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Equipment Leasing and Financing: Structuring and Documenting the Transaction

Navigating Financing Structures, Characterization Issues, and Other UCC, Tax and Accounting Implications

WEDNESDAY, OCTOBER 17, 2012

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Today's faculty features:

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Equipment Leasing & Financing:

Structuring & Documenting the Transaction Navigating Financing Structures, Characterization Issues, and Other UCC, Tax and Accounting Implications

Teleconference Program

Presented by

Edward K. Gross and Denise L. Blau,
Vedder Price P.C.

October 17, 2012

Equipment Leasing & Financing

I. Intro

- LPG Strafford Publications - Webinar Sponsor
- Vedder Price P.C. - Denise and Eddie
  - What we'll cover
    - Structuring and documenting **commercial** equipment lease/financing transactions
    - UCC characterization issues
    - Tax and accounting implications
    - Questions

II. Structuring and Drafting to Achieve Lessor's Investment Purposes

- Certainty of Payment - Essential to Financing Parties
  - **Generally**
    - Lessor -
      - UCC-2A's statutory "irrevocable and independent" ("**Hell or High Water**") obligations under "finance leases."
      - Other direct "**Hell or High Water**" obligations: contract law.
    - Assignee (*e.g.*, a financing provider or other investor buying, monetizing or lending against the lease and equipment)
      - See above re Lessor (by assignment)
      - UCC-9's waiver of defenses

Structuring and Drafting *(con't)*

- **Finance Leases - Statutory "Hell or High Water"**
  - If lease is UCC-2A "**finance lease**", Lessee's payment obligations automatically "HorHW" once Lessee has accepted the equipment under the lease (§ 2A-407(2)).
  - "**Finance Lease**" - § 2A-103 (1)(g), must:
    - be a "**lease**" (*i.e.*, a true lease, TBD) as defined in § 2A-103(j), and
    - meet certain criteria - essentially, establishes Lessee's having chosen property to be leased, vendor and purchase terms
  - But - even if finance lease, obligation still subject to requirements of **good faith**, and Lessee's **right to revoke acceptance** (O.C. No. 1 to § 2A-407)

Structuring and Drafting *(con't)*

- **Contractual Hell or High Water Treatment**
  - By contract – if lease includes Lessee's HorHW acknowledgment.
  - Courts in **most cases** have **strongly endorsed** HorHW provisions in finance leases and other true "leases", and are **frequently supportive** of these provisions in **non-true leases**.
  - If purported lease also contains Lessee's **agreement** that transaction will be **treated as a "finance lease,"** some **support** in **O.C. § 2A-103(1)(g)** for finance lease treatment:
    - "[i]f a transaction does not qualify as a finance lease, the parties may achieve the same result by agreement; no negative implications are to be drawn if the transaction does not qualify."

Structuring and Drafting *(con't)*

- **Waiver of Defenses - Assignee's statutory HorHW**
  - By **assignment**, Assignee has benefit of Lessor's statutory and contract HorHW (as discussed)
  - Whether true "lease" or otherwise, **if Lessee agrees to waive any defenses available against Lessor/Assignor**, UCC supports Assignee's right to collect assigned rent from Lessee even though Lessee may have defenses (§§ 9-404(a), 9-403(b) and (c)).
  - Assignee may rely on Lessee's waiver of defenses, if Assignee:
    - gives **value** (*i.e.*, pays purchase price for or makes "leveraging loans, etc.)
    - buys/monitizes lease in **good faith**, and
    - **without notice** of conflicting claims to the assigned lease or certain claims or defenses of Lessee.

Structuring and Drafting *(con't)*

- Certainty of payment risk if "re-characterized"
  - Courts have typically upheld HorHW provisions under UCC-2A **finance leases** and other **true "leases"**
    - Most recent cases support lessors' rights to payments notwithstanding lessee's complaints about equipment and/or related services to be provided by third parties.
    - Some cases have questioned lessees' unconditional obligations where lessor had defrauded lessee in non-true lease transaction.
  - But, **non-true lease** HorHW acknowledgments are **also often enforced**, absent bad facts (or bad law).

Structuring and Drafting *(con't)*

- **Practice Implications**
  - For **Lessors**
    - Include "HorHW" and/or "benefits of a UCC-2A Finance Lease" acknowledgments by Lessee, even if non-true lease.
    - Lease Documents should include a reliable acknowledgment by Lessee of its **unconditional and irrevocable acceptance** of related equipment.
    - See Other "Lease Document Protections" below.
  - For **Vendors**
    - If vendor provides lease financing, consider establishing finance affiliate as "lessor" to support "finance lease" status.
  - For **Assignees**
    - Require **Waiver of Defenses** by Lessee.
    - Require **representations by assigning lessor**, and **acknowledgment by lessee,** that **no defenses** to rent obligations.

Structuring and Drafting *(con't)*

- **Events of Default under a lease**.
  - **Generally** - May rely on UCC-2A statutory defaults in § 2A-523, as well as default triggers in the lease (§ 2A-501 (1)).
  - **§ 2A-523 statutory default "triggers"** are much **more limited** than typically provided in most lease forms.
- **Rent and Other Damages** - Generally.
  - **§ 2A-523** recognizes Lessor's right to exercise **remedies in the lease** - unless inconsistent with UCC-2A.

Structuring and Drafting *(con't)*

- **§ 2A-523 lists other UCC-2A remedies, including:**
  - **cancel or terminate** the lease under **§ 2A-505(1) and (2)**,
  - **take possession** of the equipment under **§ 2A-525**, **including by self-help under § 2A-501(3**),
  - recover **rent** under **§ 2A-529**,
  - **dispose** of the equipment and **recover damages** under **§ 2A-527**,
  - **retain** equipment and **recover damages** under **§ 2A-528,**
  - recover **liquidated damages** under **§ 2A-504** and
  - alternatively, recover **direct and incidental (but not consequential)** damages (less expenses) pursuant to **§ 2A-523(2)**.

Structuring and Drafting *(con't)*

- **Liquidated Damages**.
  - **§ 2A-504** permits parties to liquidate damages in a lease, "but only at an **amount** or by a **formula** that is ***reasonable in light of the then anticipated harm*** caused by the default or other act or omission" giving rise to these damages.
    - **Enforceability** - generally, **Pigs *might* win, but Hogs *will* lose**; LD provision may be enforced if
      - does ***not*** put lessor in a ***better position*** than if the lease had been **fully performed**,
      - deemed a ***reasonable pre-estimate*** of a probable loss.
    - **UCC-2A Remedies Safety Net**
      - per § 2A-504(2), if LD provision is unenforceable, or fails for its essential purpose, Lessor may rely on other remedies under UCC-2A, including referenced **statutory damages** formulas.

Structuring and Drafting *(con't)*

Drafting Considerations - Recovering Lessor's Investment.

- **Already covered**: default "triggers", enforceable remedy provisions (including liquidated damages provisions), "HorHW" acknowledgments, unconditional acceptance acknowledgment, etc.
- **Late charges**, administrative charges, default rate interest, etc.
- **Usury "savings"** clauses.
- **No invoicing or other conditions** to scheduled rent payments.

Structuring and Drafting *(con't)*

- **Acceleration provisions**
  - **Involuntary**
    - Casualties
      - Scope of "Total Losses"
      - Payment date - # of days after casualty, or receipt of insurance proceeds, etc.
      - – Casualty Insurance coverage -
        - Approved insurer, policy terms and amounts (SLV)/self-insurance
        - Lessor endorsements, including "loss payee" and breach of warranty protections, evidence of coverage, etc.
    - Events of Default and related acceleration remedies (see above)
    - Other Accelerators – required by credit approval
  - **Voluntary:** EBOs and ETOs – flexibility for Lessee, usually a fixed acceleration amount; but consider re-characterization issues (below)

Structuring and Drafting *(con't)*

- **Acceleration Amounts** –
  - Examples include stipulated loss or casualty value, early buy out amount, termination value, liquidated damages, etc.,
  - Must make Lessor "whole" (i.e., be sufficient in amount so as to allow Lessor to recover its investment, and anticipated yield), including
    - accelerated rent for remainder of term, plus anticipated end of term residual value; both discounted to present value,
    - prepayment charges,
    - recovery of loss of income tax benefits, and/or
    - scheduled rent either included or excluded

Structuring and Drafting *(con't)*

- Liability protections -
  - Lessee, governmental and other 3rd party claims -
    - Lessee claims – warranty disclaimers, consequential (etc.) damage waivers, and hold harmless agreements
    - Governmental and other 3rd party claims
      - State Tax Claims generally
        - » Lessee promises to report and pay to appropriate taxing authority in applicable jurisdictions; and/or indemnify Lessor and other "indemnitees", But,
        - » Lessee's obligations typically subject to certain conditions, exceptions and mitigation protections
      - Other 3rd party claims
        - » agreements to defend and indemnify Lessor and other "indemnitees"
        - » subject to certain conditions, exceptions and mitigation protections
  - Maintenance, operation, repair, etc., compliance with law, inspection, reporting and notice requirements, etc.
  - Liability Insurance -
    - Acceptable insurer and policy terms, including scope of coverage and amount/self-insurance/limits
    - Required "lessor" endorsements (as additional insured), including "breach of warranty" and 30 days' notice of termination, cancellation, lapse, evidence of insurance (certificate, etc.)

Structuring and Drafting *(con't)*

- **Income Tax Benefit Protections**
  - Structural Considerations (see below)
  - Indemnification - all causes (including structural) or acts or omissions.
- **Return Requirements**
  - Precise and consistent with asset management's reasonable expectations; sufficient to assure that if followed, equipment will have anticipated value taking into account intended use, asset type, age, obsolescence risks, etc.
  - Implications if impractical – see re-characterization below

Structuring and Drafting *(con't)*

- **Lessee Options - early (see above) or end-of-term.**
  - End-of-term - generally, purchase, renew or return.
  - Purchase or renew.
    - Fixed or FMV
      - If fixed, consider re-characterization risk
      - If FMSV or FMRV, consider how determined
    - Notice, appraisal period, and irrevocable commitment
  - Return -
    - has to be meaningful right to return (*i.e.*, not economically or otherwise compelled to buy or renew), including condition and other return requirements; and no expectation will be abandoned.
    - If not – see re-characterization discussion below
- **Financial Reporting, Inspections, etc.**
- **Closing Deliverables.**

"Non-True" v. "True" Leases:
Background, Rationale and Significance of Distinction

Generally, Questions to be addressed:

- What is meant by a "non-true" lease v. a "true" lease?
- How can we tell whether we have a "non-true" lease or a "true" lease?
- Why does it matter whether we have a "non-true" lease or a "true" lease?

“Non-True” v. “True” Leases *(con’t)*

What is meant by a “non-true” lease v. a “true” lease?

- **UCC Definitions**
  - “‘**Lease**’ means a transfer of the right to possession and use of goods for a term in return for consideration, but a sale or retention or creation of a security interest…is not a lease.” 2A-103(1)(j)
  - “‘**Security interest**’ means an interest in personal property or fixtures which secures payment or performance of an obligation…the retention or reservation of title by a seller of goods…is limited in effect to a reservation of a ‘security interest’.” 1-201(35)
- **“Non-true” lease** purports to be a lease, but the sum of its terms and conditions are more consistent with an installment sale.
- **“True” lease** purports to be a lease, and the sum of its terms and conditions are consistent with a lease.

"Non-True" v. "True" Leases *(con't)*

Choice of Law

- Which law determines whether the lease is "true"?
  - Federal v. state law
  - Which state's law should be applied?

UCC § 1-203; Lease or Security Interest?

- Definition of "security interest" (§ 1-201(35))
- The facts of each case over the form of the document (§ 1-203(a))
- *Per Se* Security Interest - statutory guidance of § 1-203(b)
  - Terms not subject to termination by the lessee (§ 1-203(b))
  - Nominal additional consideration, etc. (§ 1-203(d))
- Factors not determinative (§ 1-203(c))
- Common Law

"Non-True" v. "True" Leases *(con't)*

- **Credit Risks**
  - UCC/collection enforcement rights
  - Bankruptcy recovery expectations
- **Other Economic Considerations**
  - Interest rate limitations, etc.
  - Liability risks
    - Civil (*e.g.*, vicarious liability)
    - Governmental (*e.g.*, state taxes, fines, etc.)

"Non-True" v. "True" Leases *(con't)*

Reasons lessors enter into "non-true" leases:

- "Lease" characterization may be useful even if not "true"
- Casual approach by some leasing companies
- Innovative financing structures
- 100% financing
- Customizable lease terms
- Contemplates upgrades and obsolescence options
- Could be an accounting driven structure
- Permitted within bank lines (hopefully)
- Re-characterization risk addressed by precautionary measures

"Non-True" v. "True" Leases *(con't)*

"Finance Leases"

- The best kind of "true" lease for lessors
- UCC § 2A-103(1)(g)
  - Must be a "lease"
  - Must meet certain criteria establishing lessee's acquisition-related choices
- Benefits
  - Automatically "hell or high water"
  - Implied warranties automatically disclaimed
- <u>But</u> - to some, confusing terminology

Why a secured transaction?

- UCC § 9
  - Covers any transaction creating a security interest; UCC § 9-109
- Purported lessor not subjected to all or nothing risk
- UCC § 2
  - "Any retention or reservation by the seller of the title…is limited in effect to the reservation of a security interest." UCC § 2-401(1)

“Non-True” v. “True” Leases *(con’t)*

Commercial Law (UCC) Effect

- NTL “Lessor” (rights/responsibilities)
- Lease v. secured transaction (perfection)
- Lease v. secured transaction (priority)
- Lease v. secured transaction (remedies)

"Non-True" v. "True" Leases *(con't)*

Bankruptcy (Chapter 11)

- **"True" Leases**
  - Assumption of lease
    - Administrative claim
    - Cure defaults
  - Rejection
    - Return of equipment
    - Unsecured claim
  - No free ride
  - Relief from stay

- **"Non-true" Leases**
  - Adequate protection payments
  - Valuation of claim issues
    - Secured claim
    - Unsecured claim for deficiency
  - Relief from stay

“Non-True” v. “True” Leases *(con’t)*

Bankruptcy (Chapter 11)

- Impact of perfection
  - “True” lessor as creditor
  - “Non-true” lessor as creditor
  - “No Free Ride” Rule (11 U.S.C. § 365(d)(19))
- Recovery of equipment
- Payments & the nature of claims

“Non-True” v. “True” Leases *(con’t)*

“True” v. “non-true” lease documentation

- Can’t draft characterization
- Lease provisions reflect differences in credit risks and economic considerations
- Conditions precedent

"Non-True" v. "True" Leases *(con't)*

What are some examples of lease structures which raise the issue in practice?

- **"True" lease for commercial law purposes** – realistic opportunity lessee will return equipment to lessor with significant residual value and economic life
  - **Options –**
    - at lease expiration, lessee may freely choose to either (a) return the equipment, (b) purchase it for FMSV, and/or (c) renew the lease and pay FMRV for the renewal term
    - options that don't fail "bright line" test in § 1-203

"Non-True" v. "True" Leases *(con't)*

- **Meaningful Return Option** –
  - conditions consistent with anticipated residual value, and
  - not so costly or otherwise burdensome that a rational lessee would feel economically compelled to purchase the equipment instead of returning it
- **Fixed Price Purchase/Fixed Renewal Rent Options** –
  - if "fixed" purchase and/or renewal options, lessor likely to have determined by appraisal (?) that FMV at time of any termination, purchase, or renewal option is significant and no less than any fixed purchase or renewal amounts

"Non-True" v. "True" Leases *(con't)*

- **Other common structures**
  - **"First Amendment" Leases**
    - Protect Lessor against a portion of its residual exposure while still complying with "20/20" test in Rev. Proc. 2001-28
    - Options at expiration are limited to fixed purchase or fixed renewal, with standard FMV and return options at expiry of renewal term
    - Likely to be a true lease
  - **"Synthetic" Leases**
    - Accounted for as an operating lease, but treated for economic and tax purposes as a financing transaction
    - TRAC-like end of term options
    - Though similar to TRACs, can be vulnerable to a true lease challenge

"Non-True" v. "True" Leases *(con't)*

- **Terminal Rental Adjustment Clause** – creation of Federal Tax Law (IRC § 7701(h))
  - At lease expiration, Lessee must *either*
    - purchase the vehicle for fixed amount, or
    - return the vehicle and pay Lessor, as a "Terminal Rental Adjustment," the excess of (a) stipulated termination value, minus (b) net sales proceeds received by Lessor when it sells the vehicle
  - Lessee shares downside, but also gets the upside
  - Unique tax treatment only afforded to TRAC leases of motor vehicles (including trailers) – treated as "true" leases
  - Most states have adopted statutes supporting the true lease treatment of TRAC leases of motor vehicles.

"Non-True" v. "True" Leases *(con't)*

- True v. "non-true" lease documentation issues
  - **Can't draft characterization**
    - Intent does not matter – acknowledgments and agreements are ineffective as to third parties
    - Achieve certain protections and benefits by agreement (*e.g.*, lessee's "hell or high water" obligation to pay rent without regard to actual characterization; see § 2A-407)
  - **Lease provisions – reflect differences in credit risks and economic considerations**
    - Rent (loan v. lease installments)
    - Late charges (w/usury savings clauses for "non-true" leases)
    - Term of lease and any options (frequently determines "true" lease or "non-true" lease status)

“Non-True” v. “True” Leases *(con’t)*

- **Lease Provisions**
  - **Net lease/“hell or high water”** (“non-true” lease – not automatic)
  - **Maintenance/return and inspection** (“non-true” and “true” lease – collateral and RV expectations)
  - **Insurance** (“non-true” and “true” lease – casualty; “true” lease – liability insurance to cover ownership risks)
  - **Indemnification** (“true” lease – state tax, income tax and liability essential)
  - **Disclaimers** (“non-true” lease – seller; “true” lease – automatic if finance lease)
  - **Representations** (differences – title/security interest reps)
  - **Default and remedies** (under UCC-2A and/or UCC-9)
  - **Governing law and choice of forum** (important to both)

“Non-True” v. “True” Leases *(con’t)*

- **Lease Provisions**
  - **Granting clause** (useful for “non-true” lease to specify scope of secured obligations, etc.; also useful for “true” lease so as to collateralize sublease proceeds, etc.)
  - **Usury savings clause** (essential to “non-true” lease)
- **Conditions precedent**
  - “Non-true” lease – perfection, competing interests; “true” lease – ownership risks
  - Appraisal – establish pertinent values
  - Lien searches/releases – consider priority risks
  - Precautionary filings (§ 9-505)

IV. Tax and Accounting Implications

Federal Tax Guidance on True Leases

- Criteria
  - The criteria for a “true lease” for federal income tax purposes are not the same as those for a corporate, UCC or bankruptcy true lease.
  - Unfortunately, the criteria are sometimes difficult to articulate.
  - But, the determination of whether a lease is a “true lease” for federal income tax purposes is important to a lessor because the lessor in such a “true lease” owns the equipment for such purposes, and is entitled to depreciation deductions.

Tax and Accounting Implications *(con't)*

Federal Tax Guidance on True Leases

- Sources of Federal Tax Guidance
  - Except as to "safe harbor" leases in the 1980s and certain TRAC leases, there is no statutory authority.
  - IRS administrative guidance.
  - Case law.
- Case law requirements for a "true lease" for federal tax purposes
  - Helvering v. F.& R. Lazarus & Co., 308 U.S. 252, aff'g 101 F.2d 728 (6th Cir. 1939)
    - "True lease" characterization is not determined by the location of the title or labels used by the parties.
    - "True lease" characterization is instead determined by the substance and realities of a transaction.

Tax and Accounting Implications *(con't)*

- <u>Frank Lyon v. U.S.</u>, 435 U.S. 561 (1978)
  - The case involved a genuine multi-party transaction.
  - The transaction had economic substance which was compelled or encouraged by business or regulatory realities.
  - The transaction was motivated by tax-independent considerations and was not shaped solely by tax avoidance features.
  - The transaction was determined to be a "true lease" for federal income tax purposes.
- <u>Rice's Toyota World, Inc. v. Comm'r, 81 T.C. 184 (1983)</u>
  - Requires a lessor to have a business purpose exclusive of the tax benefits.
  - Requires a transaction to have a reasonable possibility of pre-tax profit.
  - However, the court did not indicate that a specific pre-tax profit was required.

Tax and Accounting Implications *(con't)*

- IRS administrative guidance requirements for a "true lease" for federal tax purposes
  - IRS ruling guidelines for leases of personal property
    - Revenue Ruling 55-540, 1955-2 C.B. 39
    - Revenue Procedure 75-21, 1975-1 C.B. 715
    - Revenue Procedure 75-28, 1975-1 C.B. 752
    - Revenue Procedure 76-30, 1976-2 C.B. 647
    - Revenue Procedure 79-48, 1979-2 C.B. 529
    - Revenue Procedure 2001-28, 2001-1 C.B. 1156
    - Revenue Procedure 2001-29, 2001-1 C.B. 1160

Tax and Accounting Implications *(con't)*

- Requirements of IRS ruling guidelines
  - Lessor must make a minimum unconditional "at risk" investment of 20% in the lease transaction.
  - Lessor must realize a pre-tax profit from the lease.
  - Lessor must realize a "reasonable" cash flow from the lease.
  - Lessee cannot invest in the cost of the leased property.
  - Lessee can have an option to buy the leased property, but only if it is priced at fair market value.
  - Lessor cannot compel lessee or another person to buy the leased property.
  - Lessee cannot provide the debt or guaranty any debt incurred by lessor to acquire the leased property.
  - The leased property must have a 20% useful life and 20% residual value at the end of the lease term ("20/20 test").

Tax and Accounting Implications *(con't)*

- Consequences of the failure of the requirements of the IRS ruling guidelines
  - The IRS ruling guidelines are applicable to persons seeking a ruling from the IRS that a transaction qualifies as a "true lease" for federal tax purposes.
  - The IRS ruling guidelines do not define the term "true lease" for federal tax purposes as a matter of law.
  - Thus, the failure to satisfy the IRS ruling guidelines may not prevent a lease transaction from being characterized as a "true lease" for federal tax purposes.

Tax and Accounting Implications *(con't)*

- Recent Changes in the Federal Tax Law
  - Is there any recent statutory authority relevant to "true lease" characterization for federal tax purposes?
    - Does the newly codified economic substance doctrine of Section 7701(o) of the Internal Revenue Code of 1986 apply?
    - Is the characterization of the lease structure less than certain enough that the new uncertain position reporting rules contemplated by IRS Announcement 2010-9 may apply?

Tax and Accounting Implications *(con't)*

- Why "True Lease" Characterization for Federal Tax Purposes Matters
  - Benefits of such "true lease" characterization
    - Lessor can take depreciation deductions for federal tax purposes.
    - Lessee can take deductions for federal tax purposes for lease payments as a business expense.
    - There should be a reduced risk of having to flag the issue on a federal income tax return.
    - There should be a reduced risk of having to disclose tax and book differences.
    - There should be a reduced risk of audit and litigation exposure.
    - There should be a reduced risk of state and local complexities.

Tax and Accounting Implications *(con't)*

- Risks of not having such a "true lease" characterization
  - Lessor loses depreciation deductions for federal tax purposes.
  - Lessee loses deductions for federal tax purposes for lease payments as a business expense.
  - There may be a risk of recharacterization as a loan, a partnership, etc.
  - There may be a risk of having to flag issue on a federal income tax return.
  - There may be a risk of having to disclose tax and book differences.
  - There may be a risk of audit and litigation exposure.
  - There may be a risk of state and local complexities.

Tax and Accounting Implications *(con't)*

- Practice Implications
  - Things to avoid in a lease that is to be a "true lease" for federal tax purposes
    - The location of legal title to the leased property not being in lessor.
    - Statements that the transaction is anything other than a "true lease" for federal tax purposes in the lease documentation or elsewhere.
    - The treatment of the transaction for federal tax purposes as anything other than a "true lease" by lessor, lessee or anyone either controls.
    - Lessor having a nominal equity investment in the leased property.
    - Lessor having a right to put the leased property to lessee or another person.
    - Lessor not having a business purpose for the lease transaction.
    - Lessee lending the funds to lessor in order for lessor to acquire the property.

Tax and Accounting Implications *(con’t)*

- The leased property not meeting the 20/20 test.
- Rent being applied to an equity interest in the leased property being acquired by lessee.
- Lessee acquiring title to the leased property after payments of stated amounts of rentals.
- Lessee acquiring title to the leased property under a purchase option which is nominal.
- Agreed “rental” payments materially exceeding the fair market value of the leased property.
- The status of the leased property as “limited use” property.
- And, perhaps most important, lessor not having the upside and downside in the residual value of the leased property.

Tax and Accounting Implications *(con't)*

- Additional transaction features which may attract special scrutiny
  - If the parties to a lease transaction are related, it may attract special scrutiny. See, for example, Shaffer Terminals v. Comm'r, 16 T.C. 356 (1951).
  - If intermediaries are used in a lease transaction, it also may attract special scrutiny. See Section 7701(l) of the Internal Revenue Code of 1986.
- Do not rely on the corporate, UCC or bankruptcy true lease requirements to create a "true lease" for federal tax purposes.
- Do remember to include a provision in the lease agreement for a transaction intended to be a "true lease" for federal income tax purposes stating that the transaction is intended to be treated as a "true lease for US federal tax purposes".

Tax and Accounting Implications *(con't)*

Accounting Treatment - Capital v. Operating Leases

- Sources of Accounting Guidance
  - Statements of Financial Accounting Standards (including SFAS 13).
  - Established by the Financial Accounting Standards Board (FASB).
- A Capital Lease
  - Lessor conveys substantially all of the risks and benefits of ownership to lessee (treated as a purchase).
  - The transaction is removed from lessor's balance sheet and recorded as a receivable.
  - The transaction is recognized as both an asset and a liability on lessee's balance sheet.

Tax and Accounting Implications *(con't)*

- An Operating Lease
  - Lessor conveys only the right to use equipment to lessee for a stated period of time, after which equipment is returned to the owner.
  - The transaction is treated as an asset on lessor's balance sheet.
  - The transaction is treated as an operating expense for lessee and does not affect lessee's balance sheet.
- Current Criteria for a Capital Lease
  - Accounting standards (including SFAS 13) generally treat transactions that meet one of the four conditions as a capital lease.
  - The Four Conditions
    - Ownership — the lease transfers ownership of the leased property to lessee by the end of the lease term.

Tax and Accounting Implications *(con't)*

- Bargain Price Option — the lease contains an option to purchase the leased property at a bargain price.
- Estimated Economic Life — the lease term is equal to or greater than 75% of estimated economic life of the leased property.
- Fair Value — the present value of the lease payments, discounted at an appropriate discount rate, equals or exceeds 90% of fair market value of the leased property.

- Current Criteria for an Operating Lease
  - Accounting standards generally treat transactions that do not meet any one of the above four conditions for capital lease treatment as operating leases.
  - That is, if it is not a capital lease, it is an operating lease.

Tax and Accounting Implications *(con’t)*

- Expected Changes in Accounting Treatment
  - On August 16, 2010, FASB and the International Accounting Standards Board (“IASB”) released an Exposure Draft that will significantly change accounting for lease transactions.
  - FASB and IASB Exposure Draft
    - Proposes the capitalization of all equipment and real estate leases of more than one year (that is, all leases of more than one year must be reported on the balance sheet).
    - If implemented, will eliminate the distinction between capital leases and operating leases for accounting purposes.

Tax and Accounting Implications *(con't)*

- Likelihood of FASB and IASB Exposure Draft Being Implemented
  - FASB and IASB recently have had disagreements as to the standards to be used for lessee income statements.
  - However, most people think that the Exposure Draft will be agreed upon, with the primary concern being the time frame for the converged standards coming into effect.

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