Equipment Lease or Sale? Beware of the Tax Consequences!

Equipment leases are often an economical way of acquiring equipment. However, if you, the business owner, are not careful, you may incur some unpleasant tax consequences. These can occur if, under the Internal Revenue Code (Code), the Internal Revenue Service (IRS) deems that your equipment lease is really a sale.

Under the Code, lease payments are considered expenses. Thus, they are deductible in the year in which you make them. In contrast, the Code treats installment payments toward a sale as capital expenses, and these may *not* be fully deductible in the year you make them. Instead, the Code specifies the number of years over which capital expenditures may only be deductible, which might exceed the length of the lease (and which will vary depending on the type of equipment).

The difference between deductions for expenses and capital expenditures can be shown by an example. Assume that you have a two-year "lease" for a photocopier, which the IRS decides is really an installment sale. You might have to spread your deductions for the payments over three or more years, even though you actually made the payments within two years. On the other hand, if the IRS decides that the transaction was a true lease, you should be able to deduct the payments during the two years in which you make them.

The IRS takes particular interest in equipment leases because they often are really sales under the Code. How does the IRS determine whether a lease is really a sale?

The IRS scrutinizes the substance, not the form, of the transaction. In other words, simply calling the transaction a lease will not make it so.

The IRS first examines the economic structure of the transaction. This is known as the "economic viability test." One indication that the transaction is a lease and not a sale is if the present value of the future rents and the expected salvage value is less than the present value of the equipment. In other words, is the lessor recovering all its profit during the term of the initial lease? If the answer is no, the lessor probably intends to lease the equipment at least once more when the initial lease ends. Many equipment leases flunk this test because the lessor recovers all its profit from the initial lease. In those cases, the lessor will not need to ever again lease the equipment to make a profit.

The economic viability test may be best explained by an example. Assume once again that you are renting a photocopier for one year, starting on

January 1, 1997. Further assume that the total lease payments that you make under the lease exceeds the amount the lessor paid for the copier. In that case, the IRS could conclude that you had, in substance, purchased the copier and that under the Code the transaction was really a sale, not a lease. Rather than deducting the full amount of the lease payments on your 1997 income tax return, you may be required to take a smaller annual capital expense deduction over a longer time period.

Of course, the economic viability test does not necessarily end the inquiry. The IRS may also look at other features of the transaction. The following features may enable the IRS to determine that a transaction is a sale rather than a lease:

* The right of the "lessee" to purchase the equipment at the expiration of the lease for a nominal price in relation to the fair market value. Purchase options for one or ten dollars are common examples.

* The payment of substantial rentals for a short original lease term in relation to the expected useful life of the property, followed by relatively nominal rental for an additional term approximately equal to the remaining useful life.

* The fact that the equipment will be virtually worthless by the end of the "lease."

* Requiring the "lessee" to repair and maintain the equipment and to assume all risk of loss and damage.

* The intent of the parties that the "lessee" will keep the equipment when the "lease" expires.

* The designation of some portion of the "lease" payments as interest.

Leasing equipment may be trickier than it seems. Before you sign an equipment lease, show it to your attorney or your accountant to make sure that it really is a lease.