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IRS Blesses TRAC Lease Securitization

By David Burton, *Bloomberg Law* — February 24, 2014

In Private Letter Ruling 201404007, released Jan. 24, the Internal Revenue Service ruled favorably on a securitization structure to raise nonrecourse financing secured by cars subject to leases with a terminal rental adjustment clause (TRAC) provided for in Section 7701(h).

Section 7701(h) converts a transaction in the "form" of a lease that under common law tax principles would likely be treated as an installment sale (i.e., debt) into a "true lease."[1] But for Section 7701(h), the transaction would likely be treated as an installment sale because the purported lessee through the TRAC:

- bears all (or in some instances most) of the risk of the residual value of the car at the end of the lease term; and
- captures all of the upside.

[1] See *Swift Dodge v. Commissioner*, 692 F.2d 651 (9th Cir. 1982), *rev'g*76 T.C. 547 (1981) (holding in case that predates Section 7701(h) that a TRAC lease arrangement is a debt financing. This case compelled the automobile industry to lobby for the enactment of Section 7701(h)).

That is, if the car at the end of the lease is worth less than an agreed amount the lessee pays the lessor, and if it is worth more than the agreed amount the lessor pays the lessee.

Section 7701(h) places conditions on this arrangement. First, but for the TRAC, the lease must otherwise be a true lease (i.e., the length of the lease term must be reasonable and the lease must contain a bargain purchase option (but for economic consequences of the TRAC)). Second, the lessee must agree in a separate statement signed under the penalty of perjury that it will use the car at least 50 percent for business purposes and that it won't be the treated as the tax owner of the car. Third, the lessor may not finance its purchase of the car with nonrecourse financing.

This ruling appears to have been motivated by the third requirement. As reflected in the diagram that follows, the loans from the third-party lenders[2] are recourse only to a limited liability company and aren't recourse to the corporation that is the "Taxpayer" that will be claiming the accelerated depreciation associated with the cars. Such nonrecourse financings are consistent with Section 7701(h), so long as the nonrecourse financing isn't used for the taxpayer's acquisition of the cars.

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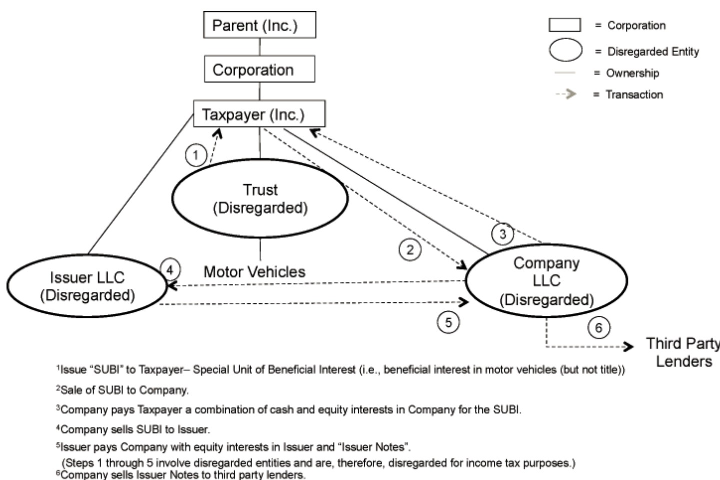
[2] The taxpayer in the ruling represented that the arrangement with the lenders was appropriately treated as debt for federal income tax purposes; thus, the ruling didn't have to analyze the unlikely possibilities that the arrangement with the lenders resulted in either of two unfortunate tax characterizations. First, that the nonrecourse financing resulted in a transfer of the tax ownership of the cars to the lenders, which presumably would only be an issue if the taxpayer and its disregarded entities were left with a de minimis equity investment in the cars. Cf. Estate of Crane v. Commissioner, 331 U.S. 1 (1947). Second, that the funds provided by the lenders were actually the proceeds from the sale of the rents from the TRAC leases, which presumably would only happen if the lender had insufficient ability to declare a default and insufficient protection against losses from collateral. Cf. Hydrometals v. Commissioner, 31 TCM 1260 (1972), aff'd485F2d 1236 (5th Cir. 1973).



The question implicit in the ruling is that if the lessor has in place a program that it repeatedly and regularly uses to raise nonrecourse debt secured by cars it recently acquired, is that program tantamount to prohibited "nonrecourse acquisition financing," as the lessor likely acquires the cars with an eye toward leveraging them with nonrecourse debt shortly thereafter.

Fortunately, as the statute doesn't preclude a split TRAC, any hesitation has proven unwarranted.

The ruling appears to apply the statutory language literally and to only look at the financing arrangements for the taxpayer's actual acquisition from the manufacturer of the car. The ruling provides:

Taxpayer represents that any amount it borrows to fund the initial acquisition from the manufacturer or dealer of a motor vehicle that is subject to a TRAC Lease will be recourse debt that Taxpayer is personally liable to repay, and that it will fund the entire acquisition price of the motor vehicle using operating capital or the proceeds of recourse debt. Hence, Taxpayer will be fully at risk on the acquisition price of the motor vehicles from the time of initial acquisition of the vehicle.

This is a laudable example of following the plain meaning of the Internal Revenue Code that allows for an administrable tax system with predictable results.

2000 ruling

The last time the IRS considered this issue was in PLR 200003015 (released Jan. 24, 2000), which was released 14 years to the day before the recent ruling. In the 2000 ruling, there was acquisition indebtedness that was recourse only to a special purpose limited liability company that was disregarded as an entity separate from the taxpayer and was supported by an undisclosed percentage of overcollateralization in the form of a pledge of unrelated assets.

The IRS in the 2000 ruling concluded that the acquisition financing arrangements didn't run afoul of the prohibition on nonrecourse acquisition indebtedness. From the text of the redacted ruling, it isn't clear if:

- the IRS naively concluded that recourse to a special purpose limited liability company that was disregarded as separate from the taxpayer was sufficient to make the debt "recourse"; or
- the overcollateralization was sufficient to make the debt recourse.

With respect to the second rationale, the redacted version didn't clearly provide that the overcollateralization was sufficient to meet the statutory requirement that the dollar value of the additional pledged assets (i.e., assets other than the purchased cars) must be at least equal to the amount of the nonrecourse debt balance.[3]

[3] Section 7701(h)(2)(B).

'Split TRAC' blessing

The 2014 ruling also raises two interesting secondary points. First, it appears to bless for TRAC lease purposes what is known in the industry as a "split TRAC" that is typically used to achieve "operating lease" treatment for purposes of the lessee's financial statements under Accounting Standards Codification 840 (formerly Financial Accounting Standard 13).[4] The ruling provides:

[4] The application of this arrangement to the "operating lease" test for financial statement purposes is discussed at Stuart Litwin, "Securitization of Equipment and Auto Leases" in Equipment Leasing-Leveraged Leasing, Section 14:5:5 (I. Shrank & A. Gough, Jr. eds.), September 2013 and http://ww2.cfo.com/gaap-ifrs/2013/05/lease-accounting-rules-tinker-dont-trash/3/ in section D.1. First Loss Guarantees.

In most Lease Agreements, the lessor bears the risk when net proceeds are less than a guaranteed amount (generally, *X* percent of book value or, if the lease is terminated at the end of the minimum lease term, *Y* percent of the original cost of the vehicle).

There is nothing in the statute that prohibits a split TRAC; however, as the cases that led to the enactment of Section 7701(h) dealt with full TRACs (i.e., the lessee's downside risk wasn't limited as described in this quotation) some traditionalists were hesitant as to how the IRS would react to a split TRAC. Fortunately, as the statute doesn't preclude a split TRAC, any hesitation has proven unwarranted.

Business use certification

The other secondary point is what happens when the lessee doesn't sign the required statement that it will use the car at least 50 percent of the time in its business and that it isn't the tax owner of the car ("Business Use Certification"). The taxpayer in the ruling represented:

Taxpayer and the lessee treat the lessee as the owner of the vehicle for federal income tax purposes and treat the arrangement between Taxpayer (or Trust) and the lessee as a loan for federal income tax purposes. Lease Agreements that do not include a Business Use Certification are not TRAC Leases and are not addressed in this ruling request.

Thus, the IRS dodged this issue, but the inclusion of the language would appear to suggest that at least the IRS wasn't offended by that approach, which seems to be the only logical way to deal with a TRAC lease that fails the statutory requirement.

It is also worth noting that the literal statutory requirement is that the Business Use Certification must be a "separate written statement" and signed under the "penalty of perjury." Presumably, these requirements are to avoid the lessee claiming that it didn't bother to read what appeared to be mere boilerplate.

The recent ruling provides helpful guidance as to how to structure TRAC lease financings. It could present valuable opportunities to financiers who appreciate its significance.

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