

# EQUIPMENT LEASING- TRUE LEASES

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The single most heavily-litigated issue in equipment leasing concerns the question whether a transaction is a "true lease" or a security interest.

A starting point: "A lease involves payment for the temporary possession, use and enjoyment of goods, with an expectation that the goods will be returned to the owner with some expected residual value remaining at the end of the lease term. In contrast, a sale involves an unconditional transfer of absolute title to goods, while a security interest is only an inchoate interest contingent on default and limited to the remaining secured debt." *White & Summers, UCC Treatise* §13-2 n.2 (2007)

## Why do we care whether a transaction is a true lease?

True leases of equipment are distinguished from sales and security interests for many purposes in the law, including

- o **Tax** – tax benefits of ownership (depreciation)/passed through to lessee in lower rental rates; state/local/federal tax laws; separate/different tax rules- *IRS Guidelines* (see *True Leases under Tax Law*)
- o **Accounting** - separate/different rules in FAS 13 (off-balance sheet “operating leases” vs. capital leases) (note coming IAS/FAS “convergence”)
- o **scope of UCC 2A** - applies only to true leases
  - UCC-1 filings generally not required to protect owner/Lor’s rights; precautionary filings allowed, UCC 9-505; fixture filings req’d- UCC 2A-309
  - warranties, remedies, contract formation, lien priority rules- all in 2A
- o **Remedies** - a true lessor’s remedies are different from those of a secured creditor, in major part because an owner/lessor (unlike a creditor) owns the residual; no notice of sale by Lor after repossession req’d
- o **Bankruptcy** – true lessors of equipment fare better than holders of “perfected security interests” who, in turn, are better off than holders of unperfected security interests, when the lessee/debtor is in Chapter 11 bankruptcy reorganization.
- o **Other** – state usury laws inapplicable to true leases (time/price doctrine); accessions, misc other (see *Leasing Is Distinctive!* 35 UCC LJ 15 (2003))



## Common Types of Equipment Lease Structures

There are many different, common lease structures. Equipment leases are not all the same, like a box of cornflakes

- o **True Lease** – owner/Lor retains meaningful “entrepreneurial stake” in the residual.  
White & Summers, UCC Treatise §30-3 & n.21 (2007)
- o **Statutory Finance Lease under UCC 2A-103(1)(g)** - a true lease
- o **Double-Dip Tax-Oriented Lease** – common for commercial aircraft leases; structured to take advantage of tax regimes of US (economic substance) and a foreign country (awarding tax benefits to “title” owner)
- o **“Synthetic” Lease** - an operating lease (off balance sheet) for accounting purposes; a sale for tax purposes
- o **TRAC vehicle lease** – 26 U.S.C. 7701(h); state TRAC laws in 48 States plus DC
- o **“Chameleon” lease**- starts out as true lease, but after a sufficient # lease extensions (using up economic useful life of the goods) , eventually transforms itself into a sale/security interest
- o **Other** – “First Amendment” lease (complies w 20/20 test in *IRS Guidelines*; option at end of initial lease term limited to fixed price purchase or fixed extension of lease term, w standard FMV and return options at expiration of extended lease term); rent-to-own



**UCC Principles** Traditional common law principles defining a true lease appear in UCC 2A-103(1)(p) (Definitions: "Lease") and, more importantly, in UCC 1-203 (2001) ("Lease Distinguished from Security Interest").

**Theory.** The overall philosophy of UCC 1-203 (2001) is to *reject* mathematical percentages and formulas (like those in FAS 13), to avoid "dumbing down" equipment leasing and making equipment leasing into a "commodity" like a box of corn flakes (where the only competition is on price), and to leave room for creativity and competition in creating new lease products. See Old Wine in New Bottles, 39 Alab.L.Rev. 615, 628-632 (1988). The statute was not intended to answer all questions about what is a true lease; instead, the statute is designed to serve the long-term public interests of the Nation by preserving creativity and competition. The statute sets forth a common law definition of a true lease that reflects mainstream case law, overrules earlier unsound cases, and liberalizes the overly restrictive "safe harbor" standards in the *IRS Guidelines*.

**In general.** The statute in UCC 1-203(a) (2001) first sets out the general test: "Whether a transaction in the form of a lease creates a lease or a security interest is determined by the facts of each case." The critical inquiry is into the "economic realities," not the old "intent of the parties" test or the form of words used.

**Disguised security interests.** A transaction creates a security interest, under UCC 1-203(b) (2001), if the rent the lessee is to pay "is an obligation for the term of the lease and is not subject to termination by the lessee and" there exists any of the circumstances (b)(1) through (b)(4) (*i.e.*, lessee uses up the economic life of the goods, or, in effect, becomes the owner)

**True lease safe harbors.** The statute in UCC 1-203(c)(2001) then lists safe harbor characteristics that are consistent with true lease status (full payout, net lease, FMV options).

## § 1-203

## UNIFORM COMMERCIAL CODE

## Art. 1

### § 1-203. Lease Distinguished From Security Interest.

- (a) Whether a transaction in the form of a lease creates a lease or security interest is determined by the facts of each case.
- (b) A transaction in the form of a lease creates a security interest if the consideration that the lessee is to pay the lessor for the right to possession and use of the goods is an obligation for the term of the lease and is not subject to termination by the lessee, and:
- (1) the original term of the lease is equal to or greater than the remaining economic life of the goods;
  - (2) the lessee is bound to renew the lease for the remaining economic life of the goods or is bound to become the owner of the goods;
  - (3) the lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or for nominal additional consideration upon compliance with the lease agreement; or
  - (4) the lessee has an option to become the owner of the goods for no additional consideration or for nominal additional consideration upon compliance with the lease agreement.
- (c) A transaction in the form of a lease does not create a security interest merely because:
- (1) the present value of the consideration the lessee is obligated to pay the lessor for the right to possession and use of the goods is substantially equal to or is greater than the fair market value of the goods at the time the lease is entered into;
  - (2) the lessee assumes risk of loss of the goods;
  - (3) the lessee agrees to pay, with respect to the goods, taxes, insurance, filing, recording, or registration fees, or service or maintenance costs;
  - (4) the lessee has an option to renew the lease or to become the owner of the goods;
  - (5) the lessee has an option to renew the lease for a fixed rent that is equal to or greater than the reasonably predictable fair market rent for the use of the goods for the term of the renewal at the time the option is to be performed; or
  - (6) the lessee has an option to become the owner of the goods for a fixed price that is equal to or greater than the reasonably predictable fair market value of the goods at the time the option is to be performed.
- (d) Additional consideration is nominal if it is less than the lessee's reasonably predictable cost of performing under the lease agreement if the option is not exercised. Additional consideration is not nominal if:
- (1) when the option to renew the lease is granted to the lessee, the rent is stated to be the fair market rent for the use of the goods for the term of the renewal determined at the time the option is to be performed; or
  - (2) when the option to become the owner of the goods is granted to the lessee, the price is stated to be the fair market value of the goods determined at the time the option is to be performed.
- (e) The "remaining economic life of the goods" and "reasonably predictable" fair market rent, fair market value, or cost of performing under the lease agreement must be determined with reference to the facts and circumstances at the time the transaction is entered into.



## Official Comment

Source: Former Section 1-201(37).

**Changes from former law:** This section is substantively identical to those portions of former Section 1-201(37) that distinguished "true" leases from security interests, except that the definition of "present value" formerly embedded in Section 1-201(37) has been placed in Section 1-201(28).

1. An interest in personal property or fixtures which secures payment or performance of an obligation is a "security interest." See Section 1-201(37). Security interests are sometimes created by transactions in the form of leases. Because it can be difficult to distinguish leases that create security interests from those that do not, this section provides rules that govern the determination of whether a transaction in the form of a lease creates a security interest.

2. One of the reasons it was decided to codify the law with respect to leases was to resolve an issue that created considerable confusion in the courts: what is a lease? The confusion existed, in part, due to the last two sentences of the definition of security interest in the 1978 Official Text of the Act, Section 1-201(37). The confusion was compounded by the rather considerable change in the federal, state and local tax laws and accounting rules as they relate to leases of goods. The answer is important because the definition of lease determines not only the rights and remedies of the parties to the lease but also those of third parties. If a transaction creates a lease and not a security interest, the lessee's interest in the goods is limited to its leasehold estate; the residual interest in the goods belongs to the lessor. This has significant implications to the lessee's creditors. "On common law theory, the lessor, since he has not parted with title, is entitled to full protection against the lessee's creditors and trustee in bankruptcy . . . ." 1 G. Gilmore, *Security Interests in Personal Property* Section 3.6, at 76 (1965).

Under pre-UCC chattel security law there was generally no requirement that the lessor file the lease, a financing statement, or the like, to enforce the lease agreement against the lessee or any third party; the Article on Secured Transactions (Article 9) did not change the common law in that respect. Coogan, *Leasing and the Uniform Commercial Code*, in *Equipment Leasing—Leveraged Leasing* 681, 700 n.25, 729 n.80 (2d ed.1980). The Article on Leases (Article 2A) did not change the law in that respect, except for leases of fixtures. Section 2A-309. An examination of the common law will not provide an adequate answer to the question of what is a lease. The definition of security interest in Section 1-201(37) of the 1978 Official Text of the Act provided that the Article on Secured Transactions (Article 9) governs security interests disguised as leases, i.e., leases intended as security; however, the definition became vague and outmoded.

Lease is defined in Article 2A as a transfer of the right to possession and use of goods for a term, in return for consideration. Section 2A-103(1)(f). The definition continues by stating that the retention or creation of a security interest is not a lease. Thus, the task of sharpening the line between true leases and security interests disguised as leases continues to be a function of this Article.

This section begins where Section 1-201(35) leaves off. It draws a sharper line between leases and security interests disguised as leases to create greater certainty in commercial transactions.

Prior to enactment of the rules now codified in this section, the 1978 Official Text of Section 1-201(37) provided that whether a lease was intended as security (i.e., a security interest disguised as a lease) was to be determined from the facts of each case; however, (a) the inclusion of an option to purchase did not itself make the lease one intended for security, and (b) an agreement that upon compliance with the terms of the lease the lessee would become, or had the option to become, the owner of the property for no additional consideration, or for a nominal consideration, did make the lease one intended for security.

Reference to the intent of the parties to create a lease or security interest led to unfortunate results. In discovering intent, courts relied upon factors that were thought to be more consistent with sales or loans than leases. Most of these criteria, however, were as applicable to true leases as to security interests. Examples include the typical net lease provisions, a purported lessor's lack of storage facilities or its character as a financing party rather than a dealer in goods. Accordingly, this section contains no reference to the parties' intent.

Subsections (a) and (b) were originally taken from Section 1(2) of the Uniform Conditional Sales Act (act withdrawn 1943), modified to reflect current leasing practice. Thus, reference to the case law prior to the incorporation of those concepts in this article will provide a useful source of precedent. Gilmore, *Security Law, Formalism and Article 9*, 47 Neb.L.Rev. 659, 671 (1968). Whether a transaction creates a lease or a security interest continues to be determined by the facts of each case. Subsection (b) further provides that a transaction creates a security interest if the lessee has an obligation to continue paying consideration for the term of the lease, if the obligation is not terminable by the lessee (thus correcting early statutory gloss, e.g., *In re Royer's Bakery, Inc.*, 1 U.C.C. Rep.Serv. (Callaghan) 342 (Bankr.E.D.Pa.1963)) and if one of four additional tests is met. The first of those four tests, subparagraph (1), is that the original lease term is equal to or greater than the remaining economic life of the goods. The second of these tests, subparagraph (2), is that the lessee is either bound to renew the lease for the remaining economic life of the goods or to become the owner of the goods. *In re Geirke Enterprises*, 1 Bankr. 647, 651-52 (Bankr.W.D.Wis.1979). The third of these tests, subparagraph (3), is whether the lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or for nominal additional consideration, which is defined later in this section. *In re Celeryvale Transp.*, 44 Bankr. 1007, 1014-15

## Official Comment

(Bankr.E.D.Tenn.1984). The fourth of these tests, subparagraph (4), is whether the lessee has an option to become the owner of the goods for no additional consideration or for nominal additional consideration. All of these tests focus on economics, not the intent of the parties. *In re Berge*, 32 Bankr. 370, 371-73 (Bankr.W.D.Wis.1983).

The focus on economics is reinforced by subsection (c). It states that a transaction does not create a security interest merely because the transaction has certain characteristics listed therein. Subparagraph (1) has no statutory derivative; it states that a full payout lease does not *per se* create a security interest. *Rushion v. Shea*, 419 F.Supp. 1349, 1365 (D.Del.1976). Subparagraphs (2) and (3) provide the same regarding the provisions of the typical net lease. *Compare All-States Leasing Co. v. Ochs*, 42 Or.App. 319, 600 P.2d 899 (Ct.App.1979), with *In re Tillery*, 571 F.2d 1361 (5th Cir.1978). Subparagraph (4) restates and expands the provisions of the 1978 Official Text of Section 1-201(37) to make clear that the option can be to buy or renew. Subparagraphs (5) and (6) treat fixed price options and provide that fair market value must be determined at the time the transaction is entered into. *Compare Arnold Mach. Co. v. Balls*, 624 P.2d 678 (Utah 1981), with *Aoki v. Shepherd Mach. Co.*, 665 F.2d 941 (9th Cir.1982).

The relationship of subsection (b) to subsection (c) deserves to be explored. The fixed price purchase option provides a useful example. A fixed price purchase option in a lease does not of itself create a security interest. This is particularly true if the fixed price is equal to or greater than the reasonably predictable fair market value of the goods at the time the option is to be performed. A security interest is created only if the option price is nominal and the conditions stated in the introduction to the second paragraph of this subsection are met. There is a set of purchase options whose fixed price is less than fair market value but greater than nominal that must be determined on the facts of each case to ascertain whether the transaction in which the option is included creates a lease or a security interest.

It was possible to provide for various other permutations and combinations with respect to options to purchase and renew. For example, this section could have stated a rule to govern the facts of *In re Marhoefer Packing Co.*, 674 F.2d 1139 (7th Cir. 1982). This was not done because it would unnecessarily complicate the definition. Further development of this rule is left to the courts.

Subsections (d) and (e) provide definitions and rules of construction.



## Guiding Principles

- o **Oversimplified, the owner/lessor's meaningful economic stake in the residual is the touchstone of a true lease.** Ordinarily this means: (a) lessee can't use up the economic useful life of the goods by leasing them for too long; and (b) lessor must have some meaningful entrepreneurial stake in the residual (usually, this means some potential for upside gain or downside loss on the residual). See, e.g., Aerospace v. Comdisco, 113 F.3d 1240 (9<sup>th</sup> Cir. 1997) (true lease where economic value of goods not exhausted at end of lease term); White & Summers, UCC Treatise §30-3, quoting Old Wine in New Bottles, 39 Alab.L.Rev. at 631-2
- o **"Right to Walk Away."** Without a non-terminable lessee obligation, the transaction cannot be a security interest. Transactions are true leases, not sales or security interests, where the lessee has a "right to walk away" without penalty, before becoming the owner or exhausting the economic useful life of the goods. See, e.g., In re Marhoefer, 674 F.2d 1139 (7<sup>th</sup> Cir. 1981) (court holds transaction a true lease, despite \$1 purchase option, because lessee was not obligated to continue the lease for 8 years until the \$1 purchase option arose).
- o **Options.** Options to extend lease or purchase the equipment are commonplace. Yet if a "lease" transaction uses up economic life of the goods, or is the functional equivalent of ownership (e.g., if lease has "nominal" option purchase price), transaction is a sale. Options that are "stated to be" at FMV are within the "safe harbor" of UCC 1-203(d)(1)&(2). An opposite benchmark, defining

## Guiding Principles- (cont'd)

"nominal," appears in UCC 1-203(d)(2001):

Additional consideration is nominal if it is less than the lessee's reasonably predictable costs of performing under the lease agreement if the option is not exercised.

This non-exclusive definition of "nominal" is satisfied if it is cheaper for the lessee to exercise the option than it would be to comply w provisions for ending the lease (e.g., by packing up the goods and shipping them back to the lessor). See, e.g., In re Our Secret, 282 BR 697 (BkNMex2002) The cases on "nominal" options are often unilluminating, citing things such as low absolute value or low percentage of original equipment cost. True test seems to be: An option is "nominal" if at the outset of the transaction (or whenever the lease is renewed) the only sensible economic choice for lessee is to exercise the option and purchase the goods, or extend the lease to use up the useful economic life of the goods.

With respect to fixed-price options, the **"irresistible option"** or **"only sensible economic choice"** test involves a comparison of (a) the dollar amount of the fixed-price purchase option, with (b) the originally-estimated dollar value of the residual, made at the outset of the lease, looking forward in time and estimating what the residual will be worth in the future when the option arises. See UCC 1-203(e)(2001) and *Practical Tips*

## Practical Tips

- o **Document originally expected residual value-** see attached samples
- o **True lease status bolstered by incidental use restrictions-** Typical restrictions in equipment leases may bolster "true lease" status. See, e.g., LTR 9108012 (1991):
  - (1) Lee barred from assigning lease or subletting the goods
  - (2) Lee barred from placing liens on the equipment
  - (3) Owner/Lor retains right to terminate lease on 90 days' advance notice
  - (4) Lee barred from using leased vehicle to tow any boat, trailer, or other vehicle
  - (5) Use of leased equipment limited to continental limits of the United States
  - (6) At end of the lease, owner/Lor can "do as it pleases" with the equipment (as opposed to being under an obligation to dispose of the equipment). See, e.g., Addison v. Burnett, 41 Cal.App.4<sup>th</sup> 1288, 49 Cal.Rptr.2d 132 (6<sup>th</sup> Dis. 1996).
- o **Safeguards if "lease" is recharacterized-** Key Equipment case
  - (1) UCC-1 financial statement filings (UCC 9-505); UCC Art 9 safeguards for secured creditors (e.g., granting clauses, lien searches as closing conditions, lien removal provisions, usury and other loan-related protections)
  - (2) Ensure that warranty disclaimers ("as is") are effective, whether sale or lease; assign Lor's warranty rights against mfg to Lee- provides Lee with a minimum adequate remedy; in finance leases, exclude Lee's (B's) right to reject or revoke acceptance



## ***True Leases Under Tax Law***

Tax authorities state that a transaction is a true lease (and not a sale) for federal income tax purposes, if the owner/lessor retains "significant and genuine attributes of the traditional lessor status" or significant "benefits and burdens of ownership." See, e.g., Frank Lyon v. United States, 435 U.S. 561, 584 (1978); Sun Oil v. Commissioner, 562 F.2d 258 (3d Cir. 1977), cert. denied, 436 U.S. 944 (1978); Larsen v. Commissioner, 89 T.C. 1229, 1267 (1987); LTR 9144001 (May 14, 1991). A true lease transaction is "imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached." Frank Lyon, *supra*, 435 U.S. at 584; LTR 8515036 (1985). Operating case-by-case, the courts in tax cases have inquired into (1) whether legal title passes to the lessee; (2) how the parties treat the transactions; (3) whether the lessee acquired an equity interest in the property; (4) which party pays the taxes; (5) which party bears the risk of loss or damage to the property; and (6) which party receives the profit from the operation, retention, or sale of the property. See, e.g., Grodt & McKay Realty v. Commissioner, 77 T.C. 1221 (1981).

To decide whether a transaction is not a true lease, the IRS looks at similar factors under Rev.Rul. 55-540, 1955-1 C.B. 39, including (1) whether the lease term extends beyond the useful life of the property or whether, after a shorter committed lease term, the lessee has the right to extend the lease, at nominal rental, over the property's entire life; (2) whether portions of the periodic payments give the lessee an equity interest in the property; (3) whether the lessee will acquire title after payment of a stated amount of "rentals"; (4) whether the lessee's payments for a short period of time are an inordinately large part of the total sum necessary to acquire title (*i.e.*, "front loaded" payments); (5) whether the rental payments exceed fair rental value; (6) whether at the end of the term the lessee can acquire the property for a nominal purchase price; and (7) whether some portion of the periodic payments is designated (or readily recognizable) as interest.<sup>1</sup>

There are stringent *IRS Guidelines* for issuing advance rulings on "leveraged leases" in IRS Rev.Proc. 2001-28, 2001-1 C.B. 1156 (incorporating old IRS Rev.Proc. 75-21, 1975-1 C.B. 715).<sup>2</sup> An agreement will be considered a true lease under the

<sup>1</sup> Though Rev.Rul. 55-540 was of particular importance through the 1960s, it "suffered from a number of deficiencies: some of its principles appeared incorrect or at least exaggerated;33 it did not provide reliable guidance for cases that did not reach the extremes with which it was concerned; and it did not consider at all the effect on the true lease analysis of nonrecourse lessor debt financing. [33 "For example, the suggestion that if rents contain an element recognizable as the 'equivalent of interest' the lease lease is a conditional sale is appropriate only if the 'interest' is interest on a purchase price payable by the lessee."] Robinson & Macon, Tax Aspects of Equipment Leasing ch.4, §4:2.2 p.4-17 & nn.33-34 in 1 Equipment Leasing-Leveraged Leasing (Shrank & Gough 4<sup>th</sup> ed. 2010) [hereinafter "Robinson & Macon (2010)"]

<sup>2</sup> Together with IRS Rev.Proc. 2001-29, IRS Rev.Proc. 2001-28 combines the substance of IRS Rev.Proc. 75-28 (checklist for IRS rulings on leveraged leases); Rev.Proc. 76-30 (relating to "limited use

*Guidelines* if (1) the owner/lessor has made a minimum 20% “at risk” equity investment (i.e., the owner/lessor’s consideration plus personal liability to purchase the property is 20% or more of the cost of the property at the start of the deal) which must remain at risk throughout the lease term; (2) the Lessee Group must have no “investment” in the cost of the property; (3) the residual value at the end of the agreement equals at least 20% of the original cost of the property, and the remaining useful life at the end of the lease term is at least 20% of the original useful life of the property; (4) any lessee purchase option cannot be exercised at a price less than the fair market price of the goods at the time the purchase option is exercised; (5) there are no “puts” giving the lessor the right to cause anyone to purchase the property; and (6) the lessor must meet certain “minimum profit” and “cash flow” test. See, e.g., Robinson & Macon, Tax Aspects of Equipment Leasing ch. 4 §4:2.3 pp.4-19 to 4-20 in 1 Equipment Leasing- Leveraged Leasing (Shrank & Gough 4<sup>th</sup> ed. 2010) [hereinafter “Robinson & Macon (2010)"]; LTR 9144001 (May 4, 1991).

Tax authorities agree that the minimum 20% “at risk” investment criteria of the *IRS Guidelines* is “arbitrary and substantially higher than has been required by many cases that have focused on the equity investment.” Robinson & Macon (2010) at p.4-26. The cases suggest that 13% initial equity investments, or even 10% initial equity investments, will satisfy the initial equity investment required for a true lease. *Id.* at p.4-26 & n.55. Transactions are frequently structured, however, to comply with the 20% *Guideline* figure as a “safe harbor.”

True lease status under tax law also requires that there be some economic useful life left in the equipment at the end of the lease.

[T]he case law provides support – indeed, provides the basis – for the *Guidelines*’ requirement of a substantial residual value and remaining useful life, but it does not specify any required minimum residual value or remaining life.<sup>3</sup> As was the case with the comparison of *Guidelines* and case law requirements of an initial equity investment, the cases have found true lease status where the expected residual values were substantially below 20% of original cost. The cases generally reject the notion that residual value must be determined without regard to inflation, with one of the important cases in the true lease area specifically reciting as pertinent the enhancing effect on residual value of anticipated inflation. [Robinson & Macon (2010) at p.4-45, citing Estate of Thomas v. Comm’r, 84

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property”); and Rev.Proc. 79-48 (lessee improvements). Technically, these IRS Guidelines “are not intended to be used for audit purposes.” IRS Rev.Proc. 75-21 section 3. Their impact is in fact much greater and influences audits. See Robinson & Macon (2010) pp.4-18 to 4-19, 4-20 n.39.

<sup>3</sup> “Prior to the *Guidelines*, the IRS informally required that the property have an estimated residual value of at least 15% of cost or, if greater, a value which when discounted to the commencement of the lease at 6% annually was at least equal to 5% of cost; and a remaining useful life equal to the greater of two years and 10% of the property’s originally estimated useful life. Thus, the *Guidelines* present a more stringent standard.” Robinson & Macon (2010) at p.4-41.

T.C. 412, 429 (1985)]

The cases find true leases where the residuals are at 13% or 15% of original cost. See Robinson & Macon (2010) at p.4-45 n.106 (collecting cases). Lower residual amounts may be permissible and consistent with true lease status in particular circumstances. See Levy v. Commissioner, 91 T.C. 838 (1988); LTV v. Commissioner, 63 T.C. 39 (1974).

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Tax law examines the “facts and circumstances” of each case, case-by-case, to determine whether a transaction is a “true lease.” But it generally focuses on “the principal aspects of a true lease – the availability to the lessor of a substantial anticipated residual value in property in which it has made a substantial equity investment, the enjoyment of which is subject to market forces and conditions, and the opportunity of the lessor, by realizing such residual value, to achieve a substantial economic profit from the lease transaction apart from tax benefits.”<sup>4</sup> Robinson & Macon (2010) p.4-16. The *IRS Guidelines* provide “safe harbor” guidance. They are a useful benchmark, not a straitjacket.

November 10, 2010

EDWIN E. HUDDLESON

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<sup>4</sup> Similarly, “the most important determinant of the lessor’s tax ownership of property subject to a long-term leveraged lease is the expectation and availability to the lessor of a substantial residual value, that is, valuable useful life remaining after the term of the lease and debt.” Robinson & Macon (2010) at p.4-41.



**HELM**  
**FINANCIAL CORPORATION**

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VIA AIR COURIER

December 26, 1985

Ms. Mary Gallagher-Reff  
Assistant Secretary  
Chemical Bank  
110 East 59th Street  
New York, New York 10022

Dear Mary:

We have made an appraisal of the Ortner "quick dump" hopper cars (the "Equipment") described in Schedule I for the purpose of expressing an opinion of their economic life, the non-limited use nature of the Equipment and their fair market value both at the closing dates and at the end of the base lease term.

Helm Financial's personnel have over fifty years of cumulative experience in the railcar industry. We have rendered opinions and conducted studies and appraisals for many institutions in the banking, insurance, investment, leasing and railroad industries. We are also a leading company in rail equipment remarketing field and, as such, have sold or leased thousands of railcars that have been subject to long term leases.

It is our understanding that the Equipment will be acquired by Chemical Business Credit Corporation, and leased to a lessee (the "Lessee") subject to a twenty-two year and six month lease (the "Lease Term"). These railcars are to be used in the Lessees' normal freight service.

Helm's determination of the economic life and fair market value of the Equipment is based upon: 1) a thorough knowledge of the history of the railcar industry; 2) indepth discussions with railroad mechanical, operating and management personnel; 3) discussions with manufacturers' representatives, railcar repair and sales management and technical consultants; and, 4) the latest used railcar sales information available for similar equipment.

December 26, 1985  
Ms. Mary Gallagher-Reff  
Page Two

Based upon our findings and the afore mentioned information,  
we advise you that, in our opinion:

- (a) The fair market value of the Equipment as of the respective closing date for each unit is equal to the Purchase Price set forth in Schedule I.
- (b) Without including any effect for inflation or deflation during the Lease Term, and after subtracting any costs to the lessor for removal and delivery of the Equipment at the end of the Lease Term, the fair market value of the Equipment at the end of the Lease Term will be in excess of 20 percent of its original cost.
- (c) The estimated useful life of each unit of Equipment on the closing date with respect to such unit is equal to at least 125 percent of the Lease Term.
- (d) The Equipment is, and will be, suitable for use by numerous users other than the owner, Lessee, or any assignee of the Lessee or any affiliate of any of the foregoing at any time during its useful life.

Our opinion relies on the assumption that the Equipment will be maintained in conformance with the maintenance provisions contained in the lease and will be returned in the condition required by the lease and that the market for used equipment of this nature at the termination of the Lease Term will reflect no unusual conditions of supply and demand.

If you have any questions, please do not hesitate to call.

Sincerely,

  
Richard C. Kirchner  
President

AKK:lel

SCHEDULE 1

<u>Description</u>	<u>Quantity</u>	<u>Purchase Price</u> <u>(Not Including Transportation)</u>
Order "quick dump", aluminum open top hopper cars built in December, 1985.	600	\$43,620.00 per railcar



**MARSHALL AND STEVENS  
INCORPORATED**

71 Broadway  
New York, NY 10006  
(212) 425-4300

May 7, 1987

File Reference: 36-3707-F

Chemical Bank  
277 Park Avenue  
New York, New York 10022

Attention: Mr. J. Kenneth Biegen  
Associate

Gentlemen:

At your request, we have inspected and appraised the warehouse conveyor distribution equipment (the "Equipment") located in West Sacramento, California. It is our understanding that this Equipment is currently being leased to \_\_\_\_\_ (the "Lessee") for a period of twelve (12) years (the "Lease Term") and the original cost to the Lessor (United Leasing Trust No. 82-1), as of September, 1982 (the "Lease Commencement Date"), was \$13,384,449. This Equipment was originally appraised by Marshall and Stevens at lease commencement (report reference #14-2875 dated September 15, 1982).

Our investigations involved a study of the history and evolutionary background of equipment of this type. In addition, we have held discussions with various manufacturers and other users to determine the reliability of the subject equipment and recommended maintenance policies. We also have discussed general maintenance, historical market trends and sales of similar type of equipment in the secondary market through conversations with used equipment dealers and users, as well as manufacturers. A personal inspection of the equipment was made on April 29, 1987.

To formulate our opinions, we have reviewed the equipment specifications together with their estimated costs. We are familiar with the conveyor industry and keep abreast of technological advancement in this field. We also have conducted preliminary market surveys of current and future demands for products of this type.

The purposes of this investigation and appraisal are as follows:

1. To express an opinion as to the Economic Useful Life of the equipment as required by Revenue Procedure 75-21 Section 4 (1) (C) as supplemented by Revenue Procedure 75-28 Section 4.02 (6).
2. To express an opinion of the Fair Market Value of the equipment at the end of the specified lease as required by Revenue Procedure 75-21 Section 4 (1) (C) as supplemented by Revenue Procedure 75-28 Section 4.02 (6).

The engineering and accounting cost data and information for the Equipment that was used in this appraisal study was made available to Marshall and Stevens by . . . . . The appraisal studies included interviews and discussions with representatives of . . . . . and other project participants.

#### DEFINITIONS

In our investigation and conclusions we have adopted the following definitions:

##### Economic Useful Life

The estimated period of time over which it is anticipated that an asset may be profitably used.

##### Fair Market Value

The amount for which an asset would exchange between a willing buyer and a willing seller, each having a reasonable knowledge of all pertinent facts, neither being under compulsion to buy or sell, and with equity to both.

##### Residual Value

The Fair Market Value of an asset at a given point of time in the future.

DESCRIPTION OF EQUIPMENT

The Equipment included in this lease transaction is composed of a warehouse conveyor system designed, manufactured and installed by Rapistan Division, Lear-Siegler, Inc., Grand Rapids, Michigan and located in the Lessee's warehouse at Sacramento, California, together with certain related equipment acquired from, or installed by, Lodi Metal Tech, Inc. and Thiel Structural Steel, Inc., including, but not limited to, the following items:

Racks, Shelving and Platforms

Rollers and Belts

Conveyors, Diverters and Chutes

Pick Cars

Scanners and Microprocessor

and all Associated Electrical Motors and Controls.

The major portion of the Equipment is manufactured by Rapistan, which is an industry leader in conveyor equipment. Rapistan, established in 1938, is widely known and has an excellent reputation for manufacturing quality products. The Rapistan systems included in this lease transaction are still relatively state-of-the-art and Rapistan provides service for all of their equipment worldwide. Rapistan does not offer any trade-in policy, but there is a large used market for conveyor equipment if it is in good condition. There are also a number of remarketing companies that specialize in relocating used systems. The two other major manufacturers in the warehouse conveyor industry are Interlake and Buschman.

ECONOMIC USEFUL LIFE

A standard method for estimating normal life, or remaining useful life, of machinery and equipment would be to rely on past studies of various property classes and determine an effective age for the property being appraised, taking into consideration improvements to the property which reduce the effect of physical depreciation. Further adjustments could be made to reflect technological changes and attitudes in the marketplace.



In our previous meeting with personnel from \_\_\_\_\_, we discussed current maintenance procedures, preventative maintenance, scheduled downtime for major repairs and refurbishments, and past changes and future plans for the Equipment. We also talked about the mechanical condition of the Equipment as well as its technological condition.

Since the Equipment under consideration consists of different classifications of equipment, suffering differing amounts of physical, technological, and economic depreciation, each class has been studied relative to its economic useful life. Based upon the methodology described above, we feel that the equipment will have an Economic Useful Life of not less than 20 years (as of September, 1982).

#### RESIDUAL VALUE

Assuming proper maintenance is performed on the Equipment under study, it is possible to estimate a residual value at the end of the Base Lease Term. Again, the property method of establishing residual value is to analyze each classification of equipment. As mentioned earlier in this report, we discussed at great length the maintenance procedures currently being implemented, and we feel that due to the excellent maintenance being implemented on the equipment and its top-of-the-line quality and condition, the Useful Life and Residual Value of the Equipment would exceed the industry average. For purposes of this analysis, calculations have been made in current dollars and in real (inflated) dollars to estimate the future values of the subject Equipment.

In the previous section, an estimate was made to ascertain the remaining useful lives of the various equipment classifications. The analysis included allowances for physical, technological and economic depreciation. Since all causes of depreciation were taken into account for estimating remaining useful life, it is possible to establish residual values for each type of Equipment. For the purposes of this analysis, the Equipment is being valued in-place as an operating entity and dismantled on a piecemeal basis.

Our conclusion of the estimated Market Value of the equipment, in current and real (inflated) dollars, at the end of the 12 year base lease term is shown in the summary of conclusions.

SUMMARY OF CONCLUSIONS

Based upon these investigations and analyses, Marshall and Stevens Incorporated states its opinion that:

- (a) The economic Useful Life of the equipment at lease commencement (September, 1982) was not less than 20 years, which was more than 125% of the base lease term;
- (b) An amount equal to at least 34% of the original cost of the equipment is a reasonable estimate of what the Fair Market Value-in-Use of such items will be as of the end of the lease term for such items without including in such amount any increase or decrease for inflation or deflation during the lease term;
- (c) An amount equal to at least 31% of the original cost of the equipment is a reasonable estimate of what the Fair Market Value-in-Use of such items will be as of the end of the lease term for such items, including an increase for inflation during the lease term at a 3.5% rate;
- (d) An amount equal to at least 21% is a reasonable estimate of what the Fair Market Value (piecemeal) of the equipment will be at the end of the lease term without including any increase for inflation or decrease for deflation during the lease term;
- (e) An amount equal to at least 32% is a reasonable estimate of what the Fair Market Value (piecemeal) of the equipment will be at the end of the lease term including an increase for inflation during the lease term at a 3.5% rate.

Mr. J. Kenneth Biegen  
Chemical Bank

May 7, 1967  
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Marshall and Stevens Incorporated is an appraisal firm that provides professional valuation services on a national and international basis. Marshall and Stevens is very familiar with the conveyor and warehousing industry and has provided numerous valuation services within these industries. A copy of this report, together with the information from which it was prepared, has been retained in our document files and is available for review upon request.

Very truly yours,

*Marshall and Stevens Incorporated*  
MARSHALL AND STEVENS INCORPORATED

*J. P. Grace*  
James P. Grace  
Valuation Consultant

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MARSHALL AND STEVENS INCORPORATED

USEFUL LIFE / RESIDUAL VALUE SUMMARY  
 WASHINGTON DISTRIBUTION CENTER  
 SACRAMENTO, CALIFORNIA  
 MAY 8, 1967

SCHEDULE A

EQUIPMENT DESCRIPTION	LESSOR'S ORIGINAL COST (9-23-62)	ECONOMIC USEFUL LIFE (9-23-62)	RESIDUAL VALUE-18 USE (9-23-64)	RESIDUAL VALUE 18-USE (9-23-64)	PIECES RESIDUAL VALUE (9-23-64)	PIECES RESIDUAL VALUE (9-23-64)
	(1)	(2)	(CONSTANT 1)	(REAL \$)	(CONSTANT 1)	(REAL \$)
(2) RAPIDTAC CONVEYOR SYSTEMS	9,970,831	20	3,100,000	4,820,007	2,860,200	3,107,520
RACKING (LOHI METAL TECH. INC.)	2,760,743	25	1,110,497	1,883,810	724,791	1,800,000
CONVEYOR PLATFORM (TRIEL STRUCTURAL STEEL, INC.)	634,878	20	237,000	300,902	97,064	60,000
TOTALS	13,366,452		4,447,497	6,904,719	3,682,055	4,967,520

NOTE: ALL RESIDUAL VALUES, STATED IN REAL (INFLATED) DOLLARS, ARE BASED ON AN ANNUAL INFLATION RATE OF 3.5 %.



#### STATEMENT OF PROCEDURAL POLICIES

All related facts, comments and statistical information set forth in the report have been obtained from sources believed to be knowledgeable, reliable and accurate.

All opinions of Market Value based on the foregoing are those of Marshall and Stevens Incorporated utilizing widely recognized and approved appraisal methods. Our conclusions assume the existence of prudent management policies over whatever period is reasonable and necessary to maintain the character and integrity of the Facility. We assume no responsibility for changes in market conditions or for the inability of the owner to locate a purchaser at the appraised value.

The fee established for the formulation and reporting of these conclusions has not been contingent upon the values or other opinions presented. Neither the appraisers nor any officer of Marshall and Stevens Incorporated has any direct or indirect interest in the property appraised.

The written consent and approval of Marshall and Stevens Incorporated is required for the conveyance of all or any part of this report to the general public through advertising, public relations, news, sales or other such media.