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Termination Values

A termination value (TV) is an amount paid by a lessee to a lessor when the lessee no longer wants to comply with the rental schedule in the lease contract. The value of the TV must be at least equal to the amount that makes the lessor whole with respect to his outstanding investment and the resulting cash flows occurring due the termination event. The three components of the termination value are unrecovered investment, outstanding indebtedness, and taxes due upon termination.

The lessor's unrecovered investment balance includes earnings to date and reflects the value of the remaining cash flows as measured using the lessor's yield method. To obtain his required yield and protect his earnings to date, the lessor must receive an amount equal to the outstanding investment balance in the previous period, plus earnings on that balance calculated for the period of the termination event. Additionally, the investment balance must be adjusted for cash flows occurring in the current month prior to or on the date of termination. For example, the amount of prorated arrears rent that has already been accrued by the lessor may be paid separately by the lessee, and any amount paid should then be netted against the unrecovered investment. Termination values for 467 rent structures must take into account the prepaid/deferred balance to make cash and taxable income agree upon termination.

Any outstanding non-recourse debt balance plus accrued interest to the day of termination must be paid. Although the lender may have a lien on the asset and receive this money directly from the lessee, the payoff of the loan must be included in termination value since, for tax purposes, the payment to the lender is viewed as being payment on behalf of the lessor.

To determine the taxes due upon termination, taxable income in the fiscal year of termination must be recalculated to reflect the receipt of the termination value, 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 tax due on the date of termination should be the tax liability recalculated in the year of termination plus any make-up payments from the prior year less estimates paid during the fiscal year prior to termination.

In addition to the termination value the lessor may require an additional amount to be paid by the lessee in the event of a termination. These additional amounts may consist of a fixed expense, an amount to represent additional days of return on the outstanding investment balance, an amount to represent the present value of an expected residual value gain at lease end, or an amount to give the lessor a different rate of return upon termination. In general, TVs are negotiated amounts, and any additional expenses vary by transaction.

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