How three numbers may threaten leasing opportunities

IRS coding technicality requires fine-print reading

by Todd Skulte

Medical technology leasing is critical to hospitals and healthcare systems' ability to compete or – even more simply – exist. Leasing has become the preferred strategy for organizations that can't absorb the outright costs of expensive technology but need to continuously upgrade equipment to meet patients' needs.

However, because of a technical aspect of Section 470 of the Internal Revenue Code ("Code section 470") introduced by the American Jobs Creation Act of 2004, tax-exempt organizations will either have to give up a critical feature of leasing or face an increase in rents of 15 percent.

What is Section 470?

Code section 470 of the Internal Revenue Code contains what is known as the "Loss Trapping Rules." These rules diminish the benefits of leasing to tax-exempt entities by limiting a lessor's ability to use deductions associated with the ownership of equipment to the extent of the rental income generated in connection with the lease of the equipment.

The Loss Trapping Rules were enacted to eliminate perceived tax abuses associated with highly structured, much publicized lease-in/lease-out ("LILO") and sale-in/sale-out ("SILO") transactions. However, the Loss Trapping Rules were not intended to "inhibit legitimate commercial leasing transactions that involve a significant and genuine transfer of the benefits and burdens of tax ownership between the taxpayer and the tax-exempt lessee."

Who's at risk?

Loss Trapping Rules apply to leases to tax-exempt organizations that do not meet certain criteria. Under the rules, leases to tax-exempt hospitals are prohibited from having fixed price purchase options where the leased property has a class life of more than seven years (other than fixed-wing aircraft and vessels). The problem is that medical equipment has a class life of nine years.

Accordingly, the presence of a fixed-price purchase option causes the lease to be subject to the Loss Trapping Rules despite the fact that the lease is a "legitimate commercial leasing transaction that involves a significant and genuine transfer of the benefits and burdens of tax ownership between the taxpayer and the tax-exempt lessee."

This is troubling because many fiscally responsible hospital executives frequently ask for a fixed price purchase option price to ensure that – if the hospital needs the leased equipment – the "all–in" cost of that equipment is capped. In fact, a fixed price purchase option is considered standard and customary in a lease of medical equipment. Accordingly, because of the Loss Trapping Rules, tax-exempt hospitals must sacrifice the flexibility of a fixed price purchase option or face an increase in rents of 15 percent.

What to do?

The industry is asking Congress to change the class life of medical equipment to seven years or less so that a fixed price purchase option does not cause a lease of medical equipment to a tax-exempt hospital to be subject to the Loss Trapping Rules. In addition, medical industry associations are encouraging concerned administrators to write their Congressperson to request that the class life of medical equipment be changed from nine years to seven years or less. The industry believes changing the class life of medical equipment will protect standard medical leasing transactions from the impact of the Loss Trapping Rules while maintaining the intent of the rules. However, only time will tell if this letter writing campaign can affect change. **HPN**

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