Recently Asked Questions

Many are frequently asked too

By: Bill Bosco, Leasing 101

I get lots of questions asked and will devote this article to answer a few that may have broad interest.

Question: Can you structure TRAC (terminal rental adjustment clause) lease that fully amortizes (also known as a Zero TRAC) such that the lease is a true lease and an off balance sheet operating lease? Many fleet managers want a 50 month TRAC lease with 2% per month "amortization" so they can easily calculate the TRAC value of any vehicle by multiplying 2% times the months elapsed in the term. The typical fully amortizing fleet lease has a 12 month firm term followed by a series of 38 monthly options to renew or terminate with a TRAC adjustment. The maximum lease term is 50 months at which point the TRAC is fully amortized.

Answer: The short answer is yes, but first I should say check my answer with your tax and accounting advisors to make sure they agree.

In my opinion to be an operating lease for accounting purposes, and thus off balance sheet, the structure must include the following:

1) There can be no lessee fixed price purchase option. The major accounting issue is to make sure the structure does not include an option to buy the vehicle for the TRAC amount at expiry as an option to buy for zero is a bargain for accounting purposes. Regarding fixed price purchase options set at the TRAC amount during the term, they are problematic at any point along the term where the option price is less than expected fair market value. That is virtually certain to happen due to the steep amortization pattern compared to the expected fair market value curve of the leased vehicle. Also the periods that precede a bargain purchase option are included in the lease term for accounting purposes which will impact the structuring of the amount of residual risk the lessor must assume (the longer the lease term the more risk the lessor must assume).
2) The structure must include a split or modified TRAC, that is, a TRAC with a capped residual guarantee. The residual guarantee is capped at an amount in the TRAC structure that when the guarantee is included as a minimum lease payment in the present value calculation of the remaining minimum lease payments (rents and residual guarantees) in the lease term and any renewal term results in a present value that is less than 90% of the fair value of the vehicle at the beginning of the lease term or renewal term.
3) Justification off balance sheet treatment is difficult for a fully amortizing TRAC. I personally never liked them because of the difficulty in defending off balance sheet treatment but my former employer did them all the time with major lessee/customers and they were accepted by their big 4 audit firms.

   There is an exception to the 75% useful life test and the 90% PV test that says that if the lease term (meaning also a renewal term) begins in the last 25% of the useful life of the leased asset you disregard those tests when classifying the lease/renewal. The text from FAS 13 is as follows with highlighting provided by me:
   "7. c. The lease term (as defined in paragraph 5(f)) is equal to 75 percent or more of the estimated economic life of the leased property (as defined in paragraph 5(g)). However, if the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, this criterion shall not be used for purposes of classifying the lease.

   7. d. The present value at the beginning of the lease term of the minimum lease payments (as defined in paragraph 5(j)), excluding that portion of the payments representing executory costs such as insurance, maintenance, and taxes to be paid by the lessor, including any profit thereon,

equals or exceeds 90 percent of the excess of the fair value of the leased property (as defined in paragraph 5(c)) to the lessor at the inception of the lease over any related investment tax credit retained by the lessor and expected to be realized by him. However, if the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, this criterion shall not be used for purposes of classifying the lease. A lessor shall compute the present value of the minimum lease payments using the interest rate implicit in the lease (as defined in paragraph 5(k)). A lessee shall compute the present value of the minimum lease payments using his incremental borrowing rate (as defined in paragraph 5(1)), unless (i) it is practicable for him to learn the implicit rate computed by the lessor and (ii) the implicit rate computed by the lessor is less than the lessee's incremental borrowing rate. If both of those conditions are met, the lessee shall use the implicit rate."

The useful life of a business fleet car is typically considered to be 5 years (60 months) as a business will turn over older fleet cars to always have "good looking" fleet cars maintain its image to customers. A fully amortizing TRAC term runs 50 months. 25% of 60 months is 15 months and conversely 75% of 60 is 45. As a result when the fully amortizing TRAC reaches month 46 (within the last 25% of the useful life) you ignore the useful life and PV classification tests.

In my opinion for tax purposes the major concern is also regarding purchase options. There can be no bargain purchase option as that would violate the IRS true lease guidelines. The term “terminal rental adjustment clause” means a provision of an agreement which permits or requires the rental price to be adjusted upward or downward by reference to the TRAC amount realized by the lessor under the agreement upon sale or other disposition of such property (note there is no mention of inclusion of a purchase option in the TRAC definition). IRS Code Section 7701(h)(1) provides that in the case of a qualified motor vehicle operating agreement that contains a terminal rental adjustment clause (a TRAC lease), the agreement is treated as a lease if (but for such terminal rental adjustment clause) the agreement would be treated as a lease for federal income tax purposes, and the lessee is not treated as the owner of the property subject to the agreement during the period the agreement is in effect. What this means is that, but for the TRAC provision, the lease must meet the true lease guidelines which prohibit bargain purchase options.

In summary the lease cannot contain a bargain purchase option and the present value of the minimum lease payments must be less than 90% of the fair value of the vehicle at the beginning of the firm term and any renewal term.

Question: In the accounting for a true lease can one record a 0% residual even though the IRS guidelines require the leased asset have at least a 20% residual value at the end of the lease?

Answer: US GAAP defines the residual value to be booked as “the estimated fair value of the leased property at the end of the lease term”. In practice lessors book a conservative value rather than the “true” expected fair value of the leased asset at lease expiry to avoid residual write downs or residual losses. In essence most lessors are interested in maintaining quality of earnings so they assume conservative residuals. In my experience I have seen many leases where a low and at times zero residual was booked because of the nature of the asset while there was documentation in the tax files to support that in a best case scenario one could expect the asset to have a 20% value at the end of the lease term.

Question: Will the proposed new lease accounting rules cause tax law to change?

Answer: No. the IRS, state income tax, local sales tax and local property tax laws are all based on a risks and rewards analysis of leases to determine whether the lessee or lessor is the “true” owner of the leased asset. Since this analysis is based on economic substance I see no reason for them to change. The proposed accounting rules break from the traditional alignment (in FAS 13) with the tax view (risks and rewards). This break in tax and accounting views if enacted will be most problematic for lessees of equipment. The proposed rules would treat operating leases (most often these are true leases for tax purposes) as though they are capital leases for P&L purposes meaning instead of rent expense the P&L cost will be front loaded (a combination of straight line amortization of the asset plus imputed interest on the lease liability). This creates a book tax difference resulting the need for deferred tax accounting by lessees. State income taxes also consider true leases to have rent as the deduction. Also in state tax apportionment calculations operating leases/true leases are treated differently than capital leases (capital lease assets are considered the same as owned assets). Sales tax laws tax capital leases like a purchase so there is a risk of error in taxing a capitalized operating lease. Likewise for property tax purposes a lessee must pay property tax on capital leases so capitalized operating leases may be erroneously included in property tax returns

About the Author:

Bill Bosco is the Principal of Leasing 101, a lease consulting company. Bill has over 37 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, www.leasing-101.com or 914-522-3233.