Proceedings of the Third Harvard University Forum on Islamic Finance: Local Challenges, Global Opportunities
Cambridge, Massachusetts. Center for Middle Eastern Studies, Harvard University. 1999. pp. 191-197

Cross-Border *Ijāra*

A Case Study in the U.S. Taxation of Islamic Finance

Robert W. Toan*

ABSTRACT

An Islamic financial instrument is subject to U.S. taxation whenever the transaction involves one or more U.S. parties. As the number of such transactions grows, U.S. tax treatment of Islamic financial transactions is becoming increasingly important. Two critical tax questions arise. Will Islamic financial instruments be taxed less favorably than their conventional counterparts? And if so, can transactions be structured that satisfy the *sharīᶜa* while enjoying favorable U.S. tax treatment? This problem is illustrated by cross-border *ijāra*, in which a foreign Islamic financial institution leases equipment to an American company. U.S. tax law grants favorable treatment to "finance" leases—those treated as loans for tax purposes. While it may seem paradoxical for an *ijāra* transaction to qualify as a loan, Islamic law and American tax law emphasize different factors in determining whether the lessor or the lessee is the "owner" of the property, and, therefore, whether the transaction is treated as a loan or a lease. With careful attention to both systems, *ijāra* transactions should be able to secure favorable U.S. tax treatment.

I. INTRODUCTION

The dramatic growth of Islamic finance over the last two decades is one of the more striking phenomena in international banking. Twenty years ago there were a handful of Islamic financial institutions; today there are over 187 Islamic banks worldwide, and major international banks such as Citibank have established their own Islamic financial arms.[i] Total assets of Islamic financial institutions are estimated at over $100 billion[ii] compared with $5 billion in 1985, and the market is growing at an annual rate of 15% per year.[iii] Moreover, this growth is not limited to Islamic countries such as Indonesia, Pakistan, or the Gulf States. The Islamic banking sector has gained a toehold in the United States and Western Europe, with a number of non-bank Islamic financial service entities presently in operation. At least three Islamic leasing companies are operating in the U.S. The United Bank of Kuwait has recently begun offering retail Islamic mortgages in the United States, and U.S. and foreign-based multinationals such as GE, Exxon, and Royal Dutch Shell have utilized Islamic financing.[iv]

Little attention has thus far been paid to the U.S. tax treatment of Islamic financial transactions. This lack of attention is scarcely surprising considering that Islamic finance is in its infancy in the United States and other Western jurisdictions. And yet, as Islamic finance continues to expand, it will inevitably come into more contact (and perhaps conflict) with the U.S. tax system. U.S. taxation becomes relevant to a financing transaction when one or more parties is a U.S. tax resident.[v] The author has seen a number of Islamic financial transactions in which the financing party is a non-U.S. Islamic financial entity and the financed party is a U.S. tax resident. The number of such transactions appears to be on the increase.

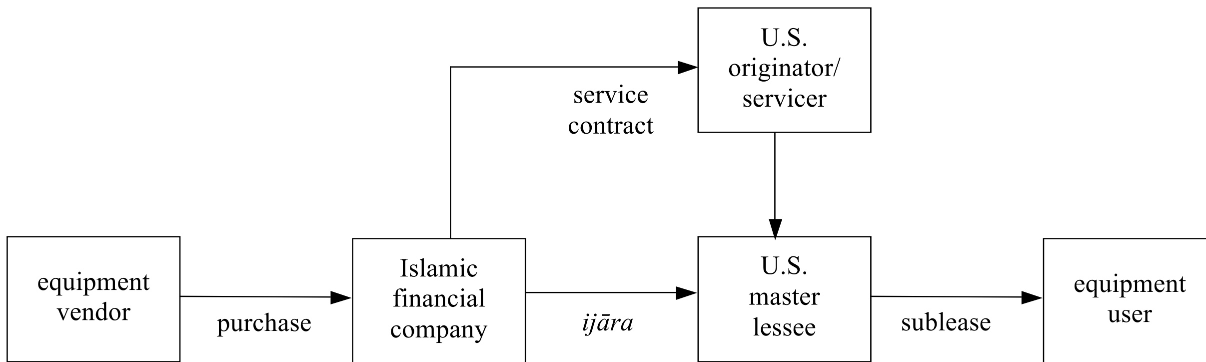
This article focuses on the taxation of one type of Islamic financial transaction—*ijāra* or Islamic leasing—in the cross-border context. In the past few years, a number of transactions have been consummated in which an Islamic financial company located outside the United States, or alternatively a fund for Islamic investors located outside the United States, has entered into an *ijāra* transaction with a U.S. lessee. The foreign finance company acquires equipment or other assets and grants their use to the U.S. company pursuant to the *ijāra*. The *ijāra* may be an isolated transaction, or part of an ongoing leasing program. Typically, the entire transaction would be originated by a U.S. leasing company, which may play an intermediary role as purchaser and reseller of the equipment or as an intervening user of the equipment, and which would also service the leases. This basic transaction structure is shown on Figure 1.

---

* General Counsel and Director of Structured Finance, Wafra Investment Advisory Group, New York, N.Y.

© 2011 The President and Fellows of Harvard College. All rights reserved.
http://ifp.law.harvard.edu/login/contact

FIGURE 1. THE STRUCTURE OF AN *IJĀRA* TRANSACTION



How will this type of transaction be taxed in the U.S.? In particular, how will the Islamic financial company be taxed? Will this taxation differ from the taxes that would have been payable if the finance company had entered into a conventional leasing transaction? Put another way, will the Islamic financial party suffer disadvantageous U.S. taxation because it has chosen the *ijāra* form rather than a conventional lease?

As we will see, under some circumstances *ijāra* transactions may be subject to decidedly more unfavorable taxation than certain other forms of leasing. However, the tax treatment will depend upon the terms of the *ijāra* transaction and need not necessarily be more unfavorable than a conventional U.S. lease. With attention to both the Islamic principles of *ijāra* and the U.S. tax principles governing cross-border leasing, an *ijāra* transaction can be structured to provide essentially the same tax benefits as other forms of leasing transactions.

The starting point is to understand the distinction between "operating" leases, which are treated as "normal" or "true" leases for tax purposes, and "finance" leases which are generally treated as loans for U.S. tax purposes. As we will see, this distinction has a number of important U.S. tax consequences. In the cross-border leasing context, it will often, although not invariably, be more favorable to have the lease qualify as a finance lease. The critical question will become this: Can *ijāra* transactions be structured to qualify as finance leases (that is, loans) for U.S. tax purposes?

II. "OPERATING" LEASES VERSUS "FINANCE" LEASES FOR U.S. TAX PURPOSES

U.S. tax law divides leases into two types: "operating" leases, also known as true leases, and "finance" leases, which are treated as similar to loans.[vi] Generally speaking, an operating lease for U.S. tax purposes is a lease where the lessor, the nominal owner, has retained sufficient ownership attributes—the so-called burdens and benefits of ownership—to be treated as the true owner for tax purposes. If the lessor is found not to have retained these attributes, the lease will be a "finance" lease and the lessee will generally be treated as the tax owner, although in some cases, depending upon the structure of the transaction, the vendor of the property or the secured lender might be considered the owner.

The most important test of tax ownership is whether the lessor has an opportunity for significant economic gain or loss with respect to the property.[vii] If substantially all the property's economic value is contained in the lease, and the lessor has no reasonable prospect for gain or loss in respect of the property (separate and apart from the value of the lease), the lease will likely be viewed as a finance lease.

Critical in determining the lessor's opportunity for gain or loss is the residual value available to the lessor at the end of the scheduled lease term. The lessor will be classified as the owner of leased property only if there is a meaningful residual value available to it. Under the advance ruling guidelines of the Internal Revenue Service, the residual value at the end of the term must be at least 20% of the lessor's equipment cost.[viii] The courts, however, have not followed any particular percentage rule and may find a true lease even where the expected residual value is substantially less than 20%.[ix]

The remaining useful life of the property at the end of the lease term is closely linked to residual value. A lease for the entire expected useful life of property will leave little if any value at the end of the term. The advance

© 2011 The President and Fellows of Harvard College. All rights reserved.
http://ifp.law.harvard.edu/login/contact

ruling guidelines specifically require that the remaining useful life at the conclusion of the lease term, including fixed rate renewals, be at least 20% of the estimated useful life.[x] If the lease term, including subsequent renewals at a fixed rate or nominal value, exceeds this limit,[xi] the lease may be treated as a sale.[xii] A lease that does not run for the entire useful life may nevertheless be treated as a sale if there is a fixed-price purchase option substantially below the expected fair market value at the conclusion of the lease term.[xiii]

The issue of residual value is not, however, the sole criterion of the treatment of finance leases. It is well established that all the facts and circumstances surrounding the lease must be considered.[xiv] In addition to insuring that the lessee will at all events have the risk and reward of the property's residual value, a lease intended to qualify as a finance lease should seek to provide the lessee as nearly as possible with the same rights and obligations as it would have in a secured borrowing. The burdens and benefits of ownership should both belong to the lessee. The documentation should limit the lessee's obligations in default and other early termination circumstances, such as casualty, to what they would have been if the documentation had followed the form of a loan. Thus the lessee should bear the risk of loss or diminution in value (a significant burden of ownership) and the lessor should be deprived of any upside potential in the property's value over what the lessor would have received had it been a mere lender. The lessor should attempt to place all of the obligations to maintain the equipment and to insure the equipment against loss on the lessee. Most finance leases will be structured as "triple net" leases in which the obligation of maintenance, the obligation to pay taxes, and the risk of loss, all of which are burdens of ownership, are placed on lessee, and the lessee must pay its full rent to the end of the lease term regardless of circumstance. In short, the structure attempts to mirror the rights and remedies associated with a secured loan transaction.

III. The Tax Advantage of Finance Leases

In the cross-border leasing context, there will generally, though not always, be a U.S. tax advantage in structuring a lease as a finance lease.[xv] If the cross-border lease is structured as an operating lease, the foreign lessor will definitely be subject to some form of U.S. taxation. This taxation can take one of two forms. First, the foreign lessor could be considered to be engaged in a U.S. trade or business and the cross-border lease income could be considered "effectively connected" with that business. In this event, the lessor will be subject to U.S. taxation on its net income at regular corporate tax rates (assuming that the lessor is a corporation) of up to 35%.[xvi] The foreign lessor will receive the benefit of depreciation to help offset its taxable income from rent, but this depreciation will generally be "recaptured" upon a sale of the property, the gain from which will also be subject to net income taxation. In addition, subject to possible treaty relief, the earnings and profits of the lessor may be subject to a 30% "branch profits" tax and certain of its interest expense payments may be subject to U.S. withholding taxes.[xvii]

A cross-border lessor that does not carry on regular and continuous business activities in the U.S. will probably not be treated as engaged in a U.S. trade or business as a result of a single lease or a very small number of leases.[xviii] However, the terms and scope of the lease will have an impact on trade or business status. Operating leases may require the lessor to perform equipment maintenance, payment of taxes, and other oversight functions either directly or through an agent. Even a single lease may require significant business activity in the U.S. if the lease relates to a number of assets, such as a fleet of cars, or if the tasks needed to maintain the assets are extensive. The activities of a U.S. agent acting on behalf of the lessor are likely to be attributed to the lessor where the U.S. agent has broad power to act for the lessor, including the power to execute contracts in the name of the lessor.[xix] The mere ownership and operation of property in the U.S. may constitute a U.S. trade or business. It is unlikely that a foreign lessor can enter into any significant number of operating leases in the U.S. without being engaged in a U.S. trade or business.[xx]

If the lessor under an operating lease structure is not treated as engaged in a U.S. trade or business, it will not be subject to net income taxes or branch profits taxes, nor need it file U.S. tax returns. However, the foreign lessor's gross rental income will be subject to a 30% withholding tax (unless reduced by applicable tax treaty).[xxi] Because the lessor will not receive the benefits of any deduction to offset the gross income subject to tax, these withholding taxes could exceed the taxes that would have been paid on a net basis.

In contrast to the foregoing, in the case of a finance lease the lessor will be viewed as making a loan to the lessee and the rental payments will generally be considered to be interest and principal payments on the loan.[xxii] The lending activity might be considered to constitute a U.S. trade or business, in which case the tax consequences would be quite similar to an operating lease which is treated as a U.S. trade or business activity. However, finance lease characterization should generally be helpful in avoiding U.S. trade or business status. Since the lessee is treated as the tax owner, the operation of this property would not generally be attributed to the foreign lessor. Finance leases are generally net leases, with the lessee performing all maintenance obligations, insuring the property, and incurring the risk of loss. All of this should be helpful in avoiding the imputation of a U.S. business

© 2011 The President and Fellows of Harvard College. All rights reserved.
http://ifp.law.harvard.edu/login/contact

activity to the foreign lessor. Of course, if the volume of leasing activity is significant, these activities could rise to the level of U.S. financing, but the volume of the required activity is probably higher than the case of operating leases.

Assuming that the foreign lessor is not engaged in a U.S. trade or business, its interest income from financing leases will very likely escape U.S. taxation altogether. Pursuant to the "portfolio interest" exemption, interest will be exempt from withholding taxes provided that certain conditions are met. In general, those conditions require that the foreign lessor not be a bank or a "10% shareholder" lessee, that the debt satisfy certain registration requirements, and that the lender provide certification of foreign status.[xxiii] It should usually be feasible to structure cross-border finance leases to satisfy the portfolio interest rules, assuming that the lessor is not a disqualified person pursuant to the foregoing rules.

The conclusion is this: When the foreign lessor is not engaging in a large number of leasing transactions, and is not otherwise engaging in U.S. trade or business, the potential for complete exemption from U.S. tax will make the financing lease structure attractive.[xxiv]

IV. *IJĀRA* AS A FINANCE LEASE

Islamic leases are similar in many respects to conventional U.S. leases. An *ijāra* transaction is considered to be the sale of the future use of an asset (usufruct, under civil law) and is an exception to the usual rule of Islamic contract law that at least one side of the contract must be performed immediately. It is required, however, that the use term and the lease consideration be fixed at the time of leasing and the lease must involve the use of a real tangible asset.[xxv] Floating rate leases are not permissible, although rent may be reset from time to time by using short-term renewable leases or mutually consensual repricing. Islamic thought views leases as containing an element of risk (*gharar*) since the value of the future use of the property may be unknown. Some schools of Islamic thought require that the lease permit either party to rescind if the value of the property is reduced through casualty or unforeseen business changes. Other schools permit more generally binding agreements although it is necessary that the lessor retain the ultimate risk of loss.[xxvi]

Ijāra transactions that are intended to be treated as operating leases for U.S. tax purposes present no particular classification problems. In this situation, the ownership of the property for tax purposes, the ownership under *ijāra* principles, and nominal ownership all coincide. In the cross-border context, however, as previously noted, operating lease treatment may be undesirable for U.S. tax reasons, and the parties may seek finance lease tax treatment. A number of Islamic law issues may make it difficult to create *ijāra* transactions that are treated as finance leases for U.S. tax and accounting purposes.[xxvii]

The law of *ijāra* does not give the parties complete flexibility in setting the lease terms. Certain rights and obligations are viewed as inherently belonging to the lessor, as the owner of the property, and other rights and obligations inherent to the lessee. One important point is that in an *ijāra* arrangement the duty to repair and maintain the property is always the obligation of the lessor. This obligation may not be shifted to the lessee. It is not clear the extent to which a lessee may even have the obligation of ordinary day-to-day maintenance.[xxviii]

Since the use of property is something which by its nature arises in the future, and therefore involves risk as to changes that may occur in the future as to the value of the asset or its use, Islamic law suggests that the lessee should have rights to cancel the lease if events cause the use to become diminished in value, consistent with the general Islamic rule that risk of loss falls on capital. The most dramatic example is a destruction of the leased property. It is fundamental that the lessor bears the risk of the loss or destruction, and that the lessee has the right to terminate the lease in the event of a significant diminution in value of the property.[xxix] If insurance is permitted (under certain interpretations insurance may be a form of forbidden *gharar*—see below), the lessor must pay the premium, although, of course, such cost could be incorporated in determining rent.[xxx]

Another problem relates to the sale or option rights at the end of the lease term. Islamic finance in general is highly adverse to the notion of gambling, or taking a risk on value, illustrated by the famous quote: "Do not buy fish in the sea, for it is *gharar* [overly speculative]."[xxxi] An agreement to buy an asset at a fixed price in the future, or an option to do so, may in strict Islamic practice be invalid since value can only be known at the end of the lease term. The OIC Fiqh Academy recommends that leases allow the lessee three termination options: (a) to extend the lease term, (b) to return the rented property, or (c) to purchase it at then current market value.[xxxii]

In summary, the following requirements of *ijāra* can make finance lease characterization difficult:

1. The obligation to maintain the equipment cannot be shifted to the lessee, as typically done in finance leases.
2. The risk of loss, diminution in value or destruction cannot be shifted to the lessee.
3. Fixed price purchase options may not be permissible.

© 2011 The President and Fellows of Harvard College. All rights reserved.
http://ifp.law.harvard.edu/login/contact

All of these issues relate to the fact that the risks of ownership, for Islamic law purposes, must remain with the lessor. This is a matter of substance, not mere form. The possession of naked title will not suffice.[xxxiii]

Nonetheless, the apparent contradictions between ownership of the lessee (for tax purposes) and ownership by the lessor (for Islamic purposes) can probably be resolved. U.S. tax law and Islamic law each has substantive requirements for determining ownership, and these requirements are not identical.

U.S. tax law, in determining ownership, looks primarily at the issue of residual value. If the lease covers substantially all the useful life of the property, or if there is a below-market value purchase option, the lessee will ordinarily be treated as the owner. The law of *ijāra* looks more to certain burdens of ownership: namely, the requirement of maintenance and the risk of loss or diminution in value.

Under Islamic law, the parties have complete freedom with regard to one element in the transaction that is key to finance lease treatment: the term of the lease. Nothing prohibits a lease for the entire useful life of the property. A lease that is truly for the entire useful life of the property may automatically satisfy another important requirement of finance lease: that the residual value at the end of the lease term, and therefore the upside/downside potential for the lessor, be minimal.

Under Islamic leasing concepts the availability of fixed price purchase options may be problematic. In the case of a lease for the entire useful life of the property, this problem may possibly be sidestepped by a zero dollar "gift" of the property to the lessee at the end of the lease term. There is at least some authority that such zero dollar purchase options are acceptable. If the parties desire that the primary term of the lease be less than the full useful life, however, and yet desire that the lease be treated as a finance lease for U.S. tax purposes, it is difficult to see how the problem of the fixed price option can be overcome. A fair market value purchase option at a time when, for example, 40% of the property's useful life remains, would leave substantial upside/downside potential in the hands of the lessor and would not be consistent with finance lease treatment.

Placing the duty of repair and maintenance on the lessor, as *ijāra* requires, is inconsistent with the usual finance lease that places such obligations on the lessee. Moreover, performing these maintenance obligations can easily entangle a foreign lessor in a U.S. business. Foreign lessors that desire finance lease treatment should circumscribe their maintenance activities as much as possible. One approach may be to hire an agent to maintain the property pursuant to a separate maintenance contract. The activities of such an agent may be attributed to the lessor and could rise to the level of a U.S. trade or business, as discussed above. Nonetheless, it may be possible to structure a maintenance contract which is sufficiently separated from the lease to constitute an Islamically valid arrangement and yet avoid agency principles under U.S. tax laws. For example, the maintenance contract might simply call for the return of the property in good order while leaving it entirely in the hands of the U.S. party to determine how to carry this out.

The retention of risk of loss or destruction by the lessor is also inconsistent with the usual finance lease. However, the lessor can obtain insurance and add the cost of insurance to the rental payments. Of itself, such an arrangement should not be fatal to finance lease treatment.

Taken overall, it should be possible to structure an *ijāra* contract to qualify as a finance lease without violating Islamic principles, provided that the lease covers most of the useful life of the property. It will be more problematic to achieve finance lease treatment in the case of a short-term lease where there is substantial residual value.

V. Burden of Proof

In order to treat an *ijāra* transaction as a finance lease (or loan) for U.S. purposes, a further issue must be confronted: Can the taxpayer avail itself of the substance over form argument to obtain tax treatment that differs from the form it has adopted? We have already concluded that the substance of *ijāra* contracts can be consistent with the U.S. tax criteria of a finance lease. Even in the case of conventional finance leases, however, it is not always clear that the taxpayer will be successful in obtaining treatment as a loan. To do so, the taxpayer must successfully argue that the lease transaction is, in substance, a secured loan, contrary to the form of the transaction.[xxxiv] The Internal Revenue Service is always free to assert substance over form; the taxpayer, however, may be bound to respect the form of the transaction. The Tax Court has held that the taxpayer, in order to treat a lease transaction as a loan for tax purposes, must produce "strong proof" that the burdens and benefits of ownership have been shifted to the lessee.[xxxv]

The "strong proof" burden is not unique to *ijāra*; it applies to any form of lease that seeks to be treated as a lending transaction. The "strong proof" burden is of special concern in the *ijāra* context, however, since there may

© 2011 The President and Fellows of Harvard College. All rights reserved.
http://ifp.law.harvard.edu/login/contact

be more ambiguity as to the substance of an *ijāra* transaction than in the case of a normal finance lease. Certain risks of ownership must be retained by the lessor and cannot be shifted to lessee.

Nonetheless, the parties to an *ijāra* contract should be free to specifically provide in the contract that both parties agree to treat the *ijāra* as a finance lease, or loan, for U.S. tax purposes. Islamic scholars have generally considered the U.S. tax or accounting treatment of an *ijāra* contract as irrelevant for Islamic law purposes. Thus, even though the contract takes the form of a lease, the parties can demonstrate their intent that the transaction should be treated as a loan for U.S. tax purposes. This will insure that the U.S. tax authorities cannot be "whip-sawed," with the two parties each claiming different tax treatment. The absence of this whipsaw possibility eliminates one policy reason for preventing the taxpayer from arguing substance over form.

VI. Conclusion

U.S. tax law has been called "interest biased." Debt is a favored form under the tax law in a variety of circumstances, treated more favorably than other forms of payment. As an example, cross-border interest payments generally escape U.S. taxation (assuming that the recipient has no U.S. trade or business) while other forms of cross-border payments, including rents, dividends and royalties, are subjected to substantial withholding taxes.

Given this preferential tax treatment accorded to interest, Islamic financial structures are at a disadvantage since the use of interest is forbidden. The problem is real. The differences between Islamic financial instruments and their Western counterparts are substantive, not mere questions of form. Islamic finance requires, fundamentally, that the risk of ownership be associated with earning a return on capital. This creates distinctive difficulties in according Islamic financial transactions the benefits associated with loans for U.S. tax purposes. In loan transactions it is the borrower, not the lender, that is the owner of the property.

Nonetheless there is good reason to believe that these contradictions can be resolved. The concepts of U.S. tax ownership are not identical with Islamic concepts of ownership. In the context of *ijāra*, Islamic law has tended to focus on certain types of risks associated with the ownership of property, while U.S. tax law has focused on different issues, predominantly related to residual value. With careful structuring, *ijāra* transactions should be able to satisfy *sharīʿa* requirements and still qualify for the favorable U.S. tax treatment accorded to lending transactions.

© 2011 The President and Fellows of Harvard College. All rights reserved.
http://ifp.law.harvard.edu/login/contact

---

[i] See DeLorenzo, Yusuf. A Compendium of Legal Opinions on the Operations of Islamic Banks. London: Institute of Islamic Banking and Insurance, 1997. p. x. The author wishes to thank DeLorenzo for numerous discussions and invaluable guidance concerning the Islamic law of *ijāra*.

[ii] Khalili, Sarah. "Unlocking Islamic Finance." Infrastructure Finance (April, 1997). p. 19.

[iii] Iqbal, Zamir. "Islamic Banking Gains Momentum." Middle East Executive Reports (January 1998).

[iv] Martin, Josh. "Islamic Banking Raises Interest." p. 25.

[v] U.S. taxation may also be relevant if the borrowing entity is an offshore corporation controlled by U.S. shareholders, or where the lending entity is a foreign entity with U.S. shareholders and is classified as a "passive foreign investment company" for U.S. tax purposes. Pursuant to the subpart F rules governing the taxation of controlled foreign corporations, income and earnings of the foreign corporation must be determined under U.S. tax principles in determining the taxation of the U.S. shareholders. See Sections 951-959 of the Internal Revenue Code of 1986, as amended (the "IRC"). Under the passive foreign investment company rules, a U.S. shareholder of a foreign company that dominantly earns passive income such as interest is subject to special tax rules concerning his tax liability in connection with his share in the offshore company's earnings. See Sections 1291-1297 of the IRC.

[vi] Depending on the circumstances, a finance lease could instead be characterized as a conditional sale for tax purposes. See Revenue Ruling 55-540, 1955-2 C.B. 39.

[vii] See, for example, Union Planters National Bank v. U.S., 426 F.2d 115, 118 (6th Cir. 1970).

[viii] The Internal Revenue Service, in Revenue Procedures 75-21, 75-28, and 76-30, 75-1 C.B. 715, 75-1 C.B. 752, and 762 C.B. 647, sets forth guidelines for ruling purposes as to the existence of a true lease as opposed to a sale or financing arrangement. The ruling guidelines may be summarized as follows: (1) The lessor must have a minimum unconditional at-risk investment throughout the lease term of at least 20% of the property's cost; (2) The residual value of the property at the end of the lease term must be at least 20% of the original cost, net of lease amounts received that are considered capital recovery; (3) The remaining useful life at the end of the lease term must be at least 20% of the original useful life; (4) The lessor cannot have the right to put the property; (5) The lessee cannot have a purchase right at less than fair market value; (6) The lessee cannot supply or guarantee the purchase cost of the property; and (7) The lessor must have a profit motive. It should be noted that these are only advance ruling guidelines, and not a statement of the law concerning tax ownership. Nonetheless, most of the factors taken into account by the ruling guidelines are found in one form or another in the case law.

[ix] See, e.g., LTV Corp. v. Commissioner, 63 T.C. 39, 50 (1974) (residual value of 10% of original cost).

[x] Rev. Proc. 75-21, Section 4(1)(C), 1975-1 C.B. 715.

[xi] See Rev. Rul. 55-540, Section 4.06, 1955-2 C.B. 39 (Internal Revenue Service would treat contracts as a sale if lessee may continue to lease property for its remaining life for a nominal payment).

[xii] See Oesterreich v. Commissioner, 226 F.2d 798, 803 (9th Cir. 1955) (rent after year 28 in a 67-year lease declined well below fair rental value although property increased in value); Estate of Starr v. Commissioner, 274 F.2d 294, 295 (9th Cir. 1959) (special use of property had no remaining useful life or residual value since not useful to anyone other than lessee).

[xiii] Swift Dodge v. Commissioner, 692 F.2d 651 (9th Cir. 1982), reversing 76 T.C. 547 (1981).

[xiv] See Frank Lyon v. U.S., 435 U.S. 561 (1978).

[xv] In the purely domestic context, the financing lease structure is not necessarily preferable to the operating lease structure. Numerous tax consequences result from having tax ownership either in the hands of the lessors or in the hands of the lessee, and which is more advantageous will depend upon the tax goals and tax positions of the parties. In the cross-border context, however, there are very particular advantages to the financing lease structure. Often, the financing lease structure is employed in order to create so-called "double-dip" leases in which tax ownership is considered to be in the hands of the lessor for foreign tax purposes but in the hands of the lessee for U.S. tax purposes, thus affording depreciation benefits in both jurisdictions. In the present discussion, we are ignoring any potential foreign tax benefits. However, as will be seen, in certain common circumstances there are sizable U.S. tax benefits to financing lease treatment.

[xvi] See IRC Sections 11, 882.

[xvii] See IRC Sections 884(a) and 884(f).

[xviii] See, e.g., Lewenhaupt v. Commissioner, 20 T.C. 151 (1953); Neill v. Commissioner, 46 B.T.A. 197 (1942). See also Rev. Rul. 73-522, 1973-2 C.B. 226. A foreign lessor that is regularly engaged in U.S. business through other activities needs to consider whether its leasing activities will be "effectively connected" to its other business.

[xix] See, e.g., InverWorld v. Commissioner, 73 T.C.M. 2777 (1997).

[xx] Another pitfall should be noted. If a foreign lessor takes the position that it is not engaged in trade or business in the United States, and therefore does not file U.S. tax returns, but is later found to be engaged in a U.S.

© 2011 The President and Fellows of Harvard College. All rights reserved.
http://ifp.law.harvard.edu/login/contact

trade or business, the Internal Revenue Service is authorized to disallow the benefit of all deductions. See Inverworld v. Commissioner, supra, footnote 17. This situation could easily arise where a lessor believes that it is acting as an investor in a few lease transactions, with all U.S. activities in connection with the leases carried out by the U.S. originator/servicer as an agent of the foreign lessor.

[xxi] IRC Section 881(a).

[xxii] If the lessor were treated as making an installment sale of the property, the tax consequences would in most respects be similar. The rental payments would in this case be treated as the purchase price of the property plus interest. See Rev. Rul. 55-540, 1955-2 C.B. 39.

[xxiii] See Sections 871(h)(2)(B) and 881(c). An interesting question could arise in connection with an Islamic financial institution as to whether such an institution is a “bank” for purposes of the portfolio debt rules. If the institution is organized pursuant to a banking statute it will probably be difficult to avoid classification as a bank. However, the special structures of Islamic financial organizations, which do not pay interest or accept deposits in the Western sense, could raise interesting speculations.

[xxiv] Different considerations will apply if the foreign lessor is otherwise engaged in U.S. trade or business or when a large number of leases are contemplated. A detailed discussion of how much leasing activity will constitute a U.S. trade or business, and other considerations that may affect this determination, is beyond the scope of this article.

[xxv] See Vogel, Frank E. and Samuel L. Hayes, III. Islamic Law and Finance. The Hague: Kluwer Law International, 1998. p. 104. (hereafter Vogel Hayes)

[xxvi] Ibid.

[xxvii] Finance leases have been stated to be un-Islamic since they are like pure financing transactions. See Accounting Issues in Islamic Banking. London: Institute of Islamic Banking and Insurance, 1994. pp. 29-30.

[xxviii] Vogel Hayes at p. 144.

[xxix] Vogel Hayes at pp. 104, 144.

[xxx] Vogel Hayes at p. 104.

[xxxi] Vogel Hayes at p. 88; citing authority.

[xxxii] Vogel Hayes at p. 263.

[xxxiii] It is sometimes mistakenly thought that Islamic legal requirements are entirely formal, so that transactions that are in essence loans bearing interest will be acceptable provided that they are given other labels. This is not the case. Each form of Islamic finance has substantive as well as formal requirements. These substantive requirements often relate to the fundamental principle that the risks of ownership (of property or a business) must be inextricably associated with earning a yield on capital. That being said, there may be transactions that for one purpose (such as taxation) will be treated as a loan under U.S. law while still satisfying the requirements of Islamic finance.

[xxxiv] See Rogers v. Commissioner, 29 T.C.M. 869, affirmed, 845 F.2d 1020 (2nd Cir. 1921). See also Smith. “Substance and Form: The Taxpayers Right to Assert the Priority of Substance.” Tax Lawyer 44(137) (1990).

[xxxv] Coleman v. Commissioner, 87 T.C. 179 (1986).

© 2011 The President and Fellows of Harvard College. All rights reserved.
http://ifp.law.harvard.edu/login/contact