Myths and Near-Myths about Lease Pricing

by David Holmgren

If lucky, a lender will experience just a near-miss from believing a near-myth about lease pricing. More likely, though, the ramifications of not having the whole story will be more serious. Here are a few myths and near-myths—plus the real story. A new product from RMA holds the truth, the whole truth, and nothing but the truth.

Lease pricing, or structuring, may seem complicated and mysterious to those who are not closely involved with it. Admittedly, a number of characteristics do contribute to the complexity of lease structures; however, arming oneself with certain insights can help counter potential confusion. A clear understanding of important terms of the industry is always helpful, as is an appreciation of the most troublesome areas of lease pricing where extra attention is called for. Toward this end, here is a list of common myths and near-myths and a brief discussion of what's true or not true about them.

If it's called a lease, it must be a lease.

This statement is deceptive. There are many different perspectives on a leasing transaction, including tax accounting, book accounting, documentation, and legal.

One of the most important perspectives is taxation. The party named by the IRS as true owner of the equipment (thus, the designation *true lease*) is the one that is entitled to depreciation benefits. Depreciation is a major factor in the economics of a lease, and the IRS does not allow both lessor and lessee to claim depreciation on the same asset. The IRS doesn't usually pay particular attention to wording in lease documents in making a determination; rather, it tries to discern the true substance of a transaction.

- If a transaction is deemed to be a true lease, the lessor receives the depreciation benefit. At the same time, the full rent payments are taxable for the lessor and deductible for the lessee.
- If a transaction is deemed to be a *conditional sale* (a loan), then the lessee receives the depreciation benefit, and only the imputed interest of the rent payments is taxable (as income to the lessor/seller and a deduction to the lessee/purchaser).

© 2000 by RMA and Ivory Consulting. *Holmgren is a senior financial analyst for Ivory Consulting Corporation, Walnut Creek, California. His responsibilities are quality control, application development, and client consulting for SuperTRUMP, the leasing industry's original PC-based financial modeling program. He publishes regularly in industry journals and speaks at industry forums.*

The Internal Revenue Service has a clear and simple way to distinguish a true lease from a conditional sale.

Our industry would be quite a bit simpler if this were true. Actually, however, several tests are applied to decide lease transaction type—pretax profit, cash flow, minimum equity, maximum leverage, lessee investment, bargain purchase, minimum risk, remaining life, and remaining value. Some of these stem from *Revenue Procedures 75-21* and *75-28*. Others have been applied in specific instances, and their general applicability is a matter of interpretation.

One general principle in distinguishing a true lease from a conditional sale is that there must be a legitimate business objective in the lease, apart from tax benefits. Another is that the owner should carry the risks of ownership, not just enjoy its benefits, that is, the owner must carry a substantial equity investment in the asset during the lease and assume a substantial residual risk. Thus, the owner's economics are partly dependent on the market value of the asset at the end of the lease. If the value of an asset is substantially consumed by one lease transaction, then the IRS could be motivated to consider the lessee (instead of the lessor) the owner.

As lessee, the best way to compare lease bids is on the basis of the lowest total rent.

Unfortunately, this statement would not be accurate in business terms, as it ignores the time value of money. Rents can be paid in monthly, quarterly, semiannual, or annual. The amounts can vary to meet a structuring purpose or because it's a floating rate lease. And the timing can vary, particularly in advance or arrears.

Two techniques quickly come to mind to help out: present-value and effective cost. The first is the present-day equivalent of all of the rent payments, computed using a discount rate representing the lessee's time value of money.

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The effective cost, sometimes called the "all-in rate," is the rate that discounts all of the rent payments to the asset cost. A further refinement is to analyze lease bids on an after-tax basis, that is, their costs including tax effects are compared. This requires a more sophisticated modeling tool, but is a more rigorous approach.

As lessee, we assume that the lessor is always passing on to us the benefits of ownership in the form of lower rents.

This would be naïve of the lessee. The lessor may or may not be sharing these benefits by reducing the rent. That's a function of how much profit, or "yield," the lessor is after. In most cases, the marketplace forces lessors to share this benefit, because lessees can shop around for competing lease bids. Sometimes, a particular lessor will be in a better position, due to its tax situation, remarketing opportunities, equipment expertise, or other reasons, to offer a more attractive lease bid, even at a higher yield, than another lessor. In comparing lease bids, the lessee should focus on the rent (assuming the bids are similar in other respects) and not on the lessor's yield. Keep in mind that the lessor's yield is partly a function of their tax position, hardly a lessee concern.

Terminating a lease is a simple matter.

Termination is when the lessee returns the equipment to the lessor before the end of the lease. The simplest approach would be to require the lessee to pay the unpaid rents, but this would be

decidedly unfair. Usually, the lessor and lessee agree upon a schedule of termination values as part of the lease documents.

A *termination value* (TV) is the amount on a particular date payable by the lessee to terminate on that date. Technically, the TV is the amount the lessor would have to receive on that date to be whole with respect to its original after-tax yield. A complication is that the TV itself is taxable to the lessor, so it must be grossed upward to cover that liability. Inasmuch as TVs can be calculated to protect different yields, most lessors choose not to reveal these sensitive calculations and include only the schedule of actual values in the documentation.

In general, a lessee should expect a schedule starting at about 100% of the equipment value and dropping fairly smoothly through the lease term to a fraction—20-30%—toward the end of the term. When comparing competing lease bids, termination schedules should be part of the lessee's analysis.

As lessor, including an early buyout option with an attractive price is a legitimate incentive.

A lease bid can include an early buyout option, which is the opportunity for the lessee to purchase the equipment for a specified amount on a particular date before lease-end. This is often a desirable feature, as the equipment will likely be well integrated into the lessee's business and the lessee may be convinced that it would need the equipment beyond lease-end anyway.

A further benefit to the lessee is that it can begin to depreciate the equipment if it exercises an early buyout. Early buyouts are frequently competitive points in lease bids. For the lessor, the danger in offering an attractive early buyout is that it will be *too* attractive; in other words, a *bargain*. This could jeopardize the true lease status of the transaction and ruin the lessor's economics. One technique to judge this is called the *economic compulsion test*, so called because it tests whether the lessee is "economically compelled" (because it's a bargain) to exercise the option. In this test, the present value of the "forgiven rents" (those occurring after the EBO date) and the fair market value of the equipment at the end of the lease is compared with the early buyout amount. If the buyout is less than present value, it is in danger of being considered a bargain. Another school of thought relies on appraisals or estimates of future equipment value to ensure that the option is not significantly under its fair value.

Rents are a level monthly amount set at the time the lease is signed.

This is often the case but certainly not always the case. The lease agreement should spell out the amount(s), timing, and periodicity of the rents. If the amount is not level, a full schedule of amounts and dates must be agreed upon. The timing specifies whether the rent is due at the start (advance) or the end (arrears) of each period. In a *flip* structure, rents are initially payable at the end of each period until the flip point; thereafter, they are payable at the start of each period. In a *split* structure, each period has an advance and an arrears portion, and each arrears payment is made together with the advance portion of the next period's payment. The periodicity, that is, whether the rents are monthly, quarterly, semiannual, or annual, may vary. The latest creative twist is called the *prepaid/deferred* structure. In such a lease, regular periods comprise the lease term for usage and tax purposes, but the actual payments are made on seemingly unrelated dates—before, during, or after those periods.

The lessee deducts from taxable income the full rent at the time it is paid.

A lessee typically is entitled to deduct the full rent but not necessarily when it is paid. The traditional calculation basis is accrual, meaning that each month, a pro-rated portion of that rental period's full amount becomes deductible, regardless of when the lessee pays the rent. Interestingly, the lessor must take advance rents into taxable income on a cash basis (that is, upon payment), but arrears rents are on an accrual basis. In the innovative prepaid/deferred structure, the deductions are made according to a separate schedule agreed upon between lessor and lessee, and those amounts generally do not coincide with the cash payments!

Buyout amounts, just like rent payments, are fully deductible.

A buyout—either an early buyout or an end-of-lease purchase—is not deductible. Rather, the equipment that is purchased is depreciated.

If the rents do not vary by more than 10%, the lease is a true lease.

This near-myth has its origin in the uneven rent test, which determines whether any year's rent varies from the average annual rent by more than 10%. However, failing this test does not mean that the lease is not a true lease. It simply means that the lessor may be subject to rent "leveling" per IRS regulation 467. However, passing the test does not qualify the lease as a true lease.

A capital lease for the lessor is also a capital lease for the lessee.

The Financial Accounting Standards Board *Statement 13* governs the treatment of leases for book accounting purposes. In general, a lease that substantially consumes the value of an asset needs to be "capitalized," or placed on the books as a capital lease (direct finance lease). Otherwise, it is an operating lease and does not need to be shown in the balance sheet. However, lessor and lessee make the decision as to whether it is capital or operating separately, and the tests are not usually the same. The main test is the PV test, sometimes called the 90% test. In this, if the present value of the minimum lease payments is equal to or over 90% of the equipment cost, it is deemed a capital lease. The lessor uses the interest rate implicit in the lease for discounting. This is the rate that discounts the rents and economic residual value to the asset cost. The lessee is directed to use that same rate if it is available; when it is not available (which is most of the time, inasmuch as the lessor is not required to reveal their assumed economic residual), *SFAS 13* directs the lessee to use its incremental borrowing rate. FASB also specifies tests relating to title transfer, bargain purchase, and economic life that also bear on the capital, versus operating designation.

Summary

Don't let the complexities of lease pricing make it seem unmanageable. Keep in mind that a transaction's tax treatment, that is, whether it is taxed as a lease or a loan, is determined by the IRS. This is separate from the accounting treatment as set forth by FASB, which governs how a transaction is reflected in the companies' accounting statements. The lessor and lessee are in the transaction for different reasons, and each uses measures suited to its own perspective. The lessor is trying to make a certain after-tax yield on its investment, while the lessee is trying to minimize its cost to use the equipment. The timing and deductibility of payments is important in the economic analysis and requires careful consideration in the projection and measurement of the cash flows. These few guidelines should help in demystifying lease pricing. ❒