Recent Cases Restricting the Availability of the Investment Tax Credit to Noncorporate Lessors and Tax Planning in the Aftermath

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RECENT CASES RESTRICTING THE
AVAILABILITY OF THE INVESTMENT TAX
CREDIT TO NONCORPORATE
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IN THE AFTERMATH

Two recent Tax Court decisions, Peterson v. Commissioner and Hokanson v. Commissioner, have severely restricted the availability of the investment tax credit to noncorporate lessors. To qualify for the credit, the term of the lease must be less than fifty percent of the property's useful life. In determining whether this provision was satisfied, the Tax Court—for the first time—applied the "reasonable certainty" and "realistic contemplation" tests. This Comment concludes that only the "reasonable certainty" test is consistent with the congressional intent underlying the noncorporate-lessee restrictions and suggests various devices for securing the credit on an individual level.

INTRODUCTION

The investment tax credit, reestablished by Congress in 1971, is intended to encourage greater investment in business equipment and facilities through a reduction in taxes. Generally, a purchaser or a corporate lessor of "section 38 property" can claim the credit. Section 38 property consists of depreciable realty—excluding buildings and their structural components—that is employed in certain activities, and depreciable tangible personalty. Additional restrictions to qualifying for the credit, embodied in I.R.C. section 46(e)(3), are placed on noncorporate lessors because Congress was concerned about "the extent to which indi-

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individuals ( singly or as a group in a joint venture) were able to utilize the tax benefits of leasing transactions (the credit and the depreciation and interest deductions) as a means to shelter from tax a substantial part of their other income. One of 46(e)(3)'s provisions requires that the term of the lease must be less than fifty percent of the property's useful life. Two Tax Court memorandum cases decided in 1982, threaten to severely restrict the availability of the credit to noncorporate lessors by making satisfaction of the fifty-percent test more difficult. As a result, reevaluation and reformulation of tax-planning strategy is needed. This Comment analyzes these cases and concludes that only one of these decisions is consistent with congressional intent. The Comment also suggests various devices for securing the credit on an individual level.

**Qualifying for the Investment Tax Credit**

Ordinarily, the amount of credit that can be claimed by the taxpayer will be ten percent of his qualified investment in the property. The qualified investment equals the sum of "(a) the applicable percentage of the basis of each new section 38 property . . . placed in service by the taxpayer during such taxable year, plus (b) the applicable percentage of the cost of each used section 38 property . . . placed in service by the taxpayer during such

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8. Peterson v. Commissioner, 44 T.C.M. (CCH) 674 (1982); Hokanson v. Commissioner, 44 T.C.M. (CCH) 550 (1982). The precedential value of Tax Court memorandum decisions, which are not reviewed by the entire court, is unclear. Some commentators have asserted that these decisions contain little or no precedential value because they usually deal with well-settled legal issues, issues of little importance, or factual determinations. D. Argue & L. Keir, Tax Court Practice 29, 100 (5th ed. 1976); Commerce Clearing House, When You Go To The Tax Court 4 (1978). Other scholars claim that memorandum cases involve important issues and possess the same precedential value as reported decisions. See H. Bickford, Successful Tax Practice 108 (2d ed. 1952); 1 Fed. Taxes (P-H) 29 (1982).

The Golsen rule requires a particular Tax Court tribunal to follow a federal court of appeals decision only if the decision is "squarely on point" and appeal from this particular tribunal's decision "lies to that Court of Appeals and to that court alone." Golsen v. Commissioner, 54 T.C. 742, 757 (1970). Branches of the Tax Court situated in other circuits are not bound by the decision. Id.

9. I.R.C. § 46(a)(2)(A)-(B) (1976 & Supp. V 1981). I.R.C. § 48(q)(1), created by Congress in the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 205(a), 96 Stat. 324, 427 [hereinafter cited as TEFRA], requires a reduction of the property's basis by 50% of the credit taken. Section 48(q)(2) provides that where the basis has been reduced and recapture must occur, "the basis of such property (immediately before the event resulting in such recapture), shall be increased by an amount equal to 50 percent of such recapture amount." Id. The alternative provided by § 48(q)(4)(B)(ii)-(III), to elect against the basis reduction and choose to lower by two percentage points the rate at which the credit is calculated (i.e., 10% to 8%), offers little relief to the taxpayer. Id. at 428.
taxable year." A ceiling on the cost of used property has been set at $150,000. "New section 38 property" is property the original use of which begins with the taxpayer, while "used section 38 property" is property that has been placed in service prior to acquisition by the taxpayer. The applicable percentage will vary depending on whether the property is recovery or non-recovery. Recovery property is property which is depreciated under the Accelerated Cost Recovery System (ACRS). Generally, any property placed into service after 1980 must be depreciated according to ACRS guidelines. Non-recovery property is property placed in service prior to 1981.

The amount of credit claimed by the taxpayer cannot exceed his tax liability for the year. If the full amount of the credit cannot be secured in the taxable year, a three year carryback and fifteen-year carryover of unused credits is permitted. If the property is disposed of by the taxpayer before the termination of its useful life, recapture of a part or all of the credit will probably occur. The amount recaptured will differ, depending on whether the property is recovery or non-recovery.

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13. I.R.C. § 46(c)(2)-(7) (1976 & Supp. V 1981). Except for three-year recovery property, for which the percentage is 60, the applicable percentage is 100. I.R.C. § 46(C)(7) (Supp. V 1981). For non-recovery property, the percentage is 100 if the property's useful life is seven years or more, $\frac{66}{2}$ if the useful life is five years or more but less than seven, and $\frac{33}{3}$ if the useful life is three or more years but less than five. I.R.C. § 46(c)(2) (1976 & Supp. V 1981).
16. Id.
17. I.R.C. § 46(a)(3) (1976 & Supp. II 1978). The taxpayer can claim the full amount of the credit up to $25,000, assuming he owes that much in taxes, plus 85% of his tax liability in excess of $25,000. TEFRA, supra note 9, § 205(b), 96 Stat. at 430.
20. I.R.C. § 47(a)(1)-(5) (1976 & Supp. V 1981). For non-recovery property, the credit is redetermined by substituting the period the property is actually held for the original useful life selected by the taxpayer. I.R.C. § 47(a)(1) (1976). The amount recaptured is then computed by subtracting the redetermined amount from the originally determined amount of credit. Id. For 5-, 10-, and 15-year recovery property, 20% of the credit is recaptured for every year that the property is owned for less than five taxable years. I.R.C. § 47(a)(5)(A)-(B) (Supp. V 1981). For three-year recovery property, 33 1/3% of the credit is recaptured for every year the property is owned for less than three taxable years. Id.
A lessor of "section 38 property" may elect to pass the credit through to the lessee with the lessee treated as having acquired the property. This alternative will be discussed in greater detail in the tax-planning section of this Comment.

Special Requirements for Noncorporate Lessors

Individuals, partnerships, and Subchapter S corporations, which pass the credit directly through to the individual shareholders, are recognized as noncorporate for purposes of section 46(e)(3). Additional restrictions are imposed on noncorporate lessors to prevent them from entering into leasing agreements as a device to shelter other income. The credit is more valuable if taken by an individual for two reasons. First, greater tax savings result because individual tax rates are higher than corporate tax rates. Because the tax rate is higher, the taxes the individual would have had to pay on the amount offset by the credit is greater. Second, money possessed by a corporation can only be used for legitimate corporate purposes, but money received on an individual level can be utilized for almost any purpose the individual desires.

The restrictions of section 46(e)(3) permit a noncorporate lessor to qualify for the credit only if:

(A) the property subject to the lease has been manufactured or produced by the lessor, or

(B) the term of the lease (taking into account options to renew) is less than 50 percent of the useful life of the property, and for the period consisting of the first 12 months after the date on which the property is transferred to the lessee the sum of the deductions with respect to such property which are allowable to the lessor solely by reason of section 162 (other than rents and reimbursed amounts with respect to such property) exceeds 15 percent of the rental income produced by such property.

Congress believed that compliance with the manufacturing provision would indicate that the lease had been entered into as "an integral part of the taxpayer's business" and not to shelter income. Satisfaction of the expense and lease duration tests would ensure that the "leasing activity constitutes a business activity of the taxpayer, rather than a mere investment, i.e., a financ-

22. See infra notes 105-20 and accompanying text.
24. See supra note 6 and accompanying text.
26. Id.
28. H.R. REP., supra note 2, at 29; S. REP., supra note 2, at 44.
Because the fifty-percent test requires a short-term lease, mere financing agreements are prevented because the lessor retains the risk of his investment over the majority of the property's useful life. Upon expiration of the original lease, the short-term lessor risks not being able to re-lease the property or being forced to accept less rent because his property has declined in value.

If these requirements are met, the amount of the credit available to the noncorporate lessor is subject to the at-risk limitations. The at-risk rule provides that if the property is purchased through financial leverage, only the at-risk portion of the property's basis will be considered in determining the qualified investment. The at-risk part is the percentage of the property that is purchased with borrowed funds for which the purchaser is personally liable or for which property other than the property leased is pledged as security.

INDEFINITE DURATION OF LEASE

Peterson v. Commissioner

Barriers to Qualification Imposed by Peterson

Until Peterson v. Commissioner, the fifty-percent test was met simply by structuring the transaction so that the stated term of the lease would be less than fifty percent of the property's useful life. In Peterson, the Tax Court looked beyond the form of the transaction to its substance, deciding for the first time the issue of whether a lease for a stated term, absent an option to renew, may be considered "of indefinite duration for purposes of the investment tax credit."

In Peterson, a group of doctors practiced medicine in the form

29. Id.
32. Id.
34. Peterson v. Commissioner, 44 T.C.M. (CCH) 674 (1982).
36. Peterson v. Commissioner, 44 T.C.M. (CCH) at 677.
of a partnership until 1970. In that year, the doctors organized a corporation under which they continued to practice, buying stock in the corporation in proportion to the shares they held in the partnership. Prior to September 30, 1976, the end of the taxable year in which the disputed credit was taken, the individual doctors' ownership interests in both organizations remained identical. The partnership purchased and leased equipment solely to the corporation, except for some inexpensive pieces of equipment leased to a hospital where some of these doctors worked. All the equipment needed by the corporation was leased from the partnership. The lease in question, entered into in 1975, was preceded by two similar leases entered into in 1970 and 1972. In all of the agreements, the stated term of the lease was less than fifty percent of the property's useful life. Although none of the leases contained an option to renew, property covered under one lease was always included in a subsequent lease. In the lease in question, the partnership leased a typewriter and computer to the corporation. The typewriter was purchased by the partnership to replace the corporation's worn-out model, while the computer was acquired because the corporation had become dissatisfied with the performance of a computer service bureau. Considerable time and effort was invested by the business manager of both the corporation and the partnership in selecting the computer. The total cost of the equipment, $162,000, included over $3,000 for improvements to the premises so the computer could be properly installed. The property in question was included in a subsequent lease entered into in 1978. Rent during the 1975 lease was set at two-and-one-half percent of the cost of the property, but under the 1978 lease, the property was reappraised and the rent was reduced to two percent.³⁷

Relying on the "reasonable certainty test" developed in prior Tax Court cases for determining whether a lessee could amortize improvements made on leased property over the term of the lease,³⁸ the court held that the term of the lease did not meet the fifty-percent test, but was of indefinite duration. The reasonable certainty test requires a determination of whether the lessee is reasonably certain to continue leasing the property beyond the stated term.³⁹ If this reasonable certainty is found to exist, the lease is deemed to be of indefinite duration.

Basing its decision on the presence of several factors, the court attached the most significance to the motivation behind retaining

³⁷. Id. at 674-76.
³⁸. Id. at 677.
³⁹. Id.
the depreciable assets in the partnership upon incorporation and having the partnership lease the property solely to the corporation; no legitimate business purpose, other than securing the tax benefit, was intended. Other factors indicative of indefinite duration were the common control of the lessor and lessee, a history of continual renewal beyond the stated term, the tailoring of the lessor's purchases for the lessee's specific needs, and the lessee's failure to lease from anyone else.

The rent at which the property could be leased was subject to change by reappraisal upon expiration of the 1975 lease, but the court dismissed this as inconsequential. The court indicated that the minimal amount expended on improvements, which would be lost when the term ended, supported a finding that the lease term was definite, but was insufficient to offset the weight of the other factors.

40. Id. at 678.
41. Id. at 677-78.
42. Id. at 679. A policy of reappraisal would appear to be an indication that the parties intended the lease to be definite because a decline or increase in the value of the property might affect the rental rate to an extent that either party might be unwilling to renew. See Alamo Broadcasting Co. v. Commissioner, 15 T.C. 534, 543 (1950) (this applies to the situation where both parties must consent to a renewal or either party has the right to terminate the lease). In the improvement cases cited by the court to support its treatment of reappraisal, the courts considered reappraisal, but found it to be outweighed by other factors showing a reasonable certainty that the lease would be renewed. See G.W. Von Keppel Co. v. Commissioner, 19 T.C.M. (CCH) 1253, 1257 (1960), aff'd, 295 F.2d 767 (8th Cir. 1961); Hens & Kelly, Inc. v. Commissioner, 19 T.C. 305, 326 (1952) (the fact that the taxpayer had originally amortized improvements over the lease term and renewal period carried more weight than the fact of appraisal). Although the same situation applies in this case, the court neglected to accord it the weight it was due.

43. Peterson v. Commissioner 44 T.C.M. (CCH) at 679. Courts in the improvement cases have held that substantial improvements whose useful life would extend considerably past the stated lease term, and which would revert to the lessor on expiration of the lease, would not have been made unless the lessee intended to retain the property for another term. Stennet v. Commissioner, 64 T.C. 221, 223 (1970); Morris v. Commissioner, 38 T.C. 279, 284-85 (1962). See Hodge v. Commissioner, 35 T.C.M. (CCH) 1564, 1568 (1976) (an inference of indefinite duration arises when substantial improvements are made near the end of the lease term); Buddy Schoellkopf Products, Inc. v. Commissioner, 65 T.C. 640, 657 (1975); G.W. Von Keppel v. Commissioner, 19 T.C.M. (CCH) 1253, 1257. Conversely, if only a minimal amount of capital is invested in improvements, the loss of this capital on expiration would not deter the lessee from terminating the leasing arrangement. The reluctance to make more substantial improvements may indicate an intent not to renew the lease.
The Reasonable Certainty Test

The reasonable certainty test, first employed in the improvement cases, applies if a noncorporate lessor claims the credit and agrees to lease property for a stated term. The courts in the improvement cases "were concerned with the precise factual issue [confronting the court in Peterson], whether the stated term of a lease should be disregarded as being not in reality its actual term."44

Before assessing the factors which the Peterson court relied upon in formulating its conclusion, it should be noted that the court followed the evidentiary rule developed in the improvement cases45 and adopted in earlier investment credit cases.46 The court, in making its determination, will look only to the facts and circumstances that existed the year the property was placed into service.47 This rule applies not only to leases with a stated term, but to leases with no set termination date.48

As did the court in Peterson, the courts in the improvements cases viewed a past history of lease renewal of property as an indication that such a pattern will not end when the lease in question terminates.49 This factor may assume greater importance in tax credit cases because it tends to show that a particular lessor will not bear the risks of ownership incumbent upon short-term lessors generally.

In Peterson, the identical taxpayers controlled the partnership and corporation.50 In the improvement cases, where the lessors and lessees are related or one of the parties exercises control over the other, many courts have held that such a relationship "makes possible the continuation of the . . . lease arrangement as long as it is advantageous."51 However, some courts have not afforded this factor the same degree of weight.52 Despite almost identical

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44. Peterson v. Commissioner, 44 T.C.M. (CCH) at 677.
47. Peterson v. Commissioner, 44 T.C.M. (CCH) at 679.
48. Id.
50. Peterson v. Commissioner, 44 T.C.M. (CCH) at 678-79.
52. Joseph N. Neel Co. v. Commissioner, 22 T.C. 1083, 1090 (1954). "While the actions of a family corporation or family group should be carefully scrutinized, it is entirely conceivable that the relations each with the other, or their respective personalities, may be such that they will deal with each other strictly at arm's length. It sometimes happens that their very nearness in blood leads them to be more independent in action than strangers in blood." Id. In this case, a lease, entered
control of the lessor and lessee corporations, the Tax Court, in *Fort Wharf Ice Co. v. Commissioner*,\(^5\) found the lease term to be definite. The court disregarded common control because the corporations were created for legitimate business purposes and functioned as "independent" entities.\(^5\)\(^4\)

The improvement cases indicate that the significance of common control depends on two variables: the degree of control and the conduct of the parties. In *Peterson*, common control carried great weight because ownership of both organizations was identical and although the reasonableness of the rent was not contested, the parties had a prior history of renewing the same equipment.\(^5\)\(^5\)

The purchase of the typewriter and computer for the corporation's specific needs\(^5\)\(^6\) tends to show that the property will be used as long as it satisfies these needs. Unless the equipment is of such a nature that it may become outmoded or unprofitable before the expiration of its useful life, or the needs of the lessee are unstable, the property would probably be employed for its entire useful life. Because the typewriter was purchased to replace a worn-out model,\(^5\) it appears likely the new machine would be used in the same way. The time and money spent to choose the computer plus its cost shows that it was bought for long-term use.\(^5\)\(^8\) The probability of renewal becomes even greater when one

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\(^5\)\(^3\) 23 T.C. 202 (1954).

\(^5\)\(^4\) *Id.* at 208.

\(^5\)\(^5\) *Peterson v. Commissioner*, 44 T.C.M. (CCH) at 678-79.

\(^5\)\(^6\) *Id.* at 677.

\(^5\)\(^7\) *Id.* at 675.

\(^5\)\(^8\) IRS Brief at 14, *Peterson v. Commissioner*, 44 T.C.M. (CCH) 674 (1982) (on file with San Diego Law Review). The doctor's practice was situated in Sacra-
realizes that if the corporation declined to continue using the computer, the partnership would have had to enter the market to dispose of it.

The court cited the tax motive for establishing the leasing operation as the most important factor in its decision to disallow the credit. Instead of disbanding the partnership when the corporation came into existence and having the corporation purchase the equipment, the partnership, by purchasing and leasing the property to the corporation, was used to capture the credit. The plan was devised so the credit could be claimed by the individual doctors, because a percentage of the total credit would pass directly to the individual doctor-partners based on their share of the qualified investment. The court found that this lack of a business purpose, other than the intent to secure the tax benefit, was the clearest indicator of an intent to renew indefinitely.

The tax motive, at least in Peterson, supports a finding of indefinite duration because it indicates that the lease is a mere financing agreement. In financing the purchase of equipment, the doctors wanted to obtain the greatest tax benefits available with the least effort and risk. This goal, prior to this case, was best realized by having the partnership continually lease the property to the corporation for terms of less than fifty percent of the property's useful life. Recapture of the credit and depreciation did not occur because the partnership remained the owner of the equipment for its entire useful life. The doctors also avoided the greater expenditures of time, effort, and money they would have incurred had they sought to lease property to or from unrelated parties.

Any of these factors alone in a particular case may be insufficient for a court to find a reasonable certainty of renewal. If a tax motive is the sole indication of indefinite duration, a court may hold the lease term does not exceed the statutory limit. However, the tax motive may provide an independent basis for denying the credit.

Tax Motive—Independent Grounds for Denial of the Credit

The tax motive for establishing the leasing arrangement provides an alternative basis for refusing the credit to the partner-
ship. Even though a transaction is entered into solely to obtain tax benefits or to avoid taxes, the courts as a general rule will permit the parties to retain the tax advantages derived from the transaction. However, the United States Supreme Court established an exception to this rule in *Gregory v. Helvering*. In *Gregory*, a corporate reorganization, motivated solely by tax considerations, met the literal requirements of the reorganization statute. The Court refused to recognize the transaction, declaring that "the rule which excludes from consideration the motive of tax avoidance is not pertinent to this situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose." The principle announced in *Gregory* rejects transactions that lack a legitimate business purpose and which contravene statutory intent because they are motivated solely by tax considerations.

However, two recent investment credit cases decided by the Tax Court suggest that some judges may disregard the parties' intentions and make a determination based on whether the statutory form was observed by the parties. In *Hokanson v. Commissioner*, the court denied the credit to a lessor who admittedly was a member of the class Congress had designed the credit to benefit; he had not leased property to shelter income, but was using the property in an active business. In refusing the credit because he did not meet the fifty-percent test, the court said, "Congress erected two hard and fast tests, neither of which petitioners meet. We realize petitioners may not be within the target class. However, . . . Congress chose an easily administered approach and sacrificed a degree of equity, and it is not for us to pass upon the wisdom of legislation." In *Carlson v. Commissioner*, a case dealing with the manufacture provision of section 46(e)(3), a lessor who possessed valid business reasons was again

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63. See *Gregory v. Helvering*, 293 U.S. 465, 468, 470 (1934); *Superior Oil Co. v. Mississippi*, 280 U.S. 395-96 (1930); *Jones v. Helvering*, 71 F.2d 214, 217 (D.C. Cir. 1934); *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934).
64. *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934).
65. *Id.*
67. *Id.*
68. *Id.*
69. *Id.*
denied the credit. Because the provisions of section 46(e)(3) are unambiguous, the court said that "under these circumstances, the presence or absence of valid business reasons of petitioner for entering into the leasing transaction in question is wholly irrelevant."\(^{70}\)

However, in the cases just cited the court disregarded the parties' intentions and the legislative history if they failed to meet the criteria of section 46(e)(3). It is questionable whether the same judges would disregard these factors if the lessor had satisfied the literal requirements of section 46(e)(3). The Gregory principle must be applied to satisfy congressional intent. Application of the principle in Peterson results in denial of the credit. The doctors were not engaged in an active business; they were simply sheltering income. Because they lacked a legitimate business purpose, they came within the class Congress intended to prohibit from claiming the credit.\(^{71}\)

**Hokanson v. Commissioner**

Barriers to Qualification Imposed by Hokanson

Nor-Pac, an Oregon corporation engaged in food distribution, became disenchanted with the transportation service it was receiving from various commercial organizations. Deciding against purchasing the necessary equipment, it entered into a lease-employment agreement with Hokanson in 1970. Under this agreement, Hokanson became the company's transportation director and leased vehicles to the corporation. Hokanson had to disband a similar business in Texas. The vehicles for which the disputed credit was taken were purchased in 1977 and 1978. Hokanson and Nor-Pac agreed on an open-ended lease that either could terminate after the initial year, and thereafter at the end of each successive year by giving thirty days' notice. The lease was reviewed by the Nor-Pac board of directors at an annual meeting where Hokanson, both orally and in writing, provided a detailed analysis of the year's trucking operations. The rent was periodically raised. Hokanson did not receive income from any other sources.\(^{72}\)

To determine whether the lease met the fifty-percent test or was of indefinite duration, the court employed the test for open-ended leases in investment tax credit cases. This test requires

\(^{70}\) Id. at 225. *See also* Tufts v. Commissioner, 70 T.C. 756, 769 (1978), rev'd 651 F.2d 1058 (5th Cir. 1981) (when the statute is unambiguous on its face, "neither the legislative history nor the regulations may be used in derogation" of the statutory language).


\(^{72}\) Hokanson v. Commissioner, 44 T.C.M. (CCH) at 550-51.
that the lessor and lessee, at the time the lease is entered into, “realistically contemplate” termination of the lease before the term of the lease extends past the fifty-percent mark.\textsuperscript{73} If the test is not satisfied, the lease term is indefinite.\textsuperscript{74} The court found the test had not been met and cited three factors that indicated the parties intended to lease the property for its entire useful life. First, no property subject to the lease had ever been used for less than fifty percent of its useful life. Second, the corporation’s switch from commercial firms to Hokanson and Hokanson’s termination of his Texas business indicated “undertakings of a long-term nature.” Finally, the bank which financed Hokanson’s truck purchases followed a policy of not extending a loan beyond the time a lease could be terminated. In this case, the loan was extended past the first year. The loan officer testified that it was his belief that the lease would run indefinitely.\textsuperscript{75}

The Realistically Contemplated Test

This decision appears to rest on the court’s interpretation of the “realistically contemplated” test. In a 1981 investment tax credit case, \textit{Ridder v. Commissioner},\textsuperscript{76} the Tax Court introduced this test for open-ended leases. The court gave little insight into what it meant by “realistically contemplated” because the taxpayer failed to present any evidence of such contemplation.\textsuperscript{77} What would satisfy this test was not delineated.

The court in \textit{Hokanson} construed the test to require the taxpayer to “give some reason to indicate termination of the lease was realistically contemplated by the parties” at the time the lease was entered into.\textsuperscript{78} “That the parties recognize a distinct possibility that the lease might be terminated” prior to the fifty-percent mark would be insufficient to satisfy the test.\textsuperscript{79}

\textsuperscript{73.} \textit{Id.} at 552.
\textsuperscript{74.} \textit{Id.}
\textsuperscript{75.} \textit{Id.} at 552-53.
\textsuperscript{76.} 76 T.C. 867, 875 (1981). The language of § 46(e)(3)(B) states that the noncorporate lessor can obtain the credit if the “term of the lease . . . is less than 50 percent.” A problem originates with open-ended leases because there is no set term. It would be unfair to deprive these lessors of the credit, because they may be assuming the same risks as a noncorporate entity who is leasing property for a closed term.
\textsuperscript{77.} \textit{Id.}
\textsuperscript{78.} Hokanson v. Commissioner, 44 T.C.M. (CCH) at 552.
\textsuperscript{79.} \textit{Id.}
Webster's New International Dictionary defines "contemplate" as "to view or consider with continued attention; to regard thoughtfully; to meditate on; to study." As long as the parties presented evidence that they actually considered termination before the fifty-percent mark, the test should be satisfied. This test does not require that termination be contemplated as a probability; it appears to require that some mechanism be established whereby the lease is examined periodically and if the leasing operation fails to meet certain realistically set criteria, the parties will not hesitate to cancel the lease. Because the purpose of the fifty-percent test is to ensure that the lessor retains the risk of his investment over the majority of the property's useful life, a "distinct possibility" of termination should be sufficient; the risk will be present when this possibility exists.

The evidence seems to contradict the court's conclusion that the parties did not "realistically contemplate" termination, but intended to lease the property for its entire useful life. The parties were unrelated, Hokanson owned no stock in Nor-Pac, and the lease was presumably negotiated at arm's length. Both parties had legitimate business reasons for dealing with each other. By discontinuing its relationship with the commercial firms, Nor-Pac showed it would not hesitate to seek other alternatives if its transportation needs were not satisfied.

The motivation of Nor-Pac for entering into the open-ended lease as opposed to a stated-term lease also indicates "realistic contemplation." Hokanson, who had just disbanded a successful business in Texas and had no other source of income besides the rent received from Nor-Pac, would have desired a lease for a stated term that satisfied section 46(e)(3) to minimize the risk that Nor-Pac would cancel. Nor-Pac was a corporation trying to maximize its profits and had already endured an unprofitable experience in relation to its transportation needs. Evidence was introduced that Nor-Pac was a "conservative organization, ... unwilling to commit itself beyond the initial lease year." It appears reasonable to assume that Nor-Pac selected an open-ended lease because such a lease gave Nor-Pac the option to opt out if it was not satisfied with the performance of the trucks.

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81. See supra note 30 and accompanying text.
82. Hokanson v. Commissioner, 44 T.C.M. (CCH) at 550.
83. Id.
84. Id.
85. Id. at 550-51.
86. Id. at 552.
term lease would offer greater economic loss if the leasing arrangement proved to be unprofitable.

Because a legitimate business purpose motivated Nor-Pac to enter into this particular type of lease, it is less likely that the annual reviews were a sham. Indeed, the court did not find that the reviews were bogus, but affirmed that the taxpayer had to provide, orally and in writing, a "detailed analysis" of the transportation division. The purpose of receiving such information appears obvious: it would allow the board to judge the efficiency of the operation. These annual meetings logically should be deemed a forum for "realistic contemplation." Such meetings would serve little or no purpose unless the board intended to decide whether to continue Nor-Pac's relationship with Hokanson.

The court found significant the history of use beyond the fifty-percent mark. When the "reasonable certainty" test is to be applied, there is no doubt such a history is important. However, past practice does not seem relevant to the question of whether the parties actually contemplated termination. Although every item leased may have been used beyond the fifty-percent mark, the parties may have in every instance considered termination.

The court also found persuasive the "long-term nature" of the parties' undertaking. Such a characterization of Nor-Pac's activities is not totally accurate. Nor-Pac made no investment in the property, so if the lease was cancelled Nor-Pac would bear no risk of loss. The corporation was simply compensating someone else for satisfying its transportation needs. There appears to be no underlying substantial cost that would discourage Nor-Pac from ending the lease if it proved unsatisfactory. The dissolution of Hokanson's Texas business to move to Oregon may raise the inference that Hokanson would not have been willing to attempt such a move unless he was assured Nor-Pac would continually lease from him. However, it is also plausible that Hokanson simply assumed the risk that Nor-Pac would remain satisfied over a period of time.

Finally, little weight can be given to the loan officer's testimony that it was his belief the lease would run indefinitely. Because a

87. Id. at 551.
88. Id. at 552.
89. Id. at 553.
90. Id.
loan officer ordinarily is not trained in the law, he may not consider all the factors a court would in determining the intent of the parties. The criteria for determining intent may differ among lending institutions, leading to the result that a loan officer of another financial institution might have reached an opposite conclusion. Unless the loan officer actually heard Hokanson and NorPac officials say they intended to lease the property indefinitely, his testimony has slight value.

A decision for the taxpayer is justified by the weight of the evidence: the absence of common control, the reason for entering into this lease, and the holding of annual meetings. An important policy reason for such a decision is that Hokanson is a member of the class Congress was trying to benefit. Hokanson entered into the lease for legitimate business reasons, not to avoid taxes. The "leasing activity constituted a business activity of the taxpayer," as opposed to a financing arrangement.91

The court's avowal that a distinct possibility of termination will not satisfy the test, coupled with the paucity of evidence to support the holding, indicate the court's actual interpretation of "realistic contemplation;" the parties must anticipate termination as a probability and offer a specific reason for such a belief. Only then does the decision seem justified. Such an interpretation not only places an evidentiary burden on the taxpayer that might be impossible to fulfill, but it is contrary to congressional intent; in those situations where a strong possibility exists that the lease will be terminated within the statutory period, the lessor retains the risk of his investment over the majority of the property's useful life, but is still denied the credit.

One solution is to discard the "realistically contemplated" test and apply the "reasonable certainty" test to all leases. The latter test relies on objective criteria; the former risks the vagaries of a subjective inquiry. Because a "reasonable certainty" would not exist if there was a "distinct possibility" of termination before the fifty-percent mark, the "reasonable certainty" test is more in line with congressional intent (because a distinct possibility of termination exists, the lessor retains the risk of his investment).

**Planning to Qualify for the Credit**

*Satisfaction of the Fifty-Percent Test in the Peterson Setting by Formulation of a Legitimate Business Purpose*

In the *Peterson* factual setting, the allowance of the credit may depend on the presence of a legitimate business purpose besides

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91. See *supra* note 29 and accompanying text.
tax avoidance. A corporation’s desire to limit its potential liability by keeping assets outside the corporation would appear to be a valid business purpose, as long as it did not result in inadequate capitalization. However, certain professional corporations, which are the most frequent participants in the *Peterson* situation, cannot, at least in California, rely on this purpose; the liability of medical and law corporations cannot exceed a ceiling amount, an amount which the corporation is required to guarantee. Even if an ordinary corporation is the party involved, a court might be reluctant to accept this purpose as legitimate if the liability insurance procured by the corporation appears adequate to cover any potential liability.

Certain financing reasons may exist for the corporation to retain assets in a partnership. A bank may wish to look to the personal assets of the partners, rather than the corporation’s assets as security for repayment of a loan. The validity of this purpose is suspect because the corporation’s shareholders may be able to guarantee repayment by pledging their personal assets as security.

A possible alternative is for several corporations to form a partnership-lessor with all the shareholders of the corporations owning proportionate interests in the partnership. In certain circumstances, the court might find that the partnership serves a valid purpose by being able to purchase the necessary equipment more cheaply and efficiently than the corporations could individually.

A Successive Lease with an Unrelated Third Party

The fifty-percent test may possibly be met by leasing the property in question to an unrelated third party after the original lessee has used the property for less than fifty percent of its useful life. However, this option will only be available under certain circumstances. Treasury Regulation section 1.46-4(d)(4)

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92. 18 H. Marsh, *California Corporation Law and Practice* 121-24 (1977). For professional corporations not regulated in a manner similar to law and medical corporations, the general rule of limited liability applies. *Id.* at 121.

93. *Cf.* Interior Sec. Corp. v. Commissioner, 38 T.C. 330, 339 (1962). Four corporations leased rental properties to a partnership which was comprised of the corporations’ shareholders. The court found it to be created for a legitimate reason; it allowed the corporations to reduce the costs they would have incurred if they would have had to manage their property individually.

provides: "if a noncorporate lessor enters into two or more successive leases with respect to the same or substantially similar items . . . , the terms of the lease shall be aggregated and such leases shall be considered one lease." Uncertainty exists because the regulation does not specify when the second lease must be entered into for aggregation to be avoided. If successive leases are entered into simultaneously or within a year of each other, the leases would most likely be aggregated. The lessor would not be retaining the risks of ownership over the predominant portion of the property's useful life, (assuming aggregation resulted in surpassing the fifty-percent test), but merely financing his purchase. However, if the second lease was entered into at some later time during the term of the initial lease, the leases might not be aggregated because the lessor had retained the risks of ownership for a reasonable period. The closer the inception of the second lease is to the end of the initial term, the more willing the courts would be to refuse aggregation. No aggregation could possibly occur if the second lease was entered into after the expiration of the first lease.

This strategy may be impractical or undesirable for many lessors to pursue in the Peterson or Hokanson situation. The lessor may encounter great difficulty in trying to locate a person or organization that will agree to lease used property at some future date. A person or organization may be unwilling to enter into such a lease because the agreement virtually forecloses the possibility of a better deal in the future for the same property. If the lessor decides to let the initial lease term expire before attempting to re-lease it, he is confronted with the very risks that he presumably was trying to avoid, that is, no entity desires to lease it, or the property has declined in value so that he must accept a reduced rent. Another factor militating against re-leasing is that quite frequently the Peterson factual situation will involve professional corporations. Doctors and attorneys, for example, may be reluctant to become involved in a true leasing business.

95. Treas. Reg. § 1.46-4(d)(4) (1964). Since the language of the regulation refers only to "leases," it apparently could be sidestepped by entering into a contract to make a lease at some future date. An initial problem with this solution is the reluctance of courts to enforce an agreement to make an agreement. See United States v. Orr Const. Co., 568 F.2d 765, 769 (7th Cir. 1977); Transamerican Equip. Leasing Corp. v. Union Bank, 426 F.2d 273, 274-75 (9th Cir. 1970). The agreement will be invalidated on the grounds of indefiniteness if the terms of the future agreement cannot be sufficiently determined. Id. at 274-75; LA. CORBIN, CORBIN ON CONTRACTS 400-05 (1963). In addition, since such a tactic, if permitted, would defeat congressional intent, the value of this ploy will depend on the court's willingness to look beyond the form of the transaction to its substance.

96. Dostart, supra note 25, at 565.

Several professional corporations, each with their own purchaser-lessee partnership, might agree to re-lease identical property among themselves, only after the original lease had expired. This ruse appears to meet the literal guidelines of section 46(e)(3), but because it is a mere financing agreement, the credit might be denied on the grounds it violates congressional intent behind the statute.

**Lease and then Sell to Unrelated Third Party**

One alternative that has been suggested is for the lessor to sell the property to an unrelated third party after initially leasing it.98 However, the same business impracticalities and risks that exist in the consecutive lease situation plague this choice. In addition, a sale will most likely result in recapture of some or all of the credit and recapture of some depreciation, but the taxpayer will have had interest-free use of the recaptured amounts.

Constant employment of this approach will result in denial of the credit.101 In *Massey Motors v. United States*, the United States Supreme Court held that for the purposes of depreciation, the "useful life of the asset must be related to the period for which it may reasonably be expected to be employed in the taxpayer's business."102 The same test is applied for purposes of the investment credit.103 If a lessor has an established practice of selling the property prior to the fifty-percent mark, the useful life will equal the term of the lease. The result is that the term of the lease is 100% of the useful life. Therefore, if economically feasible, the lessor should establish no set pattern, but alternate selling and re-lease after the initial lease has terminated.104 This would prevent the useful life from being fixed as equal to the term of the initial lease.

99. *See supra* notes 19-20 and accompanying text.
104. Under Treas. Reg. § 1.167(a)-11(b) (1973), the useful life is computed by "reference to the taxpayer's experience with similar property taking into account present conditions and future developments." If the taxpayer's experience proves to be inadequate, prevailing trade practices provide the standard. *Id.*
Elect to Pass the Credit Through to the Lessee

As a general rule, the lessor who is unable to meet the requirements of section 46(e)(3) can elect to pass the credit through to the lessee, so that for purposes of the tax credit, the lessee will be treated as the purchaser. However, if a lessor decides he can satisfy section 46(e)(3) and it is later determined by the IRS or the courts that he did not, in most cases he has forfeited his right to pass the credit. The property must be new section 38 property "in the hands of the lessor" and use of the property must commence with the lessee. Except for short-term lease property and certain corporations, the lessee can claim a credit based on the fair market value of the property. Where the property qualifies as short term, only a portion of the credit is passed through, with the lessor retaining the remainder. Property will be characterized as "short term" when its class life exceeds fourteen years, the term of the lease does not equal or surpass eighty percent of the class life, and the property is not transferred under a net lease as defined by I.R.C. section 57(c)(1)(B). To effectively pass the credit, the lessor must file an information statement with the lessee by the "due date... of the lessee's return for the lessee's taxable year during which possession of the property is transferred to the lessee." Once made, the election is irrevocable. Certain events may trigger recapture.

The pass-through is the best option available to the lessor in the Peterson and Hokanson settings. The advantages from the

105. I.R.C. § 48(d) (1976 & Supp. II 1978). Even though denied the credit, the lessor can pass it through because "in this manner, the credit is not denied to the acquisition itself, but simply to the lessor." H.R. Rep., supra note 2, at 30.
106. Dostart, supra note 25, at 563.
109. I.R.C. § 48(d) (1) (1976 & Supp. II 1978). Section 48(d)(1)(B) (1976 & Supp. II 1978) provides that "if the property is leased by a corporation which is a component of a controlled group... to another corporation which is a component member of the same controlled group," the lessee is to compute the amount of credit according to the lessor's basis in such property.
110. I.R.C. § 48(d) (1) (1976). If the lessor could not qualify under § 46(e)(3), he would not be entitled to even a part of the credit in the case of short-term property.
111. I.R.C. § 48(d) (4) (1976 & Supp. II 1978); I.R.C. § 57(c)(1)(B) (1976) defines a net lease as a lease which provides that "the lessor is either guaranteed a specific return or is guaranteed in whole or in part against loss of income."
114. Treas. Reg. § 1.47-2(b)(2) (1967). A disposition by the lessor to a person who could elect to pass the credit or a purchase by the lessee will not trigger recapture. Termination of the lease and transfer of the property by the lessee to another party will ignite recapture.
pass-through may offset the loss of the credit or encourage lessors who would qualify for the credit to choose such an election. The lessor is not limited by the fifty-percent test, but can lease the property for a longer term. The longer term allows him to minimize the risk that he will fail to recover his investment. In passing the credit through, the lessor can demand higher rent. Depending on the lessor's anticipated income and tax bracket, the amount of rent received may approach or equal the amount of credit that the lessor would be entitled to claim if he satisfied section 46(e)(3). Because the lessee is only treated as the purchaser for purposes of the investment credit, the lessor can still take deductions for depreciation, interest payments, and property taxes.

The advantage of claiming these deductions on an individual level provides a substantial incentive for a corporation to form a purchaser-lessee partnership that will pass the credit through. Whether the courts would allow the credit in this situation is questionable. Congress said that "the credit is not denied to the acquisition itself, but simply to the lessor." Yet Congress also sought to prevent leasing transactions motivated solely to gain tax benefits, that is, credit, depreciation, and interest deductions. The courts would probably allow the credit because when the credit is passed through to the corporation, Congress' major concern that the credit will be used to shelter individual income is not realized.

Elect Subchapter S Status

In Peterson and similar situations where a partnership owned entirely by a corporation is created or maintained solely to procure the credit, election of Subchapter S status by the corporation permits the credit to be obtained on an individual level. Because a Subchapter S corporation is taxed similarly to a partnership, the credit, if claimed by the corporation, will pass directly to the shareholders. The corporation in Peterson could dissolve the

119. See supra note 105.
120. See supra note 6 and accompanying text.
121. See 6 FED. TAXES (P-H) ¶ 33,362 (1982).
partnership, elect Subchapter S status, and purchase the equipment directly. Not only would the credit pass directly to the shareholders, but so would any deductions that the purchaser and owner of the property would be entitled to take—depreciation, interest payments, and property taxes.\textsuperscript{122}

In the \textit{Hokanson} situation, where an individual or partnership is leasing property for legitimate business reasons, election to Subchapter S status by the lessor offers no assistance. Because a Subchapter S corporation is considered a person for purposes of section 46(e)(3), it is subject to the same limitations as a noncorporate lessor.\textsuperscript{123} The lessor, however, might be able to persuade the corporate lessee to elect Subchapter S status by promising to pass the credit through. The lessor could then charge higher rent because the corporation's shareholders would be profiting more than if their company had remained an ordinary corporation.

Selection of this option will depend on whether the requirements for election\textsuperscript{124} of this status can be fulfilled and whether it is practical in a business sense.\textsuperscript{125} The Subchapter S Revision Act of 1982 has made election more appealing for several reasons:\textsuperscript{126} election and maintenance of status has become easier; corporation losses can now be deducted by the individual shareholder to the extent of his basis in stock and in debt owed him by the corporation;\textsuperscript{127} and unused losses can be carried over until there is a sufficient basis against which to offset them.\textsuperscript{128}

The individual shareholder must be wary that his stock interest in the corporation does not fall too far below what it was when Subchapter S status was elected, or recapture of the credit will be

\textsuperscript{122} \textit{Id.}
\textsuperscript{124} I.R.C. \textsection{}1371(a) (1976 & Supp. V 1981). A corporation can qualify for Subchapter S status if it is a “domestic corporation which is not a member of an affiliated group (as defined in section 1504) and which does not:
1) have more than 35 shareholders;
2) have as a shareholder a person . . . who is not an individual;
3) have a nonresident alien as a shareholder; and
4) have more than one class of stock.” \textit{Id.}
\textsuperscript{125} \textit{Id.} (the number of shareholders was increased from 25 to 35 by the Subchapter S Revision Act of 1982, Pub. L. No. 97-354, \textsection{}2, 96 Stat. 1669) (I.R.C. \textsection{}1371(a) to be recodified as I.R.C. \textsection{}1361(a)).
\textsuperscript{126} \textit{See} 6 Fed. Taxes, supra note 121, at \textsection{}33,665-68. Several factors will determine whether an election should be made: “the pattern of expected distributions, the shareholder's need for use of the income, and the respective tax brackets.” \textit{Id.} at \textsection{}33,666.
\textsuperscript{127} \textit{A CONCISE EXPLANATION OF THE SUBCHAPTER S REVISION ACT OF 1982, 20 TAX IDEAS REPORT BULLETIN (P-H) 2 (1982).}
\textsuperscript{128} \textit{Id.}
\textsuperscript{129} \textit{Id.}
Shareholders need not worry that the IRS or courts will refuse to recognize an election because it was chosen solely for tax reasons; both agree that such reasons are consistent with congressional intent.130

Enter Into a Management Contract

By entering into a management contract instead of a leasing agreement, the purchaser of “section 38 property” can procure the credit and avoid the noncorporate lessor limitations. The entity or individual using the property is considered the agent of the property owner. Two factors are needed for an agreement to be characterized as a management contract. The property owner must exercise a degree of control over the operation involving the property, and he must bear the risk of loss if the venture proves unprofitable.131

The tax planner will want to insert various provisions into the agreement that shift the risk of loss to the owner. Such provisions will require the property owner to pay for all expenses incurred by the agent and any damage to the property,132 to indemnify the agent for all claims arising out of the operation of the property,133 and to contribute to the agent’s losses.134 Rent could be fixed as a percentage of the venture’s net profits,135 or losses sustained in one year could be carried over to following years to reduce payments to the owner.136

It is not entirely clear what will suffice as adequate control. A recent Tax Court decision, Meagher v. Commissioner,137 indicates that a minimal amount of control will satisfy the test.138 The

129. Treas. Reg. § 1.47-4(a)(2) (1967). If the shareholder's ownership interest falls below 66 2/3% of his original interest, recapture of an amount that is proportionate to the reduction in stock interest will occur. No further recapture will take place, unless his interest then falls below 33%. Id.
132. Meagher v. Commissioner, 36 T.C.M. (CCH) at 1094.
133. Id.
137. 36 T.C.M. (CCH) 1091 (1977).
138. See Dostart, supra note 25, at 563.
court found the necessary control in the various obligations imposed on the user of the property. The user had to keep records of the equipment's operation, use best efforts to lease the property, obtain insurance naming the property owner as a co-beneficiary, and pay net profits over to the owner within a certain time. The court conceded that the owner lacked any direct control over the user's leasing activities with regard to his property.139

In a similar case, McNabb v. United States,141 the court held the agreement to be a lease, in part because the property owner had no control over the user's leasing activities. It dismissed the value of operational reports provided to the owner by the user because the owner lacked the authority to utilize the information to affect the user's leasing activities.142

Where the lessor and lessee are under common control, a management contract appears to be an effective device for avoiding the noncorporate lessor limitations. In Peterson, because the doctors control both the partnership and the corporation, it matters little that the partnership, as opposed to the corporation, assumes the risk of loss, or that the partnership exercises some control over the corporation's activities. Again, it must be emphasized that if the only motive is tax avoidance, the court may refuse to permit the credit. If the parties are unrelated, both parties may be reluctant to structure a transaction as a management contract. For a small businessman like Hokanson, the potential economic disaster that awaits him if he bears the risk of loss is a powerful deterrent. It is very questionable whether a lending institution would loan Hokanson the funds to purchase the trucks if he assumed this risk; because Hokanson is a small businessman, any loss he might have to absorb might prevent him from paying off the loan.

The willingness of the “agent” to permit the property owner a degree of control over the agent's activities will turn on which case—Meagher or McNabb—the courts follow. If Meagher is followed, an organization like Nor-Pac might well consent to such an arrangement because the requisite degree of control exercised by Hokanson would not fetter Nor-Pac's freedom to make major business decisions. In contrast, if the test in McNabb is adopted, it is extremely unlikely that Nor-Pac would agree to permit a

140. Id. The IRS apparently will follow Meagher because in Letter Ruling 7845010 (1978), it concluded that an agreement containing almost the same indicia of control that was present in Meagher was a management contract.
141. 81-1 U.S. Tax Cas. (CCH) 86,155 (1980).
142. Id. at 86,157.
mere supplier of transportation significant control over its business activities.

Enter Into a Service Contract

The restrictions of section 46(e)(3), which only apply to leases, can be avoided altogether by providing "section 38 property" as an integral part of a service. Certain express provisions in the agreement will be accepted as indicative of a service contract: retention of ownership by the taxpayer; risk of loss placed on the taxpayer if the machine is damaged or inoperative; inability of customers to alter, repair, or move the property without the taxpayer's permission; and responsibility of the taxpayer to maintain, repair, or replace the equipment and train the customer's personnel.

Until Xerox v. United States, the IRS had distinguished between leases and service contracts in tax credit situations. In Xerox, the United States Court of Claims rejected the IRS' contention that the agreement constituted a lease. Because it is uncertain whether the Commissioner will acquiesce in the decision, the taxpayer needs to be aware of the points of conflict between the IRS and the Court of Claims, especially because the IRS will first be exposed to the agreement.

Both agree that the party providing the service must retain control and possession of the property. To retain possession, the IRS has indicated that the owner must exercise actual physical control over the property, unless placement with the recipient of the services is inherent in such a transaction. In Xerox, the

143. See Xerox Corp. v. United States, 656 F.2d 659, 660 (Ct. Cl. 1981).
144. Id. at 675-76.
145. Under I.R.C. § 48(a)(4)-(5) (1976 & Supp. V 1981), a credit cannot be claimed if "section 38 property" is used (owned by or leased to) by certain tax exempt organizations or a government unit. Treas. Reg. § 1.48-1(j)-(k) (1964). As an exception to the rule, the IRS permits a credit to be taken if the property is offered as part of a service. Rev. Rul. 68-109, 1968-1 C.B. 10; Rev. Rul. 71-397, 1971-2 C.B. 63.
146. Xerox Corp. v. United States, 656 F.2d at 660.
147. Delahunt, The Investment Tax Credit for Property Leased to Exempt Organizations or to Government Units After the Xerox Case, 60 Taxes 552, 554-55 (1982).
148. Rev. Rul. 71-397, supra note 145, at 64. Placement of a switchboard with a government utility in Rev. Rul. 68-109, supra note 145, was inherent "in the sale of such services," while placement of a copy machine with the government in Rev. Rul. 71-397, supra note 145, was not. This distinction, upon which the IRS had neglected to elaborate, was properly rejected in Xerox as too "cryptic." Xerox Corp. v. United States, 656 F.2d at 675.

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court was satisfied that the taxpayer retained possession because the government could not deny the corporation access to the machines.\textsuperscript{149} A sound policy justification for rejection of the IRS' definition is that it discriminates against the property owner whose property is of such a nature that he cannot remove it daily from the other party's premises. The court also refused to recognize the IRS' distinction between the property owner providing services and the customer providing services for himself. Such a distinction would be too difficult and "cryptic" to make.\textsuperscript{150}

In addition, other factors, heretofore not recognized as important by the IRS, were cited as crucial by the court. The court attached great significance to the provision in the lease requiring an inoperative or inefficient machine to be replaced by a properly functioning machine.\textsuperscript{151} The policy of "insuring a working machine rather than keeping a machine in working order" indicates a service rather than a lease, because a lease generally implicates a particular item of property.\textsuperscript{152} Finally, the court found two aspects of payment important. The owner was paid according to the number of copies produced, rather than a fixed monthly rental.\textsuperscript{153} This suggests a service contract, because the customer was not paying for the use of the machine, but for the end product.\textsuperscript{154} The court also emphasized that remuneration was not determined by the value of the machines but was based in large part on the various obligations and risks assumed by the owner.\textsuperscript{155}

Both the United States District Court and the Tax Court are also available forums for tax disputes, and the holding of the United States Court of Claims is not binding on these tribunals. It may therefore be necessary that the taxpayer satisfy the IRS criteria in the event these other courts adopt the IRS position. By providing truck drivers, for example, Hokanson could easily sat-

\begin{footnotes}
\footnote{149. Xerox Corp. v. United States, 656 F.2d at 675.}
\footnote{150. Id. at 675-76. In Rev. Rul. 71-397, \textit{supra} note 145, and Rev. Rul. 72-407, 1972-2 C.B. 10, the customers provided their own operators for the equipment. The IRS found the customers were providing themselves with a service and denied the credit. In Rev. Rul. 68-109, \textit{supra} note 145, the customer provided operators for the switchboard and in Letter Ruling 7829066 (1978) patients had to operate televisions placed in a hospital. The IRS held that the taxpayers were providing a service. When the test by its very nature is so vague and ambiguous that it cannot be applied without producing inconsistent results, it is appropriate to retire it. If the copy machines in Rev. Rul. 71-397 had become inoperative, the customer clearly could not provide services for himself until the owner had corrected the problem. Xerox Corp. v. United States, 656 F.2d at 676 n.26.}
\footnote{151. Xerox Corp. v. United States, 656 F.2d at 676.}
\footnote{152. Id.}
\footnote{153. Id.}
\footnote{154. Id.}
\footnote{155. Id. at 660-61.}
\end{footnotes}
sify the requirement that the owner provide the services, rather than the customer providing a service for himself. Hokanson could meet the possession requirement, which demands that Hokanson exercise actual physical control over the trucks, by storing the trucks when not in use on property owned or rented by him. However, this storage cost would be reflected in the service charge and might deter the customer from entering into a service agreement. The customer, if he already possessed the space to house the trucks, presumably would pay less if he leased the trucks and provided his own drivers than if he had to pay a service charge, because such a charge would include storage costs.

If the Xerox criteria controls, the "small-time" lessor, as portrayed by Hokanson, who may lease to only one customer or whose operation is quite limited financially, may be deterred from entering into such a service agreement by two requirements. First, because the parties are unrelated, the property owner may not be willing or able to bear the risk of loss if his machine fails to produce as promised. (Even if a lease is entered into, the lessor may have to assume this risk.) Second, the owner with limited resources may not be able to afford to keep extra machines in stock to replace faulty models. The court in Xerox found such like-kind exchanges crucial to its holding.156

In the Peterson situation, assuming the IRS test controlled, the partnership would most likely fail both the possession and providing services tests. It would be highly impractical or costly to remove medical equipment, computers, or typewriters when the workday was completed or to provide personnel to operate the equipment. If compliance with the Xerox decision is required, assumption of the risk by the partnership, the owner of the property in question, would not be a source of concern because both the partnership and corporation are owned by the doctors. However, the problem of keeping extra machines in stock to replace inefficient or broken down models still remains.

Also present in the Peterson situation, where the only motive in providing a service would be to obtain the credit as an individual, is the danger that the court will invoke Gregory v. Helvering to deny the credit. However, the Tax Court recently considered whether a taxpayer was providing an air transport service or whether he was leasing planes to a corporation of which he

156. See supra notes 151-52 and accompanying text.
owned ninety-two percent.\textsuperscript{157} The taxpayer claimed he was providing a service presumably because section 46(e)(3) would preclude him from taking the credit if the agreement constituted a lease. The court held the agreement to be a lease,\textsuperscript{158} but it never questioned the proposition that the taxpayer would be entitled to the credit if the agreement was a service contract, even though his only apparent motive in structuring it as a service contract would be to obtain the credit.

**CONCLUSION**

*Peterson* and *Hokanson* have made one point emphatically clear: the noncorporate lessor restrictions now present a formidable obstacle to qualifying for the credit. The court acted consistently with congressional intent in *Peterson* because this was exactly the practice Congress had tried to legislate against. *Hokanson* should be reconsidered; it is difficult to imagine what further steps the parties could have taken to satisfy the "realistically contemplated" test. Also, the lessor was a member of the class Congress had designed the credit to benefit. Alternatives remain open to a purchaser of "section 38 property" to avoid the restrictions and qualify for the credit on an individual level. The enthusiasm of the purchaser to embrace these alternatives may be tempered by business practicalities and the willingness of the courts to look beyond the form of a transaction to its substance. A new chapter in creative tax planning has commenced.

*Tim Koltun*

\textsuperscript{157} Conway v. Commissioner, 44 T.C.M. (CCH) 269 (1982).

\textsuperscript{158} *Id.* at 272. The court mentioned four factors that justified its decision that the agreement was a lease:

1. The parties had referred to it as a lease.
2. Compensation was not based on the service he provided, but fixed according to the airplane's cost and useful life.
3. The taxpayer failed to present any evidence that he was engaged in a separate trade, rather than acting as the lessee's employee when performing these services.
4. The belief that the taxpayer's services as a pilot were rendered as an employee was strengthened by the fact that other employees of the lessee occasionally acted as co-pilot.

*Id.* at 271-72.