



A Leveraged Lease Primer

Understanding the tax and accounting treatments of this powerful equipment finance tool.

The leveraged lease product has been used by many large corporations to finance capital equipment acquisitions. Commercial aircraft, vessels, railcars and manufacturing lines are assets commonly acquired using this vehicle. Tax benefits and an optimized structure make leveraged leasing an attractive financing option.

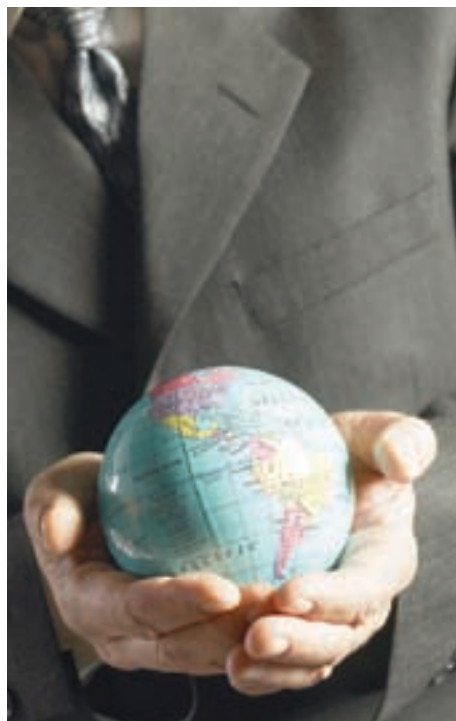
Leveraged Leasing Basics

One of the characteristics of a leveraged lease is that it involves at least the following three parties: a lessee, a lessor and a long-term creditor. The lessee, typically the end user of the equipment, is usually an organization that has an investment grade credit rating. A non-investment grade

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lessee may be supported by a credit guarantee from a more highly rated organization. Typical lessees include airlines, railroads, energy producers, and manufacturers.

The lessor, commonly referred to as the equity investor



or owner, invests an amount much less than the full cost of the equipment. The amount of the equity investment varies by transaction, but many lessors invest around 20 percent - 35 percent of equipment cost. Despite this relatively small investment, the lessor is able to depreciate the full equipment cost for tax purposes. Lessors, be they bank-owned leasing companies, independent leasing companies or captive financing companies, usually have large tax bases to fully utilize these benefits.

The remaining 65 percent-80 percent of the cost of the equipment is provided by the long-term creditor. The long-term creditor, often referred to as the third party or non-recourse lender, is the provider of the transaction's leverage. Banks, insurance companies, pension funds, or others seeking long-term returns on a money-over-money basis provide the leverage. More than one lender may participate in a given transaction. The lenders loan funds to the lessor but look to the credit of the lessee and the equipment value in the event of default. In other words, the lending is non-recourse as the lessor is not responsible to repay the loan in the event of default. The lender has some protection in that its claim does precede the lessor's claim in the event of default.

The power of the leverage effect and tax benefits lowers the money-over-money rate to the lessee relative to a typical tax lease or straight loan. Since the lessor is able to depreciate all of the equipment with only a relatively small equity investment, this economic benefit can be shared with the lessee in the form of lower rates. A leveraged lease can also be structured to meet the specific needs of the parties involved. Specialized pricing programs can optimize rent and debt schedules to meet particular criteria, such as lowest present value of rent to the lessee, highest book earnings to the lessor or minimum investment duration for the lenders. Early buyout op-

tions are popular features and give the lessee the advantage of a definite purchase price for the equipment at a particular point in the lease term. In order to avoid jeopardizing the lessor's tax treatment, the early buyout option cannot be set at a bargain price.

Tax Treatment

In order to meet the tax requirements of a leveraged lease



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and be entitled to depreciate the equipment, the lessor must have the risks and rewards of ownership. In a true tax lease, the lessor can depreciate all of the leased equipment, not just that portion financed on an equity basis. The lessor can also deduct the interest paid to the lender, since the non-recourse debt is treated as a loan between the lender and the equity participant.

The IRS, in Revenue Ruling 55-540, provided some guidance for determining whether a transaction qualified for true lease status. If a transaction has any one of the following characteristics, it may not be considered a true lease for federal income tax purposes:

- Portions of the periodic payments are made specifically applicable to an equity to be acquired by the lessee
- The lessee will acquire title upon payment of a stated amount of rentals required under the contract.
- Over a relatively short period of usage, the lessee is required to pay a large percentage of the total sum needed to secure transfer of title
- The agreed rents materially exceed the current fair rental value.
- The property may be acquired at a nominal or bargain purchase price
- Some portion of the periodic payments is designated as interest

With the increase in leveraged lease volume in the 1970s, the IRS received many requests for advanced rulings to determine whether these transactions would qualify for true lease status. The IRS issued Revenue Procedure 75-21 to provide the standards for obtaining an advance letter ruling from the IRS. Leveraged leases meeting the following standards could expect to receive a favorable ruling regarding the transaction's true lease classification:

- Lessee must have a minimum unconditional at risk investment of 20 percent when the lease begins, during the lease term and at the end of the lease. In addition, the lessor must represent that the equipment's remaining useful life is equal to no less than one year and 20 percent of the original estimated useful life.
- Lessee may not have a contractual right to purchase the property from the lessor at a price that is less than fair market value
- Lessee cannot make an investment in lease
- Lessee cannot lend any portion of the funds to, or guarantee any indebtedness of, the lessor in connection with the acquisition of the leased property.
- The lessor must expect to receive a profit apart from tax benefits. The transaction must have positive pre-tax cash flow.

In 1999, the finalized IRS Code Section 467 regulations

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were adopted with, among other things, the specific allocation of rent and Section 467 loan structuring techniques that are commonly used today. These are powerful leveraged lease structuring approaches that can greatly improve a transaction's economics.

A leveraged lease structured using the allocated rent technique has two separate rent schedules: 1) a cash rent schedule between the lessee and lessor and 2) a tax rent schedule on which taxable income is computed. There are two major constraints on the relationship between these two schedules. First, they must sum to the same figure at the end of the lease (tax rent equals cash rent.) Second, the annual balances of each schedule must be no more than one year out of synch with each other. In other words, the cash rent balance at the end of year one of a lease must be no greater than the allocated rent balance at the end of year two, and vice versa. The lessor finds this structure advantageous because there may be an opportunity to defer some taxable income from one year to another, thus having fewer taxable dollars in the earlier years of the lease and improving the after-tax cash flows. Lessees share in this advantage through potentially lower lease payments.

The Section 467 loan is the treatment applied to a lessor if the leveraged lease rental structure falls outside the allocated rent guidelines detailed above. A loan is deemed to have been made between the lessee and the lessor to represent the lessee's prepayment of rents as compared to the amount allowed under the guidelines. The lessor must treat the amount of the prepayment as a loan from the lessee and impute interest against that balance. That imputed interest is an expense and is deductible by the lessor. Lessees may take advantage of lower IRR's by utilizing the structure; however, there may be a great detriment to the lessee's cash position.

Accounting Classification

Leveraged lease accounting is addressed in Financial Accounting Statement (FAS) #13. The following must be true

to utilize leveraged lease accounting:

- Though a leveraged lease has a separate accounting classification, the lease must meet the characteristics of a direct financing lease. Leases that meet the definition of sales type or operating leases cannot be accounted for as leveraged leases.
- The lease involves at least three parties: lessee, lessor and long-term creditor.
- The financing provided by the long-term creditor is non-recourse to the general credit of the lessor and provides substantial leverage. Substantial has generally been interpreted to mean more than 51 percent of the total equipment cost.
- The net investment declines in the early years and rises in the later years of the lease. The pattern may occur more than once during the lease term. Although there is no amount by which the net investment must increase or decrease, some accounting firms have decreed that 10 percent is the minimum acceptable amount of movement.

According to FAS #13, the lessor's leveraged lease investment is recorded on the balance sheet net of the non-recourse debt. The net of the balances of the following accounts represent the initial and continuing investment in leveraged leases:

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In order to meet the tax requirements of a leveraged lease and be entitled to depreciate the equipment, the lessor must have the risks and rewards of ownership.

- Rentals receivable net of that portion of the rental applicable to principal and interest on the non-recourse debt. The rent receivable is the amount of free cash yet to be received by the lessor. Free cash equals the amount of rent received from the lessee less the amount of debt service owed to the lender.
- A receivable for the amount of the investment tax credit to be realized on the transaction. The investment tax credit, which was a tax credit available to encourage capital investment, was eliminated in 1986. Some aged leveraged leases may still carry an investment tax credit balance.
- The estimated residual value of the leased asset
- Any unearned income or deferred income. Unearned income is the estimated pre-tax lease income remaining to be allocated over the lease term. Unearned income is calculated by determining the total pre-tax income in the transaction and netting the total interest expense on the debt. Deferred income is the investment tax credit remaining to be allocated to income over the lease term. FAS #13 dictates that the investment in leveraged leases

less deferred taxes shall represent the lessor's net investment in leveraged leases for the purposes of computing net income from the lease. The deferred tax balance represents the difference between the sum of "normalized" provisions for income taxes and the sum of current taxes payable.

The "normalized" provision is determined by dividing the total taxes to be paid over the life of the lease by the total pre-tax yield and multiplying the resulting percentage by periodic pre-tax income. Assuming no tax rate change has occurred since lease inception, the deferred tax balance computed under the dictated leveraged lease methodology will equal the deferred tax balance computed under FAS #109 (where deferred taxes represent that tax effect of the temporary difference between taxes calculated on the accounting books and taxes paid.) However, if a rate change has occurred, the effect of that rate change would be reflected over the life of the leveraged lease, whereas under FAS #109 the effect would be reported immediately.

At particular points throughout the lease term, the deferred tax balance may be greater than the investment in leveraged lease balance. When this occurs the lease is said to be in the disinvestment period or sinking fund period. During the disinvestment period, the lessor has in its possession more cash than it initially invested in the transaction and may then utilize that cash for additional lending or other corporate uses.

As previously stated, the lessor's net investment, which is its investment less deferred taxes, is used as the basis for income allocation. Leveraged lease earnings are only allocated to the periods during which the lessor's net investment is positive. No earnings are recognized on the income statement during the disinvestment period. This method of income allocation is referred to as the multiple investment sinking fund (MISF), and it is the required method for leveraged leases. A summary of how leveraged lease earnings are

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FASB's new interpretation will provide new recognition and measurement guidance to be followed in scheduling of future tax cash flows.

derived is shown below:

1. Calculate the transaction's after tax cash flows, which equate to the transaction's after tax earnings
2. Apply these cash flows to the net investment consistent with the MISF yield method, so that earnings are only allocated to years with positive investment
3. Gross up income to determine the pre-tax book earnings on the leveraged lease

Leveraged lease pricing programs are available to perform these calculations before the lease is booked. Since book earnings are calculated on an after tax accounting balance, the earnings patterns are generally u-shaped, that is, higher in the beginning and ending years of the lease and lower in the middle years. The impact of deferred taxes is to initially lower the after tax accounting balance. Over time this effect is reversed as taxes are paid and the deferred tax liability is reduced. Loans and single investor leases generally have a downward-sloping earnings pattern throughout their entire lives due to the use of pre-tax accounting balances.

Recent FASB Developments

Historically, a leveraged lease should be recalculated if there is any change in an "important assumption" that impacts the transaction's total net income, such as a change in enacted tax rates or estimated residual value. Upon the occurrence of a change affecting estimated total net income, the rate of return and the allocation

of income to positive investment years would need to be recalculated from the inception of the lease. An example of a change in an important assumption that would not impact total net income is a change in the timing of tax cash flows.

In July 2005, FASB issued a proposed staff position titled FSP FAS 13-a *Accounting for a Change or Proposed Change in the Timing of Cash Flows Relating to Income Taxes Generated by a Leveraged Lease Transaction*. FASB concluded in this staff position that a material change in the timing of tax cash flows (other than as a result of a change in the applicable tax system—regular or alternative minimum tax) would also result in a recalculation of the lessor's economics with an adjustment to lease earnings. FASB decided that an entity should recognize the cumulative effect of initially applying this guidance as a change in accounting principle and thereafter as a change in earned lease income. FASB also decided that a material change in state taxes to be paid should also result in recalculation.

The final version of FSP FAS 13-a is targeted to be issued when the Uncertain Tax Positions interpretation of FAS 109 is issued. As coordinated pronouncements, FASB's new interpretation will provide new recognition and measurement guidance to be followed in scheduling of future tax cash flows. ELA will continue to provide updates on the progress of this FSP as developments occur. **ELT**

ELT thanks Deborah Brady and Paul Ingram of Key Equipment Finance for this month's column.