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United Leasing, Inc.

# [LEASE TERMINOLOGY]

Designed to help you understand the leasing business

**Add-On:**

A transaction to add related equipment to an existing lease. Typically, this term is used when the new equipment is financed using the same lease structure (i.e., Fair Market Value, \$1.00 Purchase Option, Fixed Purchase Option, etc.) as was used in the underlying transaction except that the lease term for the add-on is set so that it expires coterminously with (on the same date as) the original transaction.

**Advance Payments:**

Payments made by the lessee at the inception of a leasing transaction.

**Amortization:**

A breakdown of periodic loan payments into two components: a principal portion and an interest portion.

**APR:**

Annual Percentage Rate. The effective rate taking into account compounding and other fees. The nominal rate of interest for a specified period (usually one year).

**Bargain Purchase Option:**

An option given to the lessee to purchase the equipment on lease at a price that is less than the expected fair market value so that, at the inception of the lease, it is reasonable to assume that the lessee will definitely purchase the equipment on the option date.

**Basis Point:**

A unit of measurement equal to 1/100th of a percent. For example, 25 basis points = .25%.

**Capital Lease:**

A lease that meets at least one of the criteria outlined in paragraph 7 of FASB 13 and, therefore, must be treated essentially as a loan for book accounting purposes. The four criteria are:

- title passes automatically by the end of the lease term
- lease contains a bargain purchase option (i.e., less than the fair market value)
- lease term is greater than 75% of estimated economic life of the equipment
- present value of lease payments is greater than 90% of the equipment's fair market value

A Capital Lease is treated by the lessee as both the borrowing of funds and the acquisition of an asset to be depreciated; thus the lease is recorded on the lessee's balance sheet as an asset and corresponding liability (lease payable).

Periodic lessee expenses consist of interest on the debt and depreciation of the asset.

**Capped Fair Market Value Lease:**

A Fair Market Value Lease with a predetermined ceiling to limit Fair Market exposure at the end of the lease term.

**Coterminous:**

Two or more leases that are linked so that both will terminate at the same time.

**Depreciation:**

A tax deduction representing a reasonable allowance for exhaustion, wear and tear, and obsolescence, that is taken by the owner of the equipment and by which the cost of the equipment is allocated over time. Depreciation decreases the company's balance sheet assets and is also recorded as an operating expense for each period. Various methods of depreciation are used which alter the number of periods over which the cost is allocated and the amount expensed each period.

**Discount Rate:**

A certain interest rate that is used to bring a series of future cash flows to their present value in order to state them in current, or today's, dollars. Use of a discount rate removes the time value of money from future cash flows.

**Estimated Useful Life:**

The period during which an asset is expected to be useful in trade or business.

- used for purposes of calculating the maximum allowable term of a tax lease
- used for determining whether or not the lease is a Capital Lease
- used to determine the method of depreciation for a capitalized leased asset
- may or may not be the same as the life used for income tax purposes

**Fair Market Value:**

The price for which property can be sold in an "arms length" transaction; that is, between informed, unrelated, and willing parties, each of which is acting rationally and in its own best interest.

**Fair Market Value Lease:**

A lease which includes an option for the lessee to either renew the lease at a fair market value renewal or purchase the equipment for its fair market value at the end of the lease term. Though often referred to as tax leases, not all Fair Market Value leases qualify as tax leases.

**Finance Lease:**

A lease used to finance the purchase of equipment; not a true lease. Finance leases are generally considered to be capital leases from an accounting perspective and non-tax leases from a tax perspective.

**Financial Accounting Standards Board 13:**

Statement number 13 of the Financial Accounting Standards Board (FASB) which establishes standards for lessees' and lessors' accounting and reporting for leases. This includes the characterization of a lease as an operating lease or capital lease for the lessee's purposes.

A company's assets, liabilities and net income will differ depending on how it chooses to structure its leases. The provisions of FASB 13 derive from the view that a lease that transfers substantially all of the benefits and risks of ownership should be accounted for as the acquisition of an asset and the incurrence of an obligation by the lessee (a capital lease) and as a sale or financing by the lessor. Other leases should be accounted for as the rental of property (operating leases).

**Fixed Purchase Option:**

An option given to the lessee to purchase the leased equipment from the lessor on the option date for a guaranteed price. Both the date and the price must be determined at the inception of the lease. A typical fixed purchase option is 10% of the original cost of the equipment.

**Full Payout Lease:**

A lease in which the total of the lease payments pays back to the lessor the entire cost of the equipment including financing, overhead, and a reasonable rate of return, with little or no dependence on a residual value.

**Incremental Borrowing Rate:**

The rate that, at the inception of the lease, the lessee would have incurred to borrow over a similar term the funds necessary to purchase the leased asset.

**Lease:**

A contract through which an owner of equipment (the lessor) conveys the right to use its equipment to another party (the lessee) for a specified period of time (the lease term) for specified periodic payments.

**Lease Purchase:**

Full payout, net leases structured with a term equal to the equipment's estimated useful life. Because many Lease Purchases include a bargain purchase option for the lessee to purchase the equipment for one dollar at the expiration of the lease, these leases are often referred to as dollar buyout or buck-out leases. Lease Purchases are generally considered to be Capital Leases from an accounting perspective and non-tax leases from a tax perspective due to their bargain purchase option and length of lease term.

**Lease Schedule:**

A schedule to a Master Lease agreement describing the leased equipment, rentals and other terms applicable to the equipment.

**Lessee:**

The party to a lease agreement who is obligated to pay the rentals to the lessor and is entitled to use and possess the leased equipment during the lease term.

**Lessor:**

The party to a lease agreement who has legal or tax title to the equipment (in the case of a true tax lease), grants the lessee the right to use the equipment for the lease term and is entitled to receive the rental payments.

**Master Lease:**

A continuing lease arrangement whereby additional equipment can be added from time to time merely by describing that equipment in a new lease schedule executed by the parties. The original lease contract terms and conditions apply to all subsequent schedules. To be contrasted with a lease contract for a single transaction involving a specific unit of equipment, a Master Lease is essentially a line of credit to draw from over time in order to purchase equipment.

**Municipal Lease:**

A lease designed to meet the special needs of state and local governments. The lease contains a non-appropriation clause which states that the only condition under which the entity may be released from its payment obligation is when the legislature or funding authority fails to appropriate funds. Since the lessee is a municipality or an organization supporting the government, it is exempt from paying federal income taxes. For this reason, the IRS does not charge the lessor income taxes on leases to these customers.

**Off Balance Sheet Financing:**

A lease that qualifies as an Operating Lease for the lessee's financial accounting purposes. Such leases are referred to as off-balance sheet financing due to their exclusion from the balance sheet asset and debt presentation, except for that portion of the payments that is due in the current fiscal period. Full disclosure of such transactions is typically made in the auditor's notes to the financial statements. Periodic payments are recorded as expense items on the lessee's income statement.

**Operating Lease:**

A lease which is treated as a true lease (as opposed to a loan) for book accounting purposes. As defined in FASB 13, an operating lease must have all of the following characteristics:

- lease term is less than 75% of estimated economic life of the equipment

- present value of lease payments is less than 90% of the equipment's fair market value
- lease cannot contain a bargain purchase option (i.e., less than the fair market value)
- ownership is retained by the lessor during and after the lease term

An operating lease is accounted for by the lessee without showing an asset (for the equipment) or a liability (for the lease payment obligations) on his balance sheet. Periodic payments are accounted for by the lessee as operating expenses of the period.

**Payment in Advance:**

Periodic payments are due at the beginning of each period.

**Payment in Arrears:**

Periodic payments are due at the end of each period.

**Present Value:**

The discounted value of a payment or stream of payments to be received in the future, taking into consideration a specific interest or discount rate. Present Value represents a series of future cash flows expressed in today's dollars.

**Purchase option:**

An option given to the lessee to purchase the equipment from the lessor, usually as of a specified date.

**Residual Value:**

The book value that the lessor depreciates a piece of equipment down to during the lease term, typically based on an estimate of the future value, less a safety margin.

**Sale-leaseback:**

A transaction that involves the sale of equipment to a leasing company and a subsequent lease of the same equipment back to the original owner, who continues to use the equipment.

**Skip-payment Lease:**

A lease that contains a payment stream requiring the lessee to make payments only during certain periods of the year.

**Step-up or Step-down:**

A feature of a lease that contains a payment stream that either increases (step-up) or decreases (step-down) in amount over the term of the lease.

**Tax-Exempt Entity:**

Tax-Exempt Entities, for federal income tax purposes, generally include: any federal, state or local government (including their agencies and instrumentalities); any organization that is exempt from federal income taxes, such as non-profit charitable organizations; and most foreign persons or entities, unless a significant portion of their gross income is subject to federal income tax.

**Tax Lease:**

A generic term for a lease in which the lessor takes the risk of ownership (as determined by various IRS pronouncements) and, as the owner, is entitled to the benefits of ownership, including tax benefits.

**Useful Life:**

The period of time during which an asset will have economic value and be usable. The useful life of an asset is sometimes called the economic life of the asset. To qualify as an operating lease, the property must have a remaining useful life of 25 percent of the original estimated useful life of the leased property at the end of the lease term, and at least a life of one year.

**Upgrade:**

To trade in leased equipment for a newer, more advanced model during the lease term.