

# Certified Lease & Finance Professional Tax & Accounting Review

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## Tax Review Scenarios

The following scenarios are designed to help practice classifying leases under the current tax standards (**IRS 55-540**). For each scenario, read the description of the problem carefully and determine whether the lease should be classified as a **true lease** or a **conditional sales obligation** from the lessor's perspective. Be prepared to support your answer using the relevant IRS 55-540 criteria for classification, such as:

- Rental payments are not substantially higher than a fair rental value
- Ownership of the asset does not automatically pass to the lessee at lease maturity
- There is no nominal purchase option in the transaction
- No portion of the lease payment can be categorized as interest or go towards an equity position in the asset
- The amount of payments paid in a short-term lease are not a significant portion of the purchase price

*Reminder: A transaction is classified as a (true) tax lease only if it meets all the specified conditions. If any **one** element is met, the transaction is categorized as a conditional sales obligation.*

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### Sample #1:

A software company leases a server system for 3 years. The lease is structured with payments in arrears, and the server's useful life is 6 years. At lease end, the lessee has the option to purchase the server for fair market value. The lessor has a 5% yield.

**Question:** Is this a true lease or a conditional sales obligation?

### Sample #2:

A women's health clinic enters into a lease for an ultrasound machine for 3 years. The lease contains 4 ultrasounds for each floor of the building. The first payment will be due in advance. The lease includes a \$1 purchase option at lease maturity. The lease contains a vendor referral fee of \$500.

**Question:** Is this a true lease or a conditional sales obligation?

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## **Sample #3:**

A contractor leases a backhoe for 2 years. The machine has an 8-year useful life and must be returned to the lessor in good condition at lease end. Quarterly maintenance is required during the lease term. The lessor has a yield of 7%.

**Question:** Is this a true lease or a conditional sales obligation?

## **Sample #4:**

A warehouse enters into a lease for two scissor lifts for a term of 60 months. The equipment's useful life is 7 years. The lease includes a clause that requires the lessee to purchase the lifts at the end of the term for \$5,000 total, a price that is well below the expected FMV. The lease also requires an upfront refundable security deposit equal to one month's rent due at signing.

**Question:** Is this a true lease or a conditional sales obligation?

## **Sample #5:**

A national freight company leases a fleet of trucks for 36 months. The lessor's yield is 4%. At lease maturity, the company has the option to purchase the fleet for their FMV (which will be determined at that time). Payments are structured in arrears.

**Question:** Is this a true lease or a conditional sales obligation?

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## Tax Review Scenarios Answer Guide

### Sample #1 Answer:

This is a true lease.

- The purchase option available is for FMV, not a bargain.

### Sample #2 Answer:

This is a conditional sales obligation.

- The lease contains a bargain purchase option at lease maturity.

### Sample #3 Answer:

This is a true lease.

- No transfer of ownership, no (bargain) purchase option.

### Sample #4 Answer:

This is a conditional sales obligation.

- A fixed obligation to purchase.

### Sample #5 Answer:

This is a true lease.

- No title transfer, no nominal purchase option present
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## Accounting Review Scenarios

The following scenarios are designed to help practice classifying leases under the current accounting standards (**ASC 842**). For each scenario, read the description of the problem carefully and determine whether the lease should be classified as an **operating lease** or a **sales-type lease** from the lessor's perspective. Be prepared to support your answer using the relevant ASC 842 criteria, such as:

- Automatic title transfer
- Presence of a bargain purchase option
- Lease term is  $\geq 75\%$  of the estimated economic life of the leased property
- Present value of the minimum lease payments is  $\geq 90\%$  of the fair market value of the property
- The leased asset is of a specialized nature

*Reminder: if any **one** element is met, the transaction is categorized as a sales-type lease. If no elements are met, it will be categorized as an operating lease.*

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### Sample #1:

ABC Leasing Co. leases a high-end office copier to Main Street Legal for 3 years. The copier's useful life is 7 years. The present value of lease payments equals 40% of the fair market value of the copier, and the lessor's yield is 9%. Main Street Legal does not have an option to purchase the copier. At the end of the lease, the copier is returned to ABC Leasing Co.

**Question:** Is this an operating lease or a sales-type lease?

### Sample #2:

XYZ Hauling enters into a lease agreement for a delivery truck with a 5-year term. The lease contains 2 points, and a 6% yield for the lessor. The truck's economic life is 6 years. The present value of lease payments is 92% of the truck's fair value. Lease contains an automatic title transfer to XYZ Hauling at lease maturity.

**Question:** Is this an operating lease or a sales-type lease?

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## Sample #3:

A logistics company leases an electric forklift for 24 months to support increased warehouse activity. The economic life of the forklift is 15 years, and the equipment is brand-new at lease commencement. The lease is structured with payments in advance, first due at signing. There are no renewal or purchase options, but biannual maintenance is required in the lease duration. The forklift is returned at the end of the lease.

**Question:** Is this an operating lease or a sales-type lease?

## Sample #4:

A precision manufacturing company leases a CNC milling machine for 8 years.; the machine's economic life is 10 years. The present value of lease payments (including a residual value guarantee by the lessee) equals 88% of the machine's fair value. The lease has language that allows the machine to be purchased for \$1 at lease maturity. The lessor's yield is 7.5%.

**Question:** Is this an operating lease or a sales-type lease?

## Sample #5:

A regional hospital leases an X-ray machine under a 5-year lease agreement. The lease is structured with a 90 day deferral on payments. A security deposit of 2% of the lease total is required up front. The hospital has the option to purchase the machine at the end of the lease for \$45,000, while the machine is expected to be worth \$150,000 at that time.

**Question:** Is this an operating lease or a sales-type lease?

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## Accounting Review Scenarios Answer Guide

### Sample #1 Answer:

This is an operating lease.

- The lease term is less than the majority of the asset's useful life - 42% of its useful life is used in this lease.
- There is no transfer of ownership or bargain purchase option.
- The present value is less than substantially all of the asset's value.

### Sample #2 Answer:

This is a sales-type lease.

- The lease contains an automatic title transfer.
- The lease term also exceeds 75% of the assets useful life and that the PV of the mandatory lease payments exceeds 90% of the leased assets FMV at the inception of the lease.

*Reminder - only one of these would be required to trigger classification as a sales-type lease.*

### Sample #3 Answer:

This is an operating lease.

- The lease term does not cover the majority of the equipment's useful life - 13% of its useful life is used in this lease.
- There's no transfer of ownership and no bargain purchase option in the lease

### Sample #4 Answer:

This is a sales-type lease.

- The lease term covers a substantial portion of the asset's useful life - 80% of its useful life is used in this lease.
- The lease contains a bargain purchase option.

### Sample #5 Answer:

This is a sales-type lease.

- The lease includes a bargain purchase option that is reasonably certain to be exercised.
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## Operating Lease Practice Problem

A lessor completed and funded the following Lease:

<b>Lease Term:</b>	60 months
<b>Number of Lease Payments:</b>	60 - made monthly in advance
<b>Amount of Monthly Payments:</b>	\$8,900
<b>Refundable Security Deposit:</b>	\$15,000
<b>Broker Fee paid by Lessor:</b>	None
<b>Other Initial Direct Costs (IDC):</b>	None
<b>Cost of Leased Assets:</b>	\$575,000
<b>Estimated Economic Life of Leased Assets:</b>	84 months
<b>Unguaranteed Residual Value:</b>	Fair Market Value (FMV), estimated to be 30% of the original cost of the leased assets

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Using the information above, please complete the following as of lease inception for this operating lease:

**1. What assets (description and amount) would the Lessor report on the balance sheet?**

**2. What liabilities (description and amount) would the Lessor report on the balance sheet?**

**3. Would there be any equity reported on the balance sheet?**

**4. Create the Lessor's Balance Sheet at lease inception.**

**5. Create the Lessor's Income Statement at the end of month one.**

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### Operating Lease Practice Problem Answer Guide

1. Assets = **\$598,900** (*Advance payment of \$8,900 + \$15,000 refundable security deposit + \$575,000 leased equipment*)
2. Liabilities = **\$23,900** (*Advance payment of \$8,900 + \$15,000 refundable security deposit*)
3. Equity = **\$575,000** (*Equipment cost*)

#### 4. Lessor's balance sheet at lease inception

##### ASSETS:

Cash	\$23,900
Leased Equipment	\$575,000
Less Depreciation	<u>\$0</u>
<b>TOTAL ASSETS</b>	<b>\$598,900</b>

##### LIABILITIES & EQUITY:

Security Deposit	\$15,000
Advance Payment	\$8,900
Equity	<u>\$575,000</u>
<b>TOTAL LIABILITIES &amp; EQUITY</b>	<b>\$598,900</b>

#### 5. Lessor's income statement at the end of month one

##### INCOME:

Rental Income	\$8,900
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##### EXPENSES:

Depreciation	<u>\$6,709.33</u> [ <i>(\$575,000 equipment cost - \$172,500 unguaranteed residual) ÷ 60 month term</i> ]
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**NET INCOME:** **\$2,191.67** (*Income - depreciation*)

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## Sales-Type Lease Practice Problem

A lessor completed and funded the following Lease:

<b>Lease Term:</b>	60 months
<b>Number of Lease Payments:</b>	60 - made monthly in advance
<b>Amount of Monthly Payments:</b>	\$8,900
<b>Refundable Security Deposit:</b>	\$15,000
<b>Broker Fee paid by Lessor:</b>	None
<b>Other Initial Direct Costs (IDC):</b>	None
<b>Cost of Leased Assets:</b>	\$575,000
<b>Estimated Economic Life of Leased Assets:</b>	75 months
<b>Unguaranteed Residual Value:</b>	Fair Market Value (FMV), estimated to be 30% of the original cost of the leased assets

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Using the information above, please complete the following as of lease inception for this sales-type lease:

- 1. What assets (description and amount) would the Lessor report on the balance sheet?**
  
  - 2. What liabilities (description and amount) would the Lessor report on the balance sheet?**
  
  - 3. Would there be any equity reported on the balance sheet?**
  
  - 4. Create the Lessor's Balance Sheet at lease inception.**
  
  
  
  
  
  
  
  
  
  
  - 5. Create the Lessor's Income Statement at the end of month one.**
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### Sales-Type Lease Practice Problem Answer Guide

#### 1. Assets = **\$590,000**

**Cash:** \$23,900 (includes \$15,000 security deposit + \$8,900 advance payment)

**Net Investment in the Lease:** \$566,100

**Minimum Lease Payments Receivable:** \$525,100 (59 remaining payments x \$8,900)

**Unguaranteed Residual Value:** \$172,500 (30% of the equipment cost)

**Less: Unearned Income:** -\$131,500 ([60 payments x \$8,900] + \$172,500 - \$575,000)

#### 2. Liabilities = **\$15,000** (Security deposit)

#### 3. Equity = **\$575,000** (Equipment cost)

#### 4. Lessor's balance sheet at lease inception (Sales-Type Lease)

##### ASSETS:

Cash	\$23,900
Minimum Lease Payments Receivable	\$525,100
Unguaranteed Residual	\$172,500
Unearned Income	(\$131,500)
Net Investment in the Lease	\$566,100 (Total of the above, <u>not including cash</u> )
<b>TOTAL ASSETS</b>	<b>\$590,000</b>

##### LIABILITIES & EQUITY:

Security Deposit	\$15,000
Equity	\$575,000
<b>TOTAL LIABILITIES &amp; EQUITY</b>	<b>\$590,000</b>

#### 5. Lessor's Income Statement at the end of month one (Sales-Type Lease)

##### INCOME:

Lease Income \$2,191.67\* (Unearned income of \$131,500 ÷ 60)

##### NET INCOME:

\$2,191.67

\*\*If not using TValue or a calculator, this is the number that is calculated straight line over the term

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### Important Calculations Guide

- **Balance sheets**
    - $\text{Assets} = \text{Liabilities} + \text{Equity}$
  - **Calculating income for a month**
    - Operating Lease:  $\text{One month's rent} - \text{one month's depreciation}$
    - Sales-type Lease:  $\text{Total of unearned income} \div \text{lease term in months}$
  - **Minimum Lease Payments Receivable**
    - Sum of remaining lease payments (*\*note that this sum often includes one month less than the total term if payments are in advance*)
  - **Net Investment in the Lease**
    - $\text{Sum of minimum lease payments receivable} + \text{unguaranteed residual} + \text{unearned income}$
  - **Straight line depreciation method**
    - $(\text{Equipment cost} - \text{unguaranteed residual}) \div \text{term in months}$
  - **Unearned Income**
    - $([\text{Total sum of lease payments} + \text{unguaranteed residual}] - \text{equipment cost})$  *\*note that this will be a negative number*
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