Equipment Leasing: Considerations and Strategies

Presented by
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Equipment Leasing Considerations and Strategies

OM33 – ALA Conference 2016

Why Lease Equipment?

- Enable Growth
- Convenience & Expediency
- Tax & Accounting Benefits
- Protect Against Obsolescence
Today’s Session

Types of Leases
Accounting & tax classifications
Applicability for law firms

Business Considerations
Leasing vs. buying

Terms and Conditions
Process & economics

Case Studies
Succeed when acquiring equipment

Tax & Accounting Classifications

**Tax (IRS) Classifications**
- True Lease (aka Tax Lease)
- Conditional Sale Contract (aka Finance Lease)

**Accounting (FASB) Classifications**
- Operating Lease
- Capital Lease
Example 1: $1 Buyout Lease

Why do firms use this type of lease?

1. Preserve working capital and spread payments out over time
2. Guaranteed ownership of the asset
3. Easier, more expedient, and potentially better than a term loan
   - Fixed rate and generally no fees, no covenants, and no requirement for collateral other than the leased equipment (true with most leases)
4. Firm gets to expense the depreciation and interest expense

Tax & Accounting Classifications

<table>
<thead>
<tr>
<th>Accounting (FASB) Classifications</th>
<th>Tax (IRS) Classifications</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating Lease</td>
<td>True Lease</td>
</tr>
<tr>
<td>Capital Lease</td>
<td>Finance Lease</td>
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</tbody>
</table>

$1 Buyout
Example 2: FMV Lease

$100,000 Computer acquisition
36 Monthly payments @ $2,585
Purchase for FMV Renew Lease Return equipment

Why do firms use this type of lease?
1. Strategy to establish a refresh discipline, protect against obsolesce
2. Cheaper to pay for “use” versus “ownership”
3. Low monthly payment (total rent should be less than price of equipment)
4. Preserve working capital and spread payments out over time
5. Firm gets to expense 100% of the rental payments

Example 3: Fixed FMV

$100,000 FF&E project
60 Monthly payments @ $1,622
Purchase for FMV amount fixed at start of lease

Why do firms use this type of lease?
1. Provides a “pre-determined” FMV price at the end of the lease
2. Low monthly payment + flexibility of different lease-end options
3. Preserve working capital and spread payments out over time
4. Firm gets to expense 100% of the rental payments, which for long-life assets will greatly accelerate the potential tax deduction
Tax & Accounting Classifications

Accounting (FASB) Classifications

<table>
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<th>True Lease</th>
<th>Finance Lease</th>
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<td>Operating Lease</td>
<td>FMV</td>
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<td>FMV</td>
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</table>

Tax (IRS) Classifications

True Lease

Operating Lease

Finance Lease

FASB (GAAP) Criteria

Operating Leases must satisfy all 4 criteria:

1. The lease does not transfer ownership to the Lessee by the end of the lease term;
2. The lease cannot contain a bargain purchase option;
3. The lease term is 75% or less of the accounting life of the leased property;
4. The present value (PV) of the minimum lease payments at the beginning of the lease term is less than 90% of the equipment cost.
Financial Statement Impact

<table>
<thead>
<tr>
<th>True Lease (Tax)</th>
<th>Finance Lease (Tax)</th>
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<td>Operating Lease (GAAP)</td>
<td>Capital Lease (GAAP)</td>
</tr>
</tbody>
</table>

| No Impact | BALANCE SHEET | Record Asset and Liability |
| Lease Expense (straight-line) | INCOME STATEMENT | Depreciation Expense, Interest Expense |

FASB Accounting Changes?

- Growing need to *improve* and *simply* financial reporting for lease transactions
- *FASB* and *IASB* initiated the joint project on leases in 2006 as part of a global convergence effort
- After much debate, the IASB issued separate *lease accounting* standards
Two Lease Model Maintained by FASB

1976 - 2019
FASB Standard on Lease Accounting
Two Lease Model:
• Operating Lease
• Capital Lease

2019 - Future
FASB Standard on Lease Accounting
Two Lease Model:
• Operating Lease
• Finance Lease

FASB Lease Accounting (2019 →)

<table>
<thead>
<tr>
<th>(GAAP) Operating Lease</th>
<th>(GAAP) Finance Lease</th>
</tr>
</thead>
<tbody>
<tr>
<td>Right-of-Use Asset Non-debt Liability</td>
<td>BALANCE SHEET</td>
</tr>
<tr>
<td>Lease Expense (straight-line)</td>
<td>INCOME STATEMENT</td>
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</tbody>
</table>
IRS Rules for Leases

Agenda Topics #2 and #3

Types of Leases
- Accounting & tax classifications
- Applicability for law firms

Business Considerations
- Leasing vs. buying

Terms and Conditions
- Process & economics

Case Studies
- Succeed when acquiring equipment
Cash Purchase

**Advantages**
+ Immediate ownership of the asset
+ Eliminates the need for an additional contract
+ Provides firm with depreciation benefit for tax purposes

**Disadvantages**
+ Depletes working capital
+ Can cause year-over-year swings in distributions
+ Creates phantom income in the year of the acquisition; i.e., the firm reports taxable income but generates less cash flow

Traditional Bank Borrowing

**Advantages**
+ Using an existing bank line is comfortable to most firms
+ Allows the firm to reciprocate business if the bank is a client
+ Spreads expense over time, provides for long-term ownership
+ Provides depreciation benefit

**Disadvantages**
+ Sometimes less than 100% financing
+ May be a variable (floating) rate
+ Bank facilities may require fees, partner guarantees, more collateral, or financial performance covenants
Case #1

Modern Framework for Technology Budgeting + Asset Management

Stressed v. Strategic

Stressed Firm
- Acquire as needed
- Focus on replacing
- Reactive
- Consumed by repairs

Stable Firm
- Life cycle management
- Implement emerging I.T.
- Use I.T. as differentiator

Strategic Firm
- Acquire as needed
- Focus on replacing
- Reactive
- Consumed by repairs
Technology as a “Utility”

Electricity  Broadband Internet  Technology

+ Business critical
+ Ongoing, reoccurring and short useful life
+ Service based
+ Outsourced

Case #1 - FMV Lease [60 Atty. Firm]

$500,000 Annual lease-line for all technology equipment

Firm wanted to maintain a more updated IT environment
Leasing helped the firm set-up 3-year refresh for all IT equipment
FMV Lease Economics

1. $100,000 Computer acquisition
2. 36 Monthly payments @ $2,525
3. Purchase for FMV Renew Lease Return equipment

Advantages
+ Lowest monthly payment possible
+ Predictable, fixed-rate operating expense (no phantom income)
+ Fixed-rate financing (no covenant or guarantee requirements)
+ Helps achieve a refresh schedule (protects against obsolescence)
+ 100% of rent is tax deductible
+ Maximum flexibility

Savings via “Pay for Use”

1. $100,000 Computer acquisition
2. 36 Monthly payments @ $2,525
3. Return equipment

+ Sum of rental payments = $90,900
  \(\text{(91\% of purchase price)}\)
+ NPV* (cost) of rental payments = $86,175
  \(\text{(86\% of purchase price)}\)

*Discounted at 3.50%
Case #2 - FMV Lease [44 Atty. Firm]

$180,000
Copier Project

Equipment vendor provided lease option as a convenience
Non-vendor lease option provided lower monthly payment and additional flexibility at the end of lease

Case #3 - $1 Buyout Lease [35 Atty. Firm]

$100,000
Furniture and IT Equipment

The firm was sensitive to cash position for partner distributions
A lease option allowed the firm to spread-out the payments and preserve the firm’s cash position
Case 4/5 - Office Renovations/Relocations

Office build-outs often involve long-term tax depreciation (15 or 39 years) and shorter-term office leases (7 or 10 years).

Case #4 – Fixed FMV Lease [135 Atty. Firm]

$2.5 million Office Build-out

A portion of the renovation was not covered by the landlord’s TI allowance.

Cash flow benefits provided by the funding allowed the firm to complete the renovation in a single phase, minimizing disruption.
Recap: Tax Implications for Leases

True Lease (Tax)  Finance Lease, Loan, or Cash Purchase

Lease Expense (straight line)  INCOME STATEMENT  Depreciation Expense

Case #4 – Fixed FMV Lease [135 Atty. Firm]

On a $1,000,000 project cost, the lease allowed for accelerated tax savings, and reduced the total cost by $91,148.
The firm’s bank was not willing to finance some aspects of the project. Our financing solution included soft costs: carpeting, construction expenses and software.

Case #5 – Fixed FMV Lease [310 Atty. Firm]

$4.5 million
Nationwide renovation

Agenda Topic #4

Types of Leases
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Disadvantages with Leasing

Some companies are tied to a particular brand of equipment
- May lack the ability to finance 100% of the project
- Can be very rigid when their brand is replaced
- Determination of “fair market value” can be biased

There are over 4,600 leasing companies in the marketplace!
- Many have no expertise lending money to the legal industry
- The leasing company may end up brokering the deal
- You have to manage a lease program and some lessors have onerous terms and conditions

Relevant Terms

- Lease rate factor
- Lease commencement: immediate, monthly or quarterly, fixed at 45 days
- Lease deposit
- Fees
- Notice requirement for end of term intentions
- Renewal periods
- End of term options
## Lease Rate Factor

A *lease rate factor* is *not* an interest rate, but rather a multiplier used to determine the Lessee’s rental payment.

**Example:**

<table>
<thead>
<tr>
<th>Lease Rate Factor</th>
<th>0.02650</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equipment Cost</td>
<td>$100,000.00</td>
</tr>
<tr>
<td>Monthly Rental Payment</td>
<td>$2,650.00</td>
</tr>
</tbody>
</table>

\[(0.02650 \times 100,000.00 = 2,650.00)\]

## Commencement, Deposits, Fees

### Lease Commencement Types:
- Immediate
- Monthly
- Quarterly
- Fixed at 45 days

### Lease Deposits:
- Be sure the lease proposal specifies how the deposit will be applied
- Be sure the lease documentation is consistent on this provision

### Fees:
- Some equipment Lessors require legal fees, executory fees, UCC filing fees, documentation fees or restocking fees
- Top firms offer *no fee* contracts
Notice Requirements and Renewals

**Notice Requirement:**
- A lease will require that Lessees give notice of their end of term intentions
- Top firms today require notice 90 days prior to the end of term; other contracts could require notice much farther in advance or within a “time window”

**Renewal Periods:**
- If the Lessee does not give notice, the lease will automatically renew
- Today, top firms offer 3-month renewals; other contracts can be longer

T's + C's – End of Lease Options

- Lease contracts are extremely customizable
- Customized end of term options will maximize flexibility
- Flexibility features can influence the rental rate, so adding features that are not necessary will be more expensive
- 3 basic options at the end of the term of a FMV lease:
  - Purchase for Fair Market Value
  - Return Equipment
  - Extend Lease

- Make sure your lease allows for selective purchase/return options
**T's + C's – End of Lease Options**

- Staggered equipment returns
- Like-kind equipment return (serial number substitution)
- Technology exchange option
- Equipment return location/requirements
- Pick-up services; data sanitization services

**Contract Provisions to Avoid**
Complicated Notice Requirements

The Lessor requires notice within a certain “window”
+ If notice window is missed, lease extends
+ After lease extends once, the “notice window” re-sets, making it difficult to track

Sample Language

| Calendar month, then that day, and continuing for the number of months specified on the Schedule. This Lease with respect to any Schedule may be terminated as of the last day of the Base Term by either party giving the other party at least six months but not more than twelve months prior written notice of such termination. Otherwise, the “Term” (as defined below) with respect to any Schedule shall automatically be extended in successive one year intervals (“Extension Terms”) at the rental amount in effect as of the last billing cycle of the Base Term. |

Restocking Fees

If equipment is returned, a fee of 5%+ of original equipment cost is due
+ 5% is $5,000 for each $100,000 leased
+ This could be buried in the Master Lease, or
+ Because Lessees check the Master Lease for this, it’s in the acceptance documents

Sample Language

| This Schedule is issued pursuant to the Master Lease referenced above between Lessor and Lessee. All of the terms and conditions of the Master Lease are incorporated herein and made a part hereof as if such terms and conditions were set forth in this Schedule. By their execution and delivery of this Schedule, the parties hereby reaffirm all of the terms and conditions of the Master Lease. In the event Lessee returns the Equipment subject to this Schedule in accordance with the terms of the Master Lease, Lessee shall pay to Lessor a restocking fee equal to five percent of the original Equipment cost. |
Burdensome Return Requirements

If equipment is returned, the firm has to follow strict guidelines

+ Recertification / re-banding by the manufacturer before return
+ Choice of shipping company is restricted to “Lessor approved” freight companies
+ Original boxes and packaging materials are required
+ Failure to return equipment in approved manner results in fees and/or lease extensions

Sample language

continued maintenance provided at the best standard and most current version full service and maintenance agreement (if applicable) and return the Equipment unaltered to LESSOR, at such place designated by LESSOR, in the same condition as when received by LESSEE, ordinary wear and tear excepted. LESSOR reserves the right to approve or designate the carrier and the means of shipment. All replacement parts, additions and accessories incorporated in or affixed to the Equipment, including but not limited to wiring, software and operating systems, at or after the commencement of the LEASE shall become the property of LESSOR.

Deposits That Are Extra Fees

Many Lessors require a deposit (one month’s rent) before final documentation is sent

If it does not specifically state which payment the deposit is applied to, it will be in addition to all the others payments under the lease

+ Deposit to “first open invoice” means nothing (does not state which payment)
+ Deposit to “equipment cost” means nothing
+ Deposit to “cost” means nothing (does not state which payment)
Additional Services to Consider

- Managing and coordinating vendor progress payments
- Customized billing to meet client needs
- Pack-and-ship logistical services to simply a client’s equipment return
- Data cleansing services to ensure the security of confidential client data
- Asset management services to help track your program and leased assets

What to Look For in a Lessor

- Industry reputation and industry association membership/involvement
- Track-record of long-term relationships
- High-level, single point of service contact
- Flexible, user-friendly lease documentation
- Competitive and straight-forward pricing
Thank you for your time.

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Your Opinion Matters!
Please take a moment now to evaluate this session.

Thank you!