Anatomy of a TRAC Lease:
Comparing Current and Future U.S. GAAP

BY BILL BOSCO

Bill Bosco discusses U.S. GAAP and compares practices of today with those proposed by the FASB and IASB for the future. He also examines typical terminal rental adjustment clause structures and the future of TRACs, split-TRACs and synthetic leases.

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A Terminal Rental Adjustment Clause (TRAC) lease is unique. It is the only lease structure 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 TRAC provides for a rent adjustment, plus or minus, for the amount that sales proceeds from leased vehicle disposition exceed or fall below an agreed to strike price (aka the TRAC amount) at lease expiry. In some cases, the lessor will allow a lessee purchase option set at the TRAC amount. TRAC leases are often called "open end" leases as the lessee's ultimate obligation is not determined until vehicle disposal and TRAC provision settlement.

The IRS specifically defines rules that govern TRAC leases qualification. The only allowable assets are licensed over the road vehicles used at least 50% in trade or business of the lessee. Also, except for the TRAC provision, the lease must otherwise meet the IRS' true lease requirements and allow the lessor to claim the tax benefits associated with the leased vehicle. This unique vehicle lease tax treatment is basically a tax benefit to support the vital U.S. auto, truck and trailer industries.

TRACs, split-TRACS and synthetic leases will survive well under the FASB Lease Accounting Project. The 12-month firm term with non-bargain renewal and termination options will see increased scrutiny in terms of whether renewals should be included in the term and the amount capitalized based on compulsion to renew.

Today's GAAP

This article focuses on U.S. GAAP. The proposed IASB and FASB rules differ significantly on lessee accounting. A TRAC lease is classified as a capital lease for the lessee and a direct finance lease for the lessor under U.S. and international (IFRS) GAAP because the lessee residual guarantee is considered a minimum lease payment, and the present value (PV) of the minimum lease payment — including the lessee residual guarantee — using the implicit rate in the lease will equal the cost/fair value of the vehicle. The implicit rate must be used as the discount rate in the PV test as the lessee can calculate the implicit rate since the amount of the lessor residual is the stated TRAC amount. Additionally, under IFRS GAAP classification tests, the presence of the TRAC — giving the lessee upside rewards and downside risks — is also a factor in lease classification causing a TRAC to be a capital lease.

Lessee operating lease treatment for a lease with a TRAC provision is not possible under IFRS. Under U.S. GAAP, lessee operating lease treatment can be achieved using a "split TRAC" structure where the lessee's residual guarantee is limited at an amount such that the PV of the rents and the lessee's capped residual guarantee is less than 90% of the cost/fair value of the leased vehicle. U.S. lessors that provide a split TRAC will also have to account for the split-TRAC as an operating lease under lessor accounting rules as the terms are the same for both lessor and lessee, including both the lessee and lessor using the rate implicit in the lease as the discount rate in the PV lease classification test. In other words, the PV of the rents and capped residual guarantee is less than 90% of the vehicle's cost/fair value so it is an operating lease to the lessor. "Synthetic" leases — a lease that is a financing for tax/legal purposes but an operating lease for accounting structure as it includes a capped residual guarantee provided by the lessee — are structured using split-TRAC structures. Synthetic leases can be done for most asset types that have reasonable residual values, and are most popular in real estate and motor vehicle leasing.

Likely Future GAAP

As the FASB Leases Project stands, TRAC and split-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 or the "in-the-money" value. This means that TRACs/split-TRACs capitalize to an amount significantly less than the cost of the vehicle, an extremely important lessee accounting benefit to the TRAC structure.

The TRAC will be a finance lease with front-loaded costs (bad news) and the lease liability is debt (*really* bad news). The split-TRAC will be an operating lease under U.S. GAAP, but not so for IASB GAAP, with level rent expense (good news), and the lease liability will be classified as an "other" non-debt liability (*really* good news). Structuring a split-TRAC will continue to hold great value.

As the lease project stands, lessors will account for TRACS under the direct finance lease method and for split-TRACs under the operating lease method — the same as current GAAP. A desire will still exist for lessors to buy residual insurance to convert those split-TRAC operating leases to direct finance leases (DFLs). There are two reasons to do so. First is a better pattern of earnings as operating lease accounting has back ended earnings, while under DFL accounting the revenue is recognized at a constant rate of return as the lessor's asset amortizes. Second, financial institutions are measured by operating efficiency ratio, and the depreciation from an operating lease asset is presented as an operating expense, which deteriorates operating efficiency.

Even if a lessor buys residual insurance such that the PV of rents, lessee residual guarantee and third party residual insurance PV to 90% of the asset's value, the new rules do not consider the residual guarantees as lease payments, and will book the guarantees as a residual, which is a non-financial asset. This is a big change from current GAAP where a guaranteed residual is a financial asset. It impacts the ability to securitize guaranteed residuals and get securitization debt off balance sheet treatment. Lessors may have to record a securitization of residuals as an on balance sheet borrowing.

The proposed new rules allow capitalization exemption for leases with terms of 12 months or less. Although typical spit-TRAC structures have 12-month minimum firm terms followed by non-bargain renewal and termination, exemption may not be allowed under the short-term lease exemption in the proposed new rules as leases are often renewed beyond 12 months. The term will be a judgement call on a case-by-case basis. The lessees' auditors will examine historical performance, and may force the lessee to assume a term that matches the business' needs.

Under the proposed rules, floating rate transactions are initially booked assuming the spot LIBOR rate does not change. The IASB requires that lessees rebook floating rate leases every time the contractual rents change. The FASB allows the lessee to account for floating rent changes on a cash basis unless the lease has another change, in which case it must be rebooked using the current spot rate to calculate future rent payments.

Typical TRAC Structures

Virtually all TRAC leases are structured as split-TRACs to allow classification as an operating lease by the lessee customer.

Commercial auto fleet leases use TRAC structures. The typical fleet lease is first structured as 12-month, and 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 to renew to a maximum term with a final TRAC position. The TRAC amounts throughout the term are set at the unamortized balance at each month's 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, the TRAC amount is set at zero and the maximum term is 50 months, so the amortization is 2% per month which makes calculating the unamortized balance/TRAC amount easy when considering a termination. The lease documentation includes the resulting amortization schedule. The monthly rent has two components: the amortization, and a monthly "lease rate," which is calculated by applying a stated lease rate (LIBOR plus a spread) to the unamortized balance at the start of the rent-covered period. This structure usually has a 12-month firm term followed by termination and renewal options through to the maximum term. The lessee is not given the option to buy to ensure that the terms never include a bargain purchase option (if a purchase option is included, it would be considered a bargain as a zero dollar purchase option on a vehicle at the end of 50 months is a deal). The 90% PV test must be failed for the 12-month firm term and for each successive renewal. Each monthly renewal is considered a new lease and is subject to the PV test. In certain cases where the lessee regularly renews beyond the 12-month term, auditors may force the lessee to include a higher level of lessor-assumed renewals in the lease term to fail 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 mortgage amortization schedule based calculations assuming the "lease rate" remains the same throughout the term, assuming the TRAC amount at expiry is the residual and solving for the rent amount. The lease documentation includes the amortization schedule. The monthly rent has two components: a fixed amortization plus a monthly "lease rate," which is calculated by applying a stated lease rate to the unamortized balance at the beginning of the rent-covered period. Although the initial structure/pricing assumed a fixed lease rate to create an assumed rent schedule and a principal balance schedule, 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 non-bargain renewal options through to the maximum term. The TRAC amount is set at expected fair market value at the end of the term.

Fixed rate level payment: Structured as any fixed rate level payment lease, this structure does not include the 12-month firm term feature because it is a fixed rate transaction that lessors match fund as a treasury policy. Shortening the term through a termination would break the funding to support the transaction. The TRAC amount is set at expected fair market value at the end of the term. Trucks and trailers are typically structured using the fixed rate level payment structure due to less turnover of those assets.

The Future of TRACs, Split-TRACs & Synthetic Leases

TRACs, split-TRACS and synthetic leases will survive well under the FASB Lease Accounting Project. The 12-month firm term with non-bargain renewal and termination options will see increased scrutiny in terms of whether renewals should be included in the term and the amount capitalized based on compulsion to renew. Lessees may have to assume an initial lease term of more than 12 months if, historically, renewing beyond 12 months. In any event, the amount capitalized will be very low compared to the cost to buy the leased vehicle, and the cost pattern will be level, making the structure very attractive to lessees. m

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