Warren & Selbert

Simple as ABC.

Book Gain or Loss Upon Sale

A lessor that sells or terminates a lease may incur a book gain or loss even if the proceeds to the lessor equal the termination value. This can happen because termination values protect the **economic** earnings to date, but the lessor must receive sufficient proceeds to protect the **book** earnings to avoid a book loss. If the cumulative economic earnings to date exceed the cumulative book earnings to date, the lessor has a book gain upon sale or termination; if the cumulative economic earnings are less than the cumulative book earnings, the lessor has a book loss.

The book gain or loss upon sale or termination can be calculated as follows.

1. Net Proceeds equals the sale price plus prorated rent and prepaid/deferred balance less accrued interest and payoff of the outstanding loan balance.
2. Book Investment in Lease is the rent receivable plus the residual value and ITC receivable less any fee, revenue/expense or equity payable and less the unearned pre-tax income.
3. Pre-Tax Book Gain/Loss equals the Net Proceeds less the Book Investment in Lease.
4. Book Taxes Due on Sale is the Pre-Tax Book Gain/Loss multiplied by the composite tax rate in the year of the sale.
5. Net Deferred Taxes is the Deferred Tax Balance less the Book Taxes Due on Sale.
6. Tax Savings from the Deferred Tax Account is the Net Deferred Taxes less the income taxes due on sale, which is described below.
7. After-Tax Book Gain/Loss is the sum of the Pre-Tax Book Gain/Loss (item 3), the Book Taxes Due (item 4) and the Tax Savings from the Deferred Tax (item 6).

To determine the income taxes due on sale, taxable income in the fiscal year of the sale must be recalculated to reflect the receipt of the sale proceeds, the write-off of the remaining basis of any outstanding depreciation and fee amortization, and the adjusted amount of interest expense and rental income incurred in the year. Additional adjustments may be necessary in more complicated tax situations (e.g., AMT, NOL, or FSC). Actual taxes due on the date of the sale are the tax liability recalculated for the year of the sale, plus any make-up payments from the prior year but after the date of the sale, less estimates paid during the fiscal year prior to the date of the sale.

Any book gain/loss created by the termination of a lease for the termination value should be relatively small since the after-tax book gain/loss is the difference between the economic and book earnings to date. However, the sale of an asset subject to a lease has the potential to create a much larger gain/loss because the fair market value sale price may be significantly different from the termination value. The buyer should be aware that termination values for the entire lease term are included in the original documentation for the lease and will apply to any termination during the remaining lease term. These existing termination values may vary significantly from the amount the new owner needs to protect the economic earnings to date during his period of ownership.