

IRS Definition of a Lease

The Internal Revenue Service (IRS) also is concerned whether a lease is a CAPITAL LEASE (conditional sales contract or other form of a sale) or an OPERATING LEASE (true lease). In the case of the capital lease the IRS permits the lessee to obtain the tax benefits of investment tax credit, accelerated depreciation, and interest included in the lease payments. On the other hand, in the case of an operating lease, the IRS allows the lessor rather than the lessee to retain the investment tax credit and accelerated depreciation (the ITC, however, may be passed to the lessee at the lessor's options). Moreover, with an operating lease the lessee may not claim a separate interest deduction for interest contained in each lease payment since the total lease payment is already fully tax deductible to the lessee. Therefore, it is essential to know whether a lease is CAPITAL or OPERATING in order to ascertain who will receive the tax benefits-the lessee or the lessor.

Recently, Congress passed the "1981 Economic Recovery Tax Act" in which a lease has been defined for tax purposes such a definition has been overdue since prior to the new law there was little information available from the IRS, which clearly defined a lease.

The new tax law establishes a "safe harbor" election which virtually guarantees the lessor and lessee that their lease agreement will be considered an operating lease from a tax viewpoint if the "safe harbor" the following conditions must be met according to section 168(f) 8 of the IRS code:

1. Corporation Status

The lessor must be a corporation, Sub-Chapter S-Corporations and personal holding corporations do not qualify for "safe harbor" status. However, partnerships, all the partners of which are corporations, do qualify along with grantor trusts wherein the grantor and beneficiaries are corporations. Therefore, individuals, regular general partnerships (with noncorporate members), limited partnerships, sole-proprietors, sub-chapter S corporations, personal holding companies, and regular grantor trusts cannot avail themselves of the new "safe harbor" lease requirements. These nonqualifying entities will still be affected by the old ambiguous lease definitions promulgated by the IRS. Also, certain closely held corporations (Code Section 465) have limits on tax benefits obtainable under leveraged leases containing nonrecourse debt.

2. Minimum "At Risk" Investment

At the time the leased property is first placed in service and at all other times during the lease term, the lessor must maintain a minimum "at risk" investment of at least ten percent of the cost (adjusted basis) of such property. Recourse debt incurred by the lessor is considered part of the "at risk" minimum investment as long as such debt is not provided or co-signed by the lessee or any party related to the lessee. The lessor minimum investment will not be affected by any fixed purchase options (whether at a bargain or fair market value) or guaranteed residuals (put options) that have been structured into the lease.

3. Lease Term

The maximum term of the lease including any extension does not exceed the greater of:

- a. Ninety percent of the useful life of such property according to Section 167 of the IRS code (Facts and Circumstances life as established by the past history of the leasing company).
- b. One hundred fifty percent of the ADR class life midpoint of the property as determined by the January 1, 1981 asset depreciation range (ADR) guidelines published by the IRS. The minimum term of the lease must be at least equal to the new ACRS depreciation life, code section 168©2, which will be three years or five for most leased equipment.

4. Qualified Lease Property

The “safe harbor” rule applies only to certain types of property which conform to the following rules:

- a. Must have been placed in service after January 1, 1981.
- b. Must be “recovery property” which is property eligible for the new ACRS (Accelerated Cost Recovery System explained in chapter 13).
- c. New section 38 property in the hands of the lessor, which generally means any property, that qualifies for the Investment Tax Credit. There are additional rules making the “safe harbor” extend to transactions already completed prior to the enactment of the new law which will not be explained here since they will not be applicable after November 13, 1981. These qualifying transactions must have been entered into between January 1, 1981 and August 13, 1981 to qualify for conversion into qualifying leases. Certain qualifying mass commuting vehicles also are considered as qualified lease property.

5. Characterization By Parties

Both the lessor and the lessee must agree in a provision of the lease document that the contract agreement is to be characterized as a lease for purpose of the IRS tax treatment. This implies that the lessor will be designated the owner of the equipment which automatically entitles the lessor to the tax benefits of accelerated cost recovery, interest, and investment tax credit. Note, however, the investment tax credit may still be passed on to the lessee.

6. Election to have “safe harbor” Requirements Apply to the Transaction.

The agreement must be in writing and must state that all parties to the agreement elect to have the provisions of the safe harbor (Section 168(f)8 of the IRS code) apply to the transaction. The lessor and the lessee must also file an IRS information return concerning the safe harbor lease.

It is important to note that the Economic Recovery Tax Act of 1981 (P.L. 97-34) clearly indicates that if the “safe harbor” rules stated above are met then no other factors will be taken into account by the IRS in determining whether the

lease is truly a lease rather than a conditional sales contract. Furthermore, “an agreement between the lessor and lessee requiring either or both parties to purchase (put option or guaranteed residual) or sell (call option) the qualified leased property at some price (whether or not fixed in the agreement) at the end of the lease term shall not affect the amount the lessor is treated as having at risk with respect to the property. Thus, inclusion of any of the following items in a lease will not alter its IRS classification as an operating lease:

1. Bargain purchase option (call option at less than the leased asset’s expected future fair market value).
2. Fixed purchase options whether at a bargain or not, or for a nominal sum or not.
3. Fair market value purchase options.
4. Guaranteed residual where title may pass to the lessee (put option).
5. Guaranteed residual where title is not allowed to pass to the lessee, which may contain residual proceeds sharing with the lessee or residual stop loss agreements.
6. Bargain renewal options as long as the extended lease term is still within the “safe harbor” time limit.
7. Lessee provided or co-guaranteed financing exclusive of the lessor’s required ten percent at risk minimum investment.
8. Limited use property that can only be used by the lessee at the termination of the lease.

The impact of the new tax legislation on the leasing industry is expected to be significant. Companies unable to use their tax benefits due to prior operating losses are now able to exchange these tax benefits with lessor who will reciprocate by offering the lessee lower lease payments. Such exchanging of tax benefits has been facilitated by the new tax law. The more liberal lease definition guarantees both lessor and lessee that the lease agreement will be considered a lease for purposes of allowing the lessor to avail himself of the new accelerated depreciation (ACRS) and the increased investment tax credit which is now ten percent for ACRS five year depreciation life property (heretofore such five year life property would have qualified only for a 6.67 percent ITC).

Although, the new legislation will affect the majority of lease transactions entered into after January 1, 1981 there still remains a significant number of leases whose tax status will not be affected. These nonconforming leases will be defined according

After-Tax Present-Value of Costs

In terms of total after-tax present value of costs, leasing may provide a lower cost to the lessee than conventional financing. However, it is important to note that this situation only occurs when the lessee is in a high income tax bracket coupled with a high cost of capital. Additionally, the lease term must generally be in excess of that provided by

conventional financing. As previously explained, leasing companies will frequently offer longer terms than those available at banks. The combination of a high cost-of-capital discount rate, which exceeds the cost of debt, a high income tax bracket providing the maximum tax benefits and a long lease term will frequently result in a lease having a lower after-tax cost. Note, however, that use of a high discount rate, such as cost of capital, is subject to some controversy. This will be explained in more depth in chapter seven. On the other hand, when a lessee is in a low tax bracket or cannot use tax benefits at all due to a loss carry-forward, then a lower cost lease might also be available if the lease company retains all the tax benefits and will also pass some of these savings on to the lessee.

Another situation, which frequently results in lower after-tax present value of costs, is where the lessee acquired an asset under a short-term, full-payout lease that still qualifies as a true lease under IRS rulings. In this case, most of the cost of the equipment has been paid in tax-deductible lease payments over a shorter period of time than that required to depreciate the asset under an outright purchase financed conventionally. Thus, the tax benefit accrues to the lessee over a shorter period of time than the purchase alternative, which lowers the present value of leasing costs. It is quite difficult, however, to find a short-term full-payout lease that quality as a true lease from an IRS point of view. This characteristic will be explained in chapter two. A full-payout lease has cash returns to the lessor that are sufficient to cover the asset's cost, overhead, debt service, and reasonable rate of return without dependence upon any residual salvage value or purchase option. In other words, it is closely akin to a conditional sales contract.

To determine properly whether a lease will cost less than an outright purchase of equipment, a formal analysis should be made.

Off-Balance Sheet Financing

Lease structured as operating leases in accordance with the requirements of FASB statement No. 13 do not appear on the balance sheet of the lessee and therefore improve the company's ostensible appearance of being liquid, profitable, and solvent. This "off-balance sheet" effect of an operating lease is the subject of chapter three. Capital leases however do appear on the lessee's balance sheet and should not be confused with operating leases. The difference between these two types of leases is the subject of chapter two.

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