Anatomy of a TRAC Lease
Under Today's GAAP and Likely Future GAAP

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A TRAC (Terminal Rental Adjustment Clause) lease is a unique lease in that it is the only lease where a lessee can provide a "first loss" residual guarantee to the lessor yet the lease is viewed as a true lease for IRS tax purposes. The Terminal Rental Adjustment Clause provides for a rent adjustment, plus or minus, for the amount that the sales proceeds from disposition of the leased vehicle exceeds or is less than an agreed to strike price (aka the TRAC amount). In some cases the lessor will allow a lessee purchase option set at the TRAC amount. TRAC leases are often referred to as "open end" leases as the lessee's ultimate obligation is not determined until the vehicle is disposed of and the TRAC provision is settled. The IRS specifically defines rules that govern which leases may qualify as TRAC leases. The allowable assets are licensed over the road vehicles (cars, trucks and trailers) used at least 50% in the trade or business of the lessee. Also, except for the TRAC provision, the lease must otherwise meet the IRS' true lease requirements to be a true lease and allow the lessor to claim the tax benefits associated with the leased vehicle. This unique tax treatment for vehicle leases is basically a tax benefit given to support the auto/truck/trailer industries in the US that are such an important part of the US economy.

Today's GAAP

A TRAC lease is classified as a capital lease for the lessee and a finance lease for the lessor under US and international (IFRS) GAAP as the residual guarantee is considered a minimum lease payment and the present value (PV) of the minimum lease payments using the implicit rate in the lease will equal the cost/fair value of the vehicle. The implicit rate in the lease must be used as the discount rate since the lessee knows the lessor residual because it is the stated TRAC amount. Additionally under IFRS GAAP classification tests the presence of the TRAC, giving the lessee upside rewards and downside risk's, is also a factor in lease classification causing a TRAC to be a capital lease. Operating lease treatment is not possible under IFRS. Under US GAAP operating ease treatment can be achieved using a "split TRAC" structure (explained further below) where the lessee's residual guarantee is limited so that the PV of the rents is less than 90% of the cost/fair value of the leased vehicle. US lessors who provide a split TRAC will also have operating lease treatment as the terms are the same including both the lessee and lessor using the rate implicit in the lease as the PV test.

Likely Future GAAP

As the Leases Project stands, TRAC leases will be capitalized by lessees at the present value of the contractual rents and any bargain or compelling renewal rents plus the value of the residual guarantee (the amount the lessee expects to pay under the TRAC, said another way, the "in-the-money" value, if any). This means that TRACs capitalize to significantly less than the cost of the vehicle, a real accounting benefit to the TRAC structure. This could change if the Boards decide to use current IAS 17 GAAP concepts for lease classification and capitalization, but, as of the date of this article, that is not in the Projects tentative decisions that are being written up as the new Exposure Draft. There will be no value to structuring a split TRAC. As the leases Project stands, lessors will account for TRACS under the Receivable and Residual Method which is virtually the same a finance lease accounting under current GAAP. There will be no need for lessors to buy residual insurance.

Typical Structures

Virtually all TRAC leases are structured as split TRACs to allow the lease to be classified as an operating lease by the lessee customer. In order to be classified as an operating lease by the lessee the lease must fail the 4 lease classification tests in FAS 13 (now known as ASC840 as the FASB codified accounting rules using a new numerical system). The key test is the 90% PV test where the present value of the minimum lease payments must be less than 90% of the cost of the vehicle. The residual guarantee provided by the lessee is considered a minimum lease payment. To get the PV to be less than 90% the residual guarantee must be split with the lessor assuming an amount of residual risk and the lessee's residual guarantee being reduced so the total PV is less than 90% of cost. The amount of the lessor's residual risk is the future value of 10.1% of cost, using the rate implicit in the lease, to insure the classification calculation works in favor of operating lease classification. The lessor's residual risk is a second loss risk while the lessee's residual guarantee is a first loss guarantee. It is important to note that the lessor's lease classification will also be an operating lease. Most lessors find this unfavorable, especially financial institutions. Not only is the pattern of earnings is back ended (rent less interest cost and depreciation during the term and the residual proceeds at the end of the term), but depreciation expense is classified as an operating cost, resulting in negative impacts to financial measures applied to financial institutions. To avoid this problem, most financial institutions buy residual insurance in an amount that will cause the PV of minimum lease payments to equal or exceed 90% of cost and thus get direct finance lease accounting which produces finance revenue amortized at a constant rate over the lease term.

Commercial auto fleet leases use TRAC structures. The typical fleet lease is first structured as a 12 month lease followed by a series of monthly options to terminate and return the vehicle, with a TRAC provision keyed off the residual sale price of the vehicle, or renew the lease to a maximum term with a final TRAC position. The TRAC amounts throughout the term are set at the unamortized balance at each month end. Typical fleet structures include:

- Floating rate level amortization: The monthly amortization amount is calculated by subtracting the TRAC amount from the vehicle cost and dividing the resulting amount by the lease term. Often, at the request of the customer (fleet manager), the TRAC amount is set at zero and the term is 50 month so the amortization is 2% per month making it easy to calculate the unamortized balance/TRAC amount when considering a termination. The resulting amortization schedule is included in the lease documentation. The monthly rent has two components, the amortization component plus a monthly "lease rate" component. The monthly lease rate component is calculated by applying a stated lease rate (LIBOR plus a spread) to the unamortized balance at the beginning of the period covered by the rent. This structure usually has a 12 month firm term followed by termination and renewal options through to the maximum term. The FAS 13 90% PV test must be met for the 12 month firm term and for each successive renewal. Each monthly renewal is considered new lease and the PV test has to be dealt with. In certain cases where the lessee regularly renews beyond the 12 month firm term the auditors may force the lessee to include some level of assumed renewals in the lease term for purposes of the 90%test. In that case it will require adjusting the split TRAC calculations increasing the lessor's residual risk.

- Floating rate mortgage amortization: The amortization schedule is created by running a mortgage amortization schedule based calculations assuming the "lease rate" (LIBOR plus a spread) remains the same throughout the term, assuming the TRAC amount at expiry is the residual and solving for the rent amount. The amortization schedule is included in the lease documentation. The monthly rent has two components, the amortization component that remains fixed plus a monthly "lease rate" component. The monthly lease rate component is calculated by applying a stated lease rate (LIBOR plus a spread) to the unamortized balance at the beginning of the period covered by the rent. Although the initial pricing assumed the lease rate was fixed, this is a floating rate structure so the total rent amount in any month will change if LIBOR changes. This structure usually has a 12 month firm term followed by termination and renewal options through to the maximum term.
- Fixed rate level payment: The lease is structured as any other fixed rate level payment lease. This structure does not include the 12 month firm term feature common in floating rate structures as explained above. This is because it is a fixed rate transaction that lessors match fund as a treasury policy. Any shortening of the term through a termination would involve breakage of the funding to support the transaction. The TRAC amount is set at the residual at the end of the term.

Trucks and trailers are typically structured using the fixed rate level payment structure explained above. The reason is those assets are not turned over as frequently.

The future of TRACs

TRACs will survive very well as long as the Leases Project only requires capitalization of the value of the lessee residual guarantee. As under today's GAAP the 12 month firm term with renewal and termination options will get scrutiny 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 vehicle making the structure attractive to lessees.

About the Author:

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