

Targeting Customers for Tax Leases

Understanding Tax Footnotes

Among the reasons why a customer will lease new equipment, rather than borrowing to buy, is managing their income tax position. This is one of the most important considerations for middle market and large companies with tax issues. Said another way, companies seek the lowest after tax cost to finance new equipment acquisitions and, given certain tax scenarios, a tax lease may be the best financing product.

Middle market and large ticket lessors target potential tax lease customers by looking for customers with negative tax positions. The tax positions that will often cause a customer to choose a tax lease are the Net Operating Loss (NOL), Investment Tax Credits (ITC), Valuation Allowances and Alternative Minimum Tax (AMT) positions:

Net Operating Loss/Investment Tax Credit Carryforwards

NOL is a tax position where a company has negative taxable income. Generally a NOL can be carried back two years to offset previous years' taxable income to generate a refund. If a NOL still exists it generally is carried forward twenty years to offset future years' taxable income. Customers often lease when they have a NOL to lower their after-tax cost of financing equipment. If a customer has a large NOL carry forward it means it can't currently take advantage of tax benefits from new equipment acquired such as the accelerated depreciation write offs (MACRS deductions) in the current year or ITC. It may be advantageous to do a tax lease of equipment to be acquired, or a sale leaseback of existing equipment, as the lessor will take the tax benefits currently and charge a lower tax effected rent rate to the lessee. The customer should do a lease vs. buy analysis (see Exhibit) to determine if it is beneficial to trade off tax benefits that it may be able to use in the future for a current lower financing rate. Note that ITC carryforwards may now be an issue again with the ITC credits being allowed for certain alternative energy assets. Unused ITC credits can be carried back one year and carried forward twenty years to offset tax liabilities. It may be advantageous to do a tax lease if ITC carryforward positions will delay tax benefit utilization available from a new asset acquisition.

Valuation Allowances

A valuation allowance is a balance sheet line item that offsets all or a portion of the value of a company's deferred tax assets (expected future tax benefits recorded as an asset to offset future tax liabilities) because the company doesn't expect it will be able to earn enough taxable income in the future to realize the value of the deferred tax asset. It may be advantageous to do a tax lease if deferred tax assets will go unutilized due to new tax benefits arising from the acquisition of a new asset.

Alternative Minimum Tax

AMT is a US tax provision that causes companies with significant tax benefits preferences or credits to pay a minimum tax. The AMT is calculated by adding back adjustments to regular taxable income for AMT preference items and applying a 20% AMT rate to the AMT income. The AMT tax is compared to the regular income tax liability calculated and the taxpayer pays the higher of the two amounts. Paying the AMT generates a credit (excess of AMT over regular tax). AMT credits can be carried forward indefinitely and applied to reduce regular tax in the future when it exceeds AMT. Accelerated depreciation (MACRS) is an AMT preference item (AMT preference items

include depletion, tax exempt income, and excess bad debt reserves, among others), thus leasing new equipment rather than buying helps reduce AMT as the lessor will take the full, non AMT tax benefits currently and charge a lower tax effected rent rate to the lessee. The customer should do a lease vs. buy analysis (see Exhibit) to determine if it is beneficial to trade off tax benefits that it may be able to use in the future for a current lower financing rate.

How does a lessor determine if a potential customer has a negative tax position?

The first step is to read their tax footnote. This is a must before contacting a customer to understand which financing structure or structures would be most suitable. Although the footnote is a good source of information, talking to the customer is the best way to get an accurate tax assessment, but that opportunity will only come once you have met the customer. You want to go in to the first meeting prepared. In many cases the tax position is not a concern of the decision maker/employee of the customer you are dealing with. People like IT managers, fleet managers and procurement managers are more concerned with getting the lowest rent payment/book expense and getting operating lease treatment than in getting the lowest after tax cost. Note that a tax lease is usually what they chose because of their needs (tax leases are usually operating leases and tax lease rents are usually low as they reflect the value of passing the tax benefits to the lessor). In these cases the needs of the company may be ignored as the needs of the decision maker do not include tax considerations. In large ticket transactions often the treasurer or CFO is the decision maker and they are more likely to not know the company's tax position and understand which structure is most suitable. The treasurer/CFO is likely to be more concerned with the lowest after tax cost rather than the lowest book expense. The tax manager ultimately is the best source of tax information.

How does a lessor find potential tax lease customers efficiently? When doing target marketing lessor's use data mining techniques that search financial data for criteria that would indicate which companies are candidates for leasing. Numeric information is easy to extract like fixed assets on balance sheet, rent obligations reported in footnotes and capital expenditures reported in cash flow statements. Tax position presents a problem because there is no good numeric item to search for. The tax position is presented as text in the tax footnote. Word searches whether automatic or manual (this is how I have seen it done) are the way to get the tax position information.

What is in a tax footnote that is helpful in understanding a customer's needs? A tax footnote has four parts: Analysis of the Tax Provision, Analysis of the Deferred Tax Provision, Reconciliation of the Effective Tax Rate, and Text.

Analysis of the Tax Provision

This is in a tabular format. The total tax expense is equal to the amount of tax expense reported in the income statement and breaks the amount out between current and deferred provisions for Federal, state and foreign taxes. The current Federal provision is the amount of tax due for the current year to the IRS. A negative amount indicates a current year NOL - a good indication of a tax lease candidate. The deferred Federal tax provision is taxes provided currently but payable to the IRS in the future due to

temporary differences between book and tax income. There may be additional tax expense adjustments caused by adjustments to valuation allowances. It is common to have a net positive tax provision (a debit/expense) yet not be a full current taxpayer. That is when there is a negative current tax provision that is less than the sum of a positive deferred tax provision and any other positive adjustments to tax expense. A NOL is often caused by temporary differences. AMT is caused by preference items. There are also permanent differences like the treatment of stock options that could cause book income to be permanently higher than tax income. Absent adjustments, the net of the current and deferred tax provision should be equal to the incremental composite income tax rate times the reported book income, but due to complexities in the tax rules and in tax accounting, that is seldom the case. Since FAS Topic 740 (formerly FAS 109) is balance sheet oriented, that is the current and deferred liabilities accurately reflect taxes to be paid, any adjustments (like changes in rates applicable to future taxes or valuation allowances where deferred tax receivables are unlikely to offset future taxes payable) are charged or credited to the tax provision.

Analysis of the Deferred Tax Provision

This is an analysis of the tax effect of temporary differences. If the analysis shows a large amount for AMT preference items such as depreciation that may indicate that the customer may have an AMT problem and may be a candidate for leasing new equipment.

Reconciliation of the Effective Tax Rate

This is an analysis of the difference between the federal statutory tax rate and the effective tax rate (book tax provision divided by pre tax book income). Typical items found in the tax rate analysis are tax credits, state income taxes, foreign income taxes, tax exempt/tax reduced items like tax exempt interest and FAS Topic 740 adjustments like valuation allowances or changes in tax rates applied to timing differences. The presence of a valuation allowance means the company will not generate enough future taxable income to collect on deferred tax receivables. Leasing new equipment should help reduce tax shelter and alleviate the need for the valuation allowance.

Text

This is the most important section of the tax footnote where issues like AMT, NOL, ITC (now available for certain alternative energy assets) and excess foreign tax credit carry forwards and valuation allowances, if any, are described. The amounts of carry forwards and timing of expiration are disclosed. Lessors should focus on this section as the best source of information on a lessee's tax position.

Taxes are an important factor in our business and they will be even more important as accounting rules tighten in the future. Strange as it may seem I have heard several experienced lease professionals say that a target customer was not a tax lease candidate because they looked at the income statement and saw a positive tax provision.

Unfortunately there is no substitute for reading the text in the footnotes. I have also had the experience where leasing sales people were prepared to call on a truck user without any idea if they should lead with a loan, tax lease (TRAC or fair market value lease), or synthetic lease. In that example there is no substitute for knowing what you are doing.

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Exhibit

Lease vs. Buy Calculation

- Analysis done by the lessee to determine if a tax lease financing is more cost-effective than borrowing to buy the equipment
- The dilemma is that the tax lease rent rate looks better than the loan rate but the lessee is giving up potentially valuable tax benefits
- The calculation is a discounted cash flow analysis:
 - Calculates the PV of the after tax cash flows of the lease
 - AT cash flows = rent payments less the tax benefit of deducting the rent
 - Tax deductions are adjusted for impact of ITC carryforwards, NOL carryforwards & AMT
 - Calculates the PV of the after tax cash flows of a loan
 - AT cash flows = loan payments less the tax benefit of deducting the interest on the loan & the depreciation on the asset net of the after tax gain on sale of the asset
 - Tax deductions are adjusted for impact of NOL & AMT
 - Must assume the asset is either sold under the loan or bought under the lease assumptions to be comparable
- **The lowest PV of the 2 choices = the lowest after tax cost & therefore it is the best choice**