profitable industries, such as oil and gas, chemicals, and utilities, have received hefty benefits from safe-harbor leasing; however, the data also show that many less profitable industries also have been helped, including forest products, railroads, ferrous metals, and automobiles (see table 2). According to the Treasury,

4. *Analysis of Safe-Harbor Leasing,* Joint Committee on Taxation, 97 Cong. 2 Sess. (GPO, 1982).

Table 2 Use of Safe-Harbor Leasing by Industry[a]
Millions of dollars

Industry of seller/lessee	Basis of property
Communications equipment	157
Fabricated metal products	158
Local and intercity transit	174
Nonmetallic minerals	196
Aircraft manufacturing	221
Shipping	223
Rubber	266
Mining—metals and coal	330
Financial institutions	361
Nonferrous metals	414
Communications	430
Cement	551
Ferrous metals	1,082
Oil and gas	1,202
Motor vehicles	1,315
Chemicals	1,316
Airlines	1,392
Equipment and other lessors	1,548
Railroads	1,594
Utilities	1,685
Forest products	1,801
Total (including industries not listed separately)	17,410

a. Data are shown for all industries that leased more than $100 million in equipment before February 20, 1982. The table is limited to safe-harbor leases that took the form of wash leases.

SOURCE: *Analysis of Safe-Harbor Leasing,* Joint Committee on Taxation, 97 Cong. 2 Sess. (GPO, 1982), p. 29.