

## **Synthetic Leases**

### *Dead or the Product of the Future?*

By Bill Bosco, Leasing 101

The synthetic lease has been the poster child of the movement to reform lease accounting. US lease accounting rules have long been criticized as allowing synthetic lease transactions to be structured to fail the capitalization tests by less than a basis point and where the substance of the transaction is not reflected in the accounting results. The result is the lease is an operating lease treatment and the asset and any liability are off balance sheet so very similar transactions have drastically different accounting treatment. Undoubtedly the accounting standards boards and Securities and Exchange Commission were influenced to begin the lease accounting project because of what they heard about synthetic leases. Of course we in the industry know that although synthetic leases are being done but they amount to a small percentage of annual lease volumes (the ELFA annual survey of activity puts the percentage of synthetic leases at 0.7%).

### **Synthetic Lease Structures**

The term “synthetic” lease comes from the fact that the transaction is not a lease for tax or legal purposes because the lessee is obligated under a residual guarantee that is a “first loss” guarantee, but is made to be a lease for accounting purposes because the residual guarantee is capped with the lessor having a large enough at risk position to be classified as an operating lease. The lessor’s residual is a “last” loss position and is structured to exactly meet the minimum risk requirement.

Equipment synthetic leases are usually structured as a 12 month lease followed by a series of options to renew or terminate the lease subject to a rent adjustment upon termination based on the equipment sales price versus the stated residual. The final rent adjustment calculation is comprised of a residual guarantee that is capped and a 100% share of any residual gains. The residual guarantee is capped at an amount that when present valued along with the contractual rents results in a present value amount that is less than 90% of the fair value/cost of the leased asset. The lessor must have at least a 10.1% residual risk, on a present value basis, hence the need to cap the residual guarantee. There is a stated maximum lease term. The discount rate used to do the present value calculations is the implicit rate in the lease. In some cases the lessee can also have the option to purchase the leased asset for the residual amount (the residual amount cannot be a bargain) at the end of the firm term and every monthly renewal term.

Real Estate synthetic leases are generally structured as five year non amortizing leases with a purchase option and a capped residual guarantee at lease expiry. Equipment leases can also be structured with a longer term. The longer the term the higher the amount of lessor’s residual risk must be (the minimum lessor residual risk is the future value of 10.1% of the leased asset cost/fair value). Real estate leases that are leveraged cannot employ an SPE as the lessor because the FIN 46 consolidation rules would cause the SPE to be consolidated. In other words the asset and non recourse debt would be on balance sheet for the lessee.

The shorter the lease term the lower the amount of residual risk needed to meet the operating lease classification tests. The natural tendency would be to structure all synthetic leases with a one month term and successive renewal/termination options. FAS 13's (now known as ASC 840) definition of the lease term addresses this issue. Included in the definition of the lease term is the fixed noncancelable term of the lease **plus** all periods, if any, for which failure to renew the lease imposes a penalty on the lessee in an amount such that renewal appears, at the inception of the lease, to be reasonably assured. The Big 4 have come to a common interpretation that absent other factors, a real estate synthetic lease can be no shorter than five years and an equipment synthetic lease can be no shorter than one year. In other words their position is a lessee could not terminate the lease and replace the asset without suffering a penalty (like cost to move or replace the leased asset). I have seen Big 4 auditors challenge a 12 month firm term based on customer past behavior in extending leases. I have had to lengthen the firm term and adjust the residual guarantee to allow the lease with the longer term to meet the operating lease classification tests.

### **The future of Synthetic-Like structures**

Synthetic leases and variations (like leases with only residual guarantees and no option to purchase the asset or share in the upside) will survive very well as long as the Lease Project only requires capitalization of the **value** of a lessee residual guarantee (not the full amount of the guarantee) along with the contractual rents. I do think it makes sense under the proposed regime to include only the amount expected to be payable under the residual guarantee (the amount by which it is "in the money") in the capitalization calculation. I hope it survives in the final rule. It also makes sense as all that should be capitalized is what the lessee is obligated to pay for the temporary right to use a leased asset. Specifically regarding the residual guarantee, the lessee is only obligated to pay the expected shortfall - not the full guarantee amount. As under today's GAAP the 12 month firm term with renewal and termination options will get scrutiny under the proposed rules in terms of whether any renewals should be included in the amount capitalized. In any event the amount capitalized should be low compared to the cost to buy the leased asset making the structure attractive to lessees.

The objective of structuring under the proposed rules will be to get the lowest present value/capitalized amount for the lessee. One way to lower rents and as a result get a lower present value is through pricing in tax benefits but with low interest rates and lack of tax base among lessors, tax benefits are not as powerful a tool as in the past. Another way to lower rents and get a lower capitalized value is to assume a higher residual. This is not a real solution as one must manage residual risks to avoid losses. The last solution is to have the lessee guarantee the residual so that the residual risk is converted to credit risk and thus the lessor can raise the residual assumed in pricing. This can be accomplished through a synthetic lease or merely adding a residual guarantee to the terms of the lease. This would mean that the lease would not qualify as a true lease. Due to the lower value of tax benefits in the current environment this may not be a deal breaker.

Considering the proposed accounting rules the amounts capitalized under a five year term real estate synthetic lease is about 22% of the asset cost and for a twelve month synthetic lease is the capitalized amount is about 28% of cost. As you can see the residual guarantee is a powerful structuring tool.

## **Conclusion**

Although we are not sure what the ultimate outcome of the Lease Project will be in terms of the actual words and interpretations, it seems ironic that synthetic-like structures are likely to fare the best of all operating lease structures.

## **About the Author:**

Bill Bosco is the President of Leasing 101, a lease consulting company. Bill has over 36 years experience in the leasing industry. His areas of expertise are accounting, tax, financial analysis, structuring, pricing and training. He has been on the EFLA accounting committee since 1988 and was chairman for 10 years. He is a frequent author and speaker on leasing topics. He has been selected to the FASB/IASB Lease Project working group. He can be reached at [wbleasing101@aol.com](mailto:wbleasing101@aol.com), [www.leasing-101.com](http://www.leasing-101.com) or 914-522-3233.