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IRS True Lease Guidelines

IRS Revenue Procedures 2001-28 and 2001-29, issued in May 2001, specify that a transaction must satisfy the following four criteria to be classified as a true lease. If a transaction qualifies as a true lease, the lessor is deemed the owner of the asset and receives all depreciation and tax benefits. Furthermore, the rental payments are fully taxable for the lessor and deductible for the lessee.

1. The lessee does not have an option to purchase the asset for less than FMV.
2. The expected residual value is at least 20% and the lessor bears all residual risk.
3. The leased asset must be general-use property and have an estimated remaining useful life at the end of the lease equal to at least 20% of the original estimated useful life.
4. The lease must satisfy the IRS requirements for Profit Exclusive of Tax Benefits, Cash Flow, and Minimum Equity Investment.

The fourth requirement involves detailed calculations for each of the profit, cash and equity tests.

The **Profit Exclusive of Tax Benefits** test requires that the sum of the lessor's pre-tax inflows (total rent plus IRS Represented Residual) must exceed the pre-tax outflows (debt service, fees, other revenues and expenses, and the initial equity investment). Satisfying this test guarantees that the lessor has profit without regard to tax benefits. Note that this test uses the IRS Represented Residual which is the greater of the lessor's actual expected residual value or the IRS minimum requirement of 20%.

The analysis of **Cash Flow** is similar to the profit but test includes neither the initial equity investment nor the represented residual. For this test, the lessor's total net pre-tax cash flow during the lease (rent less debt service, fees, other revenues and expenses) is expressed as a percentage of the initial equity investment per year of lease term. A common requirement is that this measure be at least 2.00%.

The **Minimum Equity Investment** test requires that the lessor make an initial 20% equity investment and maintain that investment pro-rata on a pre-tax basis over the term of the lease. This test is performed on each rent date and compares the cumulative pre-tax cash to date to the sum of any equity investment in excess of the required minimum and a straight-line proration of the profit (as defined by the profit test). The effect of this test is to limit how rapidly the lessor may receive pre-tax cash from the lease. Some lessors interpret the minimum equity requirement as 13% instead of 20%.

An additional IRS test is the uneven or 90-110 Rent Test, which requires that the rent allocated to any lease year must be at least 90%, but no more than 110%, of the average annual rent over the term of the lease. If the cash rent payments vary by more than this, a 467 loan can be used to track the difference between the allocated rent which conforms to the 90-110 rule and the cash payments. In this case, the tax effect of the rent is split between allocated rent and allocated interest calculated using a 467 loan.

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