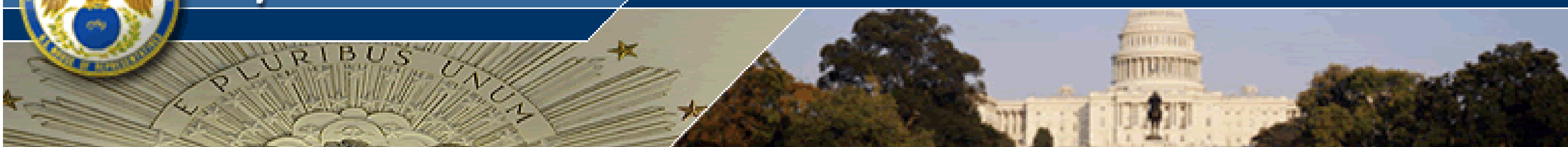

★ HEARING ARCHIVES

Statement of The Honorable Kenneth E. Bentsen, Jr., President, Equipment Leasing and Finance Association, Arlington, Virginia

Testimony Before the House Committee on Ways and Means

March 14, 2007

Mr. Chairman, Ranking Member McCrery, and members of the committee, thank you for the opportunity to present the views of the Equipment Leasing and Finance Association (ELFA) on the proposal contained in the Senate-passed version of H.R. 2 the "Small Business and Work Opportunity Act of 2007," that would retroactively impose taxes on certain cross-border leasing transactions.

ELFA is a trade association representing 760 members, including banks, financial services companies, and manufacturers, in the equipment finance industry. ELFA's members are engaged in a broad sector of commercial finance including business-to-business leasing and financing of capital equipment and software. The industry size, domestically, is estimated to comprise one-third of fixed business investment annually and its members are the major financiers of the transportation (aircraft, maritime, rail, and trucking), manufacturing, mining, medical and office equipment, construction and information technology fields. Our members' customers include Fortune 100 companies, small and medium sized enterprises, and state and local governments. Our members also provide financing for equipment globally, much of it domestically produced.

Nearly three years ago, Congress passed the American Jobs Creation Act of 2004 (Pub. Law 108-357) (the "JOBS Act"). As part of that legislation, and in response to concerns regarding certain domestic and cross-border leasing transactions, Congress created a new section of the tax code, IRC section 470, which applies a "passive-loss" type regime to certain leasing transactions involving property used by governments or other tax-exempt entities. Generally, under the provision tax losses incurred over the course of the lease are deferred and offset against future income from the property. The provision contains an exception if a taxpayer meets the requirements of all of four specifically described rules involving certain types of property, availability of funds, and where the lessor makes a substantial equity investment, and the lessee does not bear more than a minimal risk of loss.

Importantly, in 2004, Congress recognized this sweeping change in law as a policy change and decided on a prospective effective date which applies the new rules to leases entered into after March 12, 2004. Certain grandfather rules were also provided to avoid retroactive application of the new regime.

Moreover, the conferees specifically decided that "[N]o inference is intended regarding the appropriate present-law tax treatment of transactions entered into prior to the effective date . . ." , namely that no intent was given with respect to the appropriateness of transactions entered into prior to the effective date. See, H. Rpt. 108-755, p.647, 650. To now go back and retroactively change this agreement is in effect reopening the conference negotiations between the House and the Senate 3 years later and creating "double jeopardy" for taxpayers.

RETROACTIVE TAX INCREASE

The current proposal in the Senate version of H.R. 2 would undermine the decisions made by the conferees of the JOBS Act and retroactively change the effective date of IRC section 470 for cross-border leases entered into on or before March 12, 2004. The Senate proposal would reach back and impose taxes that could never have been expected on transactions that were completed years before the original JOBS Act was ever contemplated.

The Ways and Means Committee appropriately rejected the Senate proposal earlier this year in developing the House version of the "Small Business Tax Relief Act of 2007" (H.R. 976) on February 12, 2007. And, in fact, Mr. Chairman you wisely stated that such retroactive tax changes were "bad policy."

Proponents of the retroactive change to Section 470 as contained in the Senate bill assert that the provision is: a) not retroactive because it applies to future tax years albeit of transactions completed prior to March 12, 2004; and b) necessary to relieve the Internal Revenue Service of the burden of challenging certain transactions on economic substance and other grounds. Proponents further argue that the facts related to the transactions in question justify such actions.

In fact, as crafted: the provision is retroactive, the provision will result in consequences for transactions never targeted by the proponents or the government, and the provision will undermine taxpayer's due process rights.

With all due respect to the proponents of the Senate provision, I would submit to the Committee that the issue before the Congress is not the merits of the underlying transactions in question, as many of those are properly being reviewed by the IRS based on independent facts and circumstances, just as the Congress intended. The real issue is one of policy and process - the use of retroactive tax law changes to raise revenue, as the Senate version of H.R. 2 clearly does; and the due process of taxpayers, which the Senate bill undermines. We believe such actions are fundamentally unfair and unwise.

If retroactive tax policy is pursued in this instance, there is no reason retroactivity would not be pursued elsewhere thus undermining all reliance on our U.S. tax laws. The imposition of this retroactive provision would result in irreparable damage to investor confidence in the leasing market going forward, and impede the Congress' ability to utilize the tax code as a means to spur investment. For this reason, the Congress historically has opposed such retroactive tax policy.

RECOMPUTATION OF U.S. TAXPAYER'S BOOKS

Proponents of the Senate provision have asserted that the proposal is not retroactive because it applies to taxable years beginning after December 31, 2006. Clearly this is incorrect as the proposal applies to leases executed years ago. Indeed, under recently issued FASB guidance (FSP FAS 13-2), any change in the timing of cash flows caused by changes in the tax treatment of a lease will require a recalculation of earnings dating back to the inception of the lease. As a consequence, the Senate provision would result in significant new tax liabilities on U.S. taxpayers and significant adverse financial statement consequences caused by such recomputations for those affected U.S. companies which are publicly listed.

The retroactive impact on a taxpayer's books under FASB rules is described in more detail in an attachment, hereto.

The bottom line is that the provision would have the effect of disrupting the economics of multiyear transactions entered into years ago by U.S. financial institutions in reliance on existing law. This is exacerbated since the Senate provision would be unlimited in its application and would apply to transactions completed well into the last century, long before any changes along the lines of Section 470 were contemplated by the Senate.

UNDERMINES TAXPAYER DUE PROCESS

Proponents of the Senate provision have asserted that the provision contained in the Senate version of H.R. 2 would be beneficial to the Internal Revenue Service in litigation efforts against certain U.S. taxpayers involved in certain lease transactions. Ultimately any legal issues surrounding transactions completed prior to the JOBS Act effective date should properly be addressed by the IRS and in the courts on the basis of the laws that were in effect at the time the transactions were entered into. On due process grounds alone, U.S. taxpayers deserve to have their day in court without interference from the Congress before any judgment has been rendered. And to date, there have been no judgments involving such cross border transactions.

Furthermore, nothing in the Senate provision would preclude, nor could a taxpayer expect, that the government would not continue to pursue a case against the taxpayer, as such cases relate to the tax treatment of past tax years. To reopen such cases would mean that the taxpayer would be subject to double jeopardy.

Adopting legislation that goes back and retroactively changes the law in favor of the government on any provision of law is simply unfair and potentially unconstitutional. The tax system is currently working as intended, with the IRS reviewing facts and circumstances of transactions and challenging taxpayer positions, as warranted. Changing the law and economics midstream creates an unfair bias against taxpayers in favor of the government. If this is allowed, there is no reason Congress could not simply retroactively change the law in favor of the IRS on any issue the IRS is currently challenging in courts or otherwise. That is not the way our U.S. rule of law works, and it is not a change this committee should endorse.

UNINTENDED CONSEQUENCES

We believe that imposing Section 470 retroactively would result in unintended consequences, specifically by retroactively subjecting otherwise common cross-border transactions to a regime designed to address questioned transactions. That is, as drafted, the Senate provision would impose Section 470 on existing transactions never targeted by the proponents. Just as Section 470 has impacted such things as the leasing of medical equipment to non-profit institutions (an otherwise common and efficient practice) on a going forward basis, imposing Section 470 retroactively would cause a number of such previously executed cross border transactions to become uneconomic without cause.

For instance, one of the members of our organization states that the proposed retroactive change to Section 470 would eliminate net deductions for tax years 2007 and beyond on a number of lease transactions entered into years ago (with original equipment cost in excess of $800 million) that the IRS does not consider abusive. Examples include leases entered into during the mid to late 1990's such as rail leases to various European entities and a large lease of manufacturing equipment to a Canadian subsidiary of a U.S. company.

Another member highlights an existing problem with Section 470 that will only be exacerbated by applying it retroactively. Current Section 470's complex loss-trapping rules have inadvertently put not-for-profit hospitals at a competitive disadvantage, as the 9-year class life of medical equipment causes a fixed price purchase option to trigger adverse treatment to the lessor. Accordingly, a not-for-profit hospital must either face a higher lease rate by choosing to have a fixed price purchase option or lose significant flexibility by forgoing a fixed price purchase option. Not only should this existing inequity under Section 470 be fixed to recognize business realities in the area of medical equipment leases, but it should not be imposed retroactively.

Indeed, the leadership of the House Ways and Means Committee and Senate Finance Committee have recognized that as it exists today, Section 470 results in unintended consequences. On December 15, 2005, after the enactment of Section 470 in the JOBS Act, then Chairman Grassley, Senator Baucus, then Chairman Thomas, and Congressman Rangel wrote to then Treasury Secretary Snow and stated that “it has come to our attention that Section 470 may have . . . unintended consequences.” “Specifically, Section 470 as currently drafted . . . may apply to certain non-abusive transactions. . .”

As part of their letter, Senators Grassley and Baucus, and Congressmen Thomas and Rangel requested an extension of transition relief and non-enforcement of Section 470 for certain

transactions.

Because of these well-recognized unintended consequences, the Treasury Department has provided relief and non-enforcement of Section 470 for certain transactions in each of the last three (3) years. See, IRS Notice 2005-29 (2005-13 I.R.B. 796), IRS Notice 2006-2 (2006-2 I.R.B. 278), and IRS Notice 2007-4.

In addition, the tax-writing committee staffs and the staffs of the Joint Committee on Taxation and the Treasury Department have been trying to develop legislation that would correct the unintended consequence problems that exist with current Section 470. Just last year, on September 29, 2006, technical corrections legislation was introduced in Congress to address, among other things, the problems of Section 470 having unintended consequences. See, "Tax Technical Corrections Act of 2006." However, to date, those problems still exist.

It seems illogical to now retroactively impose a provision of the tax code that is well-recognized by the tax-writing committees as already having unintended consequences, thereby creating additional confusion and exacerbating IRS compliance and enforcement problems. Moreover, it is irrational to impose it retroactively so as to capture transactions that have never been in question.

CONCLUSION

Mr. Chairman, we believe taxpayers enter into transactions in full reliance on current tax law. This reliance and confidence is the bedrock of the Federal income tax system. Undermining the system by imposing retroactive tax increases is simply unfair as a matter of fundamental tax fairness. Further, it will serve to undermine the confidence of investors to deploy capital, which would devalue any attempt by Congress to use the Code as a means to incent investment.

Accordingly, I urge you and this committee to reject the Senate leasing proposal as part of the minimum wage bill or any other tax legislation. This does not let anyone "off the hook" or absolve any questions of substance, as that process is well underway in the courts, just at Congress intended when it gave the IRS the power to pursue such cases, and just as the Constitution provides for taxpayers to have their day in court.

Thank you for the opportunity to offer our views on this matter and I would be happy to answer any questions you may have.

ATTACHMENT

Effects of Retroactive Application of Section 470 on Financial Statement Earnings and Capital

Summary

The Senate proposal to make Section 470 retroactively applicable to transactions entered into prior to March 12, 2004, coupled with a current change in the GAAP treatment of leveraged leases, could have potentially significant adverse financial statement consequences to many U.S. corporations.

Financial Accounting Treatment of Leveraged Leases

The economic impact of a leveraged lease is determined by its cash flows, including tax payments and refunds, and the associated GAAP financial statement effect is computed under Statement of Financial Accounting Standards No.13 ("SFAS 13"). SFAS 13 employs a two-step methodology under which the internal rate of return ("IRR") derived from cash flows is first determined, followed by application of this IRR to the unamortized investment in the lease. The result is the amount of GAAP financial statement income that is recognized each period. Because incoming cash flows resulting from tax refunds are typically greatest in the early years of a leveraged lease, this methodology has the effect of increasing the IRR, which in turn

increases the amount of GAAP financial statement earnings that are recognized. In other words, financial statement earnings are usually the greatest during the early portion of a lease when positive cash flows are at their peak.

Until recently, SFAS 13 did not require a recomputation of GAAP financial statement earnings in situations where the timing of cash flows changed, but the total amount of income recognized over the life of a lease did not change. In other words, a change in the stream of financial statement earnings to be reported over the life of a lease would not change even though the timing of the underlying cash flows was altered[1].

Subsequent to enactment of IRC Section 470 in 2004, the FASB issued a FASB Staff Position ("FSP") that became effective on January 1, 2007. See, FSP FAS 13-2. In a significant departure from the SFAS 13 approach described above, the FSP provides that changes in the timing of cash flows caused by changes in tax treatment of a leveraged lease will require a recalculation of earnings dating back to the inception of the lease. When such changes in cash flows occur, the revised approach will result in a cumulative adjustment equal to the difference between the amount of GAAP income previously reported and the amount that would have been reported if the change in tax treatment had been known at lease inception. The entire amount of the cumulative adjustment must be reported when a change in tax treatment occurs, which will affect both current period earnings and retained earnings or capital.

Financial Statement Impact of Retroactive Application of Section 470

When IRC Section 470 was enacted it was applicable only to transactions entered into after March 12, 2004. Accordingly, neither SFAS 13 nor the FSP would require any change in the GAAP financial statement treatment with respect to transactions consummated before that date. The Senate has now included a provision in H.R. 2 (the "Small Business and Work Opportunity Act of 2007") that would make IRC Section 470 applicable to all transactions with a foreign entity or person, regardless of when they were entered into. This retroactive change to IRC Section 470 would virtually eliminate the benefit of deductions over the remaining lives of the leases. As a result, future cash flows would be dramatically reduced for a substantial period of time, and the FSP would require recalculation of the IRR from inception of the lease. Since the originally calculated IRR was heavily dependent on all future cash flows, not just those already realized, the GAAP financial statement impact on many affected lessors would be severe.

Apart from the negative tax policy considerations of retroactive application of IRC Section 470, the effect on capital markets and the economy, and on financial institutions in particular, would be extremely undesirable. These charges could also reduce retained earnings, and the regulatory capital of affected financial institutions, with potentially severe consequences such as limiting the ability to make loans, pay dividends, violation of debt covenants, rating agency downgrades, and a decrease in share values. Taxpayers clearly never anticipated that the tax law might be retroactively changed in a manner that would lead to such dire consequences.

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[1] Such a change if known from inception would have changed the IRR.

★ SEARCH

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