Systematizing the Classification of Leases for Taxes and Accounting

By David B. Holmgren

Here is a model for systematizing the process of classifying a lease for tax and accounting purposes, based on transaction specifics.

Classification of equipment leases is one of the more complicated and confusing areas of lease analysis and documentation. Precious few leasing professionals claim never to be confused by the terms bantered about: *capital, direct finance, operating, sales, true lease, tax lease, terminal rental adjustment clause, off-balance sheet loan, synthetic lease, conditional sales contract,* and so on.

At the same time, the classification has a direct bearing on taxation, accounting, and economics. The situation is made more difficult by the continuing evolution in structures and by the unclear state of some regulations. The uneven rent regulations, Section 467 of the Internal Revenue Code, are an example where official clarifications are slow in coming. Creative lessors and financiers, motivated by emerging economic opportunities or the need to replace structures eliminated by legislation, continue to find new ways to take advantage of wrinkles in tax and accounting regulations.

This article describes an approach toward integrating the tax and accounting aspects of classifications in a single model. A side benefit is the simplification or clarification of the many terms into their essential concepts. This classification model was developed as an implementation guideline for our software development, but its relevance is broader.

The Purpose

The basic purpose of the model is to systematize the process of classifying a lease for tax and accounting purposes, based on transaction specifics. Inasmuch as these classification decisions can have economic effects, making this process clearer and more consistent should be of benefit. This model also provides a framework for understanding the effects of changes in tax, accounting, or policy regulations. The endpoints for tax treatment are the *conditional sales contract* and *true lease.* The accounting endpoints are *operating lease, sales type lease, leveraged lease,* and *direct financing lease.*

In addition, the model incorporates a "lender mode" selection in both areas, indicating immediately that the transaction is a loan, without regard to other characteristics. The scope of the model is equipment leases from the lessor perspective, and of loans from the lender perspective. Thus, the model does not consider the perspective of a lessee, nor of a purchaser of equipment.

The Regulations

A discussion of lease classification calls for an early clarification of whether one is speaking of tax or accounting treatment. A complicating factor is that two organizations are responsible for classifying leases: the Internal Revenue Service for tax purposes and the Financial Accounting Standards Board for accounting purposes. The bases for the tax tests are the IRS Revenue Procedures 75-21 and 75-28 and their successors, 4.071 and others. The accounting standards are the Statement of Financial Accounting Standards No. 13 (SFAS 13) as amended.

The undertaking of a general classification model is made difficult by the variety of interpretations on many of the points on which these decisions turn. Consider this declaration of the IRS regarding the validity of a general approach.

> Whether an agreement, which in form is a lease, is in substance a condi-

No single test or general rule can be laid down, according to the IRS.

tional sales contract depends on the intent of the parties as evidenced by the provisions of the (lease or transaction) agreement, read in the light of the facts and circumstances existing at the time the agreement was executed. In ascertaining such intent, no single test or any special combination of tests is absolutely determinative. No general rule, applicable to all cases, can be laid down. Each case must be decided in the light of its particular facts.[1]

Despite this discouraging prologue, we set out to make the best of our endeavor. To the IRS's credit, it recognizes the existence of principles that are generally compelling in the absence of contradictory indications. This model encompasses some of these principles.

Tax Phase

The classification model, shown in Figure 1, begins with the tax phase, whose objective is to identify whether the transaction is a *true lease* or a *conditional sales contract* for tax purposes. (Both this and the accounting phase include choices for the user to arbitrarily select the endpoints.) This distinction has a material economic effect, as the components of taxable income for the owner/lessor are determined as follows:

- True lease: MACRS depreciation tax benefits are allowed as deductions from taxable income, interest paid is deductible, and rent and residual are taxable income.
- Conditional sales contract: Cash inflows to

Figure 1

TAX CLASSIFICATION

Begin TAX CLASSIFICATION
Lender Mode
Loan
No
True Lease
User Choice
Default
CSC
Leverage > 80%
Yes
Conditonal Sales Contract
No
75-21 Tests
Leverage > 50%
Yes
Profit
Fail
Pass
Cashflow
Fail
Pass
Equity
Fail
Optionally ignore 75-21 tests because not leveraged
Pass
Put
No
Lessee Guarantee
No
Bargain Purchase
No
3rd Party Guarantee
No
Security Deposit
No
Limited Use
No
Rem. E-Life
No
Rem. E-Value
Yes
No
Uneven Rent Test
Fail
User Choice
Adjust Rents
Level per 467
True Lease
Ignore Failure

the lessor are split into principal and interest components. The interest is taxable income. The residual is considered a balloon payment, and there are no deductions for depreciation. There may be a gain at execution of the contract in the event of an excess of the deemed sales price over the cost.

The tax testing continues with a check of leverage: If it is over 80 percent, *conditional sale* is immediately assumed. This is due to the lessor's having less than 20 percent at risk. This value is only a guideline; smaller amounts may be acceptable, depending on the nature of the asset or the industry.

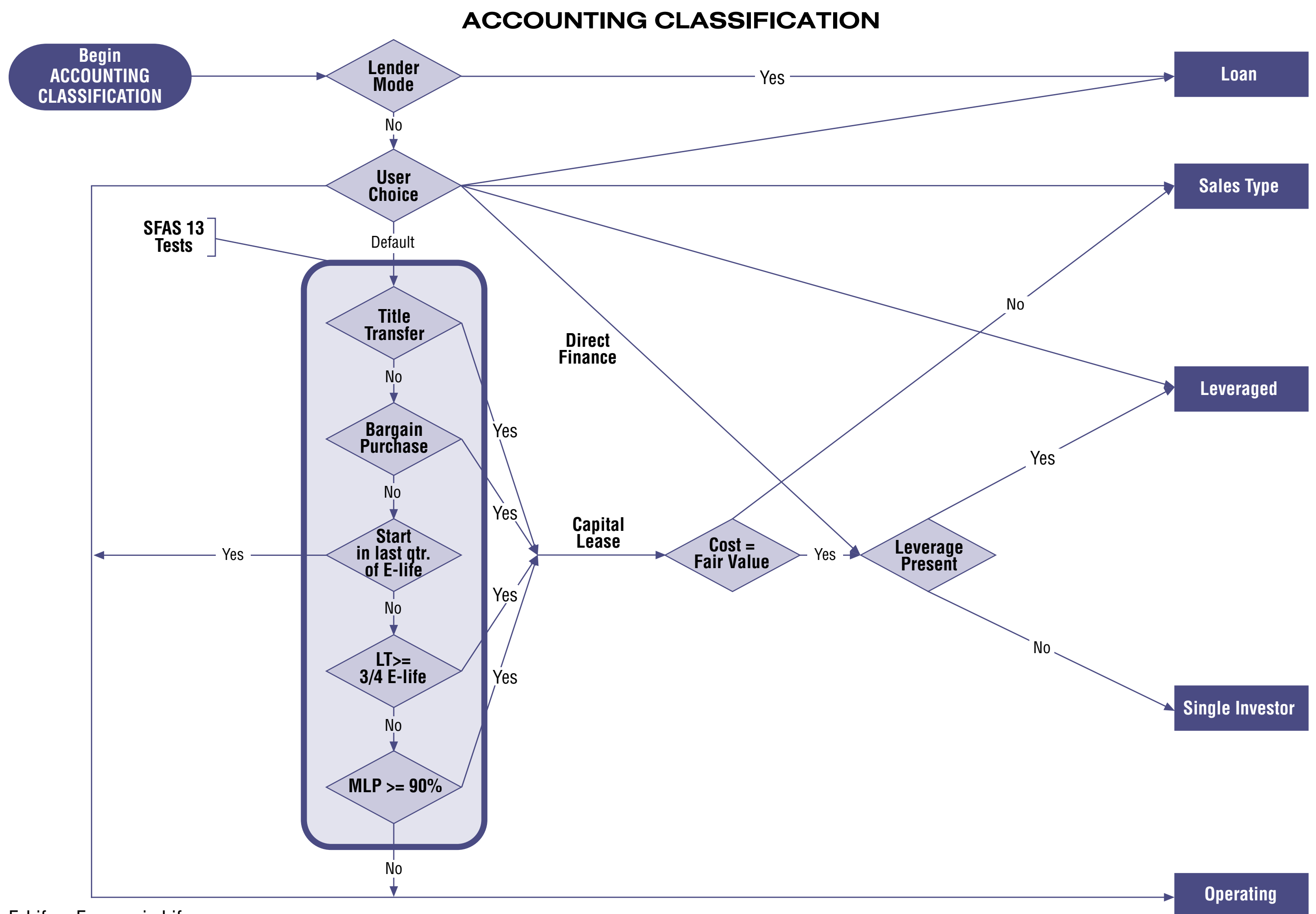
Lower thresholds are frequently used for high-tech equipment in particular. If leverage is less than 50 percent, then the 75-21 tests can optionally be bypassed, as inapplicable to nonleveraged leases. Within the range of 50 percent to 80 percent, these tests — profits test, cash-flow test, and the minimum equity test — are performed. If any one fails, the transaction is assumed to be a *conditional sale* and further tests are skipped.

The profit test checks whether the transaction, exclusive of tax benefits, produces a profit. Adding the total rents and the estimated residual, and subtracting the disbursements of principal and interest payments, equity, and fees performs this. If the result is positive, the test is passed.

The cash-flow test determines whether total rent less debt service and fees is "reasonable," which typically is taken to mean 2 percent of the equity per year. Finally, the minimum equity test checks whether the free cash is received "too quickly." This is done by adding the equity to a prorated amount of profit at each point in the lease and comparing that to the cumulative profit to that point. The prorating is usually proportional to the percentage of the lease term.

As a guideline, if leverage is over 80 percent, conditional sale is assumed.

Figure 2



E-Life = Economic Life
E-Value = Economic Value
MLP = Minimum Lease Payments

A bargain purchase option is a provision allowing the lessee to purchase the equipment for an amount less than its fair market value. This is seen as economically compelling and therefore determines conditional sale.

Some Judgmental Tests

The model then proceeds to tests that are somewhat judgmental rather than quantifiable and measurable. Specifically, these are the presence of a *put,* a *lessee residual guarantee, bargain purchase option, third-party guarantee, security deposit,* and *limited use property.* If any of these applies, then the transaction is deemed a *conditional sale* and flow proceeds to the accounting phase, bypassing the remaining tax tests. (Some of these tests use thresholds for determining whether the test passes.)

A *put* is a clause allowing the lessor to force the lessee to purchase the equipment, and a *lessee residual guarantee* is an assurance that the lessee will guarantee a certain portion of the residual value. Both indicate that the lessor is not carrying the full residual risk or that the lessee has an economic interest in the equipment beyond the lease term. Depending on transaction particulars, either may determine *conditional sale.*

A *bargain purchase option* is a provision allowing the lessee to purchase the equipment for an amount less than its fair market value. This is seen as economically compelling and therefore determines conditional sale. Whether a purchase option is a bargain is determined in the model by a simple comparison of the purchase option amount to the fair market value; if it is less, it is a *bargain purchase.*

A *third-party guarantee* is an assurance — often in the form of insurance coverage — by a party not related to the lessee or lessor to pay a certain portion of the residual. This guarantee may apply to the top or bottom of the expected residual value. The first covers the shortfall (up to the amount of insurance) between the actual proceeds and the insured residual. The second is coverage to prevent the realized value from dropping below a certain insured amount, regardless of the expected residual value.

An arm's length agreement to protect either end is a fairly standard arrangement and should not affect true lease status, especially if a significant portion of the expected residual remains unguaranteed or if the lessor retains first-loss exposure. In the model, 10 percent is used as a simplistic guideline for this test, but this area is subject to a variety of interpretations by lessors and their tax counsel.

A *security deposit* is a significant amount (10 percent or more of equipment cost) paid by the lessee and held by the lessor during the lease. Closely related to a security deposit is an investment by the lessee in the lessor's operation, or particularly in the initial funding of the equipment. Such an investment could mean that the lessor is carrying less than the full risk commensurate for true lease benefits. This, too, decides for *conditional sale.*

Next, the model tests whether the equipment is *limited use property,* a somewhat subjective point. If a reasonable interpretation indicates that its use is limited to the particular lessee, application, or facility, then the lessor would probably be seen as having a substantial interest in continuing the economic relationship with this lessee, either as a sale or a renewed lease. This also determines *conditional sale.*

Finally, two tests are applied relating to the remaining usefulness of re-leased equipment. First, the remaining economic life is compared to 10 percent of the full economic life (or alternatively, 20 percent, depending on the type of equipment), and the remaining economic value is compared to 10 percent or 20 percent of the original value (choice of test value to be consistent with the preceding test). If either is less than the comparison value, the transaction is deemed a *conditional sale.* This recognizes the circumstance that this lease will likely be the last for this equipment, so the lessor will have nothing more at risk, or, expressed differently, the remaining economic value will be consumed by this lease.

If all of these tests are passed without *conditional sale* having been determined, then *true lease* is concluded. The only remaining tax question is whether the rents meet the uneven rent test. A complete discussion of this test goes beyond the scope of this article, but in general the test is passed if each year's rent falls within 10 percent of the average annual rent.

For purposes of our model, the user has a further choice of how to handle a failure: ignore it or adjust the rents. Adjusting them means leveling them per the regulations in Section 467. (It does not disqualify the true lease status.)

Accounting Phase

The purpose of the accounting phase is to arrive at one of the endpoints—*loan treatment, sales type lease, leveraged lease, direct financing lease,* and *operating lease.* This (see Figure 2) decision will determine the lessor's balance sheet and income statement treatment. *Capital lease* is the collective designation for *sales type, leveraged,* and *direct financing.* The intent of the capital lease designation is to recognize

> ... that a lease which transfers substantially all of the risks and benefits incident to the ownership of property should be accounted for as the acquisition of an asset and the incurrence of an obligation by the lessee and as a sale or financing by the lessor.[2]

Like the tax classification process, the accounting phase begins with the lender mode question. If affirmative, *loan treatment* is decided and there are no further tests. The model then provides a choice for the user to select the accounting treatment, but in the default case the SFAS 13 tests are performed. Passing any one of these four makes the lease a *capital lease.* If none is met, it is an *operating lease.*

The first test is *title transfer.* The concept here is that if the documents state that title to the asset will transfer from lessor to lessee, then the parties should account for the transaction as if it were a sale, since the lessee is assuming the risks and benefits of ownership.

The test for a *bargain purchase option* is similar although less definitive. (Less definitive because the question of whether a purchase option constitutes a bargain may be subjective.) A bargain purchase option indicates that the lessee is entitled to purchase the equipment for an amount significantly less than the fair market value. Since it is reasonable to expect the lessee to exercise such an option, the lessee in effect has taken on the risks and benefits of ownership, and the transaction qualifies as a *capital lease.*

Then the model tests whether the lease begins in the last quarter of the economic life of the asset. If so, it is an *operating lease.* This is because there is no particular need to account for an asset on the balance sheet if its value has already been substantially consumed. If that is not the case, but the lease term is at least three-fourths of the economic life, then it is a *capital lease.* This is because the lease consumes the substantial value of the asset.

Finally, it is a *capital lease* if the present value of the minimum lease payments (MLP) is at least 90 percent of the equipment cost (discounted typically at the *interest rate implicit in the lease*). This tests whether the lessee's rent and other obligations to the lessor (such as a partial third-party residual guarantee) under the lease comprise a substantial portion of the equipment cost. This test is crucial in many structuring situations.

The *capital lease* designation is broken down by two further tests. First, is the fair value of the equipment equal to the cost? If not equal (that is, profit is generated), the transaction is deemed a sales type lease. If equal, a *direct finance lease* is concluded. This is the umbrella term for *leveraged* and *single investor* leases, which are then distinguished in the model by whether the leverage is 50 percent or more—*leveraged*—or less—*direct financing.*

Like the tax classification process, the accounting phase begins with the lender mode question. If affirmative, loan treatment is decided and there are no further tests.

Central Decision Concepts

Study of this flow process should help illustrate that certain principles are central decision concepts in lease classification. One is whether the lease transfers the substantial economic value of the asset to the lessee. Another is whether the lessor is adequately at risk to be entitled to true lease tax benefits, and whether the transaction is "legitimate" (i.e., makes a profit) exclusive of tax benefits. The financial participation or commitment of the lessee is also key.

Nevertheless, the process is complex and indeed its quirks are a source of creative structuring for financiers. For example, a synthetic lease (in which the documents describe a lease, but the lessee is the tax owner) turns on the ability to account for it as a lease but to treat it as a loan for tax purposes.

This model is intended to systematize the classification of leases from the perspectives of taxation and accounting. The purpose of the tax phase is to determine whether a transaction is a *lease* or a *conditional sales contract.* The purpose of the accounting phase is to determine whether a transaction is a *loan,* an *operating lease,* or a *capital lease*, with three subcategories for capital: *sales type, leveraged lease,* and *direct financing lease.*

The model should address most companies' needs as is, although individual customizations are easily accommodated. For example, for the tests that use a threshold value (e.g., 10 percent to consider a security deposit significant), the model can provide for user input of the threshold.

Endnotes

[1] Revenue Ruling 55-540, Section 4.

[2] SFAS 13, Para. L10. 103.

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