

Using Technology to Lease Technology

By Howard K. Weber

Since leasing was first used as a financial tool, pricing has been a complex matter. To price properly, many variables must be taken into account including: funding date, credit rating of lessee, residual assumed, tax rate, term of the transaction, desired spread over an index, etc.

Once all the variables are determined, a mathematical algorithm may generally be used to determine the lease rate, assuming that some general assumptions beyond the specific ones mentioned above remain static.

In the early days of leasing, before computers enabled lessors to calculate rentals easily, most lessors used the ever-famous "blue book" to determine lease pricing. For those of you too young to remember vinyl LP records, telephones with dials, and television sets that only showed black and white pictures, the "blue book" was a rather thick reference manual filled with lease rate factors for various combinations of the variables mentioned above. Naturally, while the blue book was useful for some combinations, it was not useful for all combinations, and many times the lease practitioner had to make estimates of rates by interpolating between two rates.

Technology quickly changed all that and put the blue book industry out of business. Computer software quickly enabled sales representatives in the field to quickly and easily enter data and to receive back an accurate price quote based on that data.

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Dismantling the 'Great Wall' of Risk

The Key to Turning Lease Financing into a Mainstream Financial Product in China

Part One of a Two-Part Series

By Jonathan Fales

A growing number of lessors exhibiting cautious optimism are slowly, but successfully, knocking down the "great wall" that separates them from turning lease financing into a mainstream financial product in China. Investing in the Chinese leasing market can be a sound decision for lessors whose customers are asking for leases there; who can effectively manage the risks; and who are equipped to deal with major differences between the United States and China, which include language, culture, and the number and nature of business regulations.

This investment, however, will require a significant and ongoing commitment. A sound exit strategy also should be a part of the investment plan, keeping in mind that China is just as aggressive about keeping foreign equity investment from leaving the country as it is about bringing it in.

This two-part article (based on a 2005 white paper issued by ELA's Equipment Leasing Foundation, "Knocking Down (Great) Walls") will look at the key legal and regulatory issues surrounding investing in the Chinese leasing market. This installment looks at the history of this market and examines the current legal and regulatory climate.

Most international lessors with operations in China today have Chinese partners, due, in part, to the fact that a local partner was required to obtain a leasing license. With the recent availability of the Wholly Foreign-Owned Enterprise ("WFOE") option and a new leasing law being considered, however, many large lessors are seeking to establish operations on their own. Smaller lessors, on the other hand, may continue to seek out partners, primarily due to the regulatory capital requirements. The second part of the series compares and contrasts the experiences of a

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Great Wall

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WFOE with a partnership initiative and evaluates the pros and cons of each direction.

LEASING IN CHINA:

A BRIEF HISTORY

During the early 1980s, China was in the initial stages of its migration from a centrally planned economy to a market-based one. To take advantage of these growth opportunities, Chinese manufacturers needed new state-of-the-art production equipment, much of which had to be imported. Since most Chinese manufacturers lacked adequate capital, several new lessors were created to provide financing to these firms. Most of these leasing companies were joint ventures between Chinese and either Japanese or Korean lessors; Deutsche Leasing was also present. All of these lessors had their plans reviewed and approved by the Peoples' Bank of China ("PBOC").

By the early 1990s, the Chinese economy had expanded significantly. This expansion also made new sources of funds available to Chinese manufacturers. Most European and North American multinationals began leasing operations in China during the mid-1990s. Hewlett-Packard, IBM, Siemens, and AT&T Capital were among the companies that established small leasing operations in

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Beijing and Shanghai. Due to the limited credit information available and questionable legal recourse in the event of default, these lessors tended to lease primarily to other creditworthy multinationals, as well as to a small number of the larger, and better-known, Chinese companies.

Today's Market Size

While the exact number of leasing companies is not known, it is estimated that China has more than 10,000 small lessors, many or most of which are car rental companies. These lessors are in addition to the relatively small group of larger, well-capitalized lessors.

Data gathered by the Financial Leasing Committee of the China Society of Finance indicate that the total leased assets by leasing companies in China as of December 2003, was 21.36 billion renminbi (the renminbi, hereinafter "Rmb," is the Chinese currency), which is approximately US\$2.6 billion. This figure indicates a leasing penetration rate of 0.44% of capital formation, which contrasts with the prevailing level of 30% in the United States. (That does not include hire-purchase agreements. Including hire-purchase transactions would push the rate closer to 40%.) This indicates the tremendous growth potential of the Chinese leasing industry.

THE ACCOUNTING, LEGAL, AND REGULATORY LANDSCAPE

Lease Accounting

China has evolved from a centrally planned accounting system, put in place after 1949, to a comprehensive set of standards that tend to harmonize the Chinese standards with those of the International Accounting Standards Board. In 1993, with a view of aligning China's accounting and reporting practices with global standards, and supported by funding from the World Bank, China's Ministry of Finance ("MOF") developed approximately 30 accounting standards that were to be applied in China's socialist market economy.

At the end of 2000, MOF released a new accounting system for business enterprises. This system is an integrated framework for accounting preparation and reporting, and its

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Equipment Leasing Newsletter®

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Editorial e-mail: jgromer@alm.com
Circulation e-mail: subspa@alm.com

LJN's Equipment Leasing Newsletter P0000-235
Periodicals Postage Pending at Philadelphia, PA
POSTMASTER: Send address changes to:

ALM
1617 JFK Blvd., Suite 1750, Philadelphia, PA 19103
Annual Subscription: \$429

Published Monthly by:

Law Journal Newsletters

1617 JFK Boulevard, Suite 1750, Philadelphia, Pa 19103
www.ljnonline.com

Like Kind Exchange for Equipment Leasing

By Jeff Nelson and Bill Bosco

Competitive pressures in the Equipment Leasing Industry continue to build into 2006. Although industry surveys project a healthy 7% to 8% growth in overall leasing volumes from 2004 to 2006, readily available capital continues to drive down returns as well as margins, especially for the best credit customers. In reaction to these competitive pressures, savvy lessors are increasingly taking advantage of a tax strategy involving the implementation of a Like Kind Exchange (“LKE”) Program. LKE Programs enable equipment lessors to systematically avoid current recognition of taxable gain on the disposition of tax leased equipment and defer the requisite payment of state and federal income tax.

The establishment of an LKE Program provides lessors with a significant source of interest-free capital that, when considered in funding new leases, can often improve margins by 20 to 60 basis points. In addition, the advantage of an “institutionalized” LKE Program can continue indefinitely, or, for at least as long as a lessor maintains its investment in like kind assets. Best of all, when properly implemented, LKE Programs enable lessors to

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avoid “recapture” of 30% and 50% “Bonus” depreciation for certain tax leases originated between Sept. 11, 2001 and Dec. 31, 2004, which are just now starting to come to term.

A SHORT HISTORY AND RATIONALE FOR LKE

LKE has been a part of our tax code for a very long time. The original rule was introduced in 1921, and although frequently modified and clarified, retains its fundamental identity and functionality in its current form of Internal Revenue Code (“IRC”) §1031. Originally, Congress offered the following rationales as justification for non-recognition of gain in an exchange:

1) Continuity of investment — a taxpayer does not benefit and should not be taxed where it merely replaces one business asset with a second business asset of like kind and equivalent value;

2) Lack of liquidity — where a taxpayer needs proceeds from the disposition of old assets in order to acquire new assets in sufficient volume to maintain the size and scope of its business activity, the taxpayer lacks the wherewithal to pay taxes in regard to the reinvestment;

3) Administrative convenience — “horse trades” and similar exchanges justify non-recognition of gain or loss because of the administrative burden and uncertainty in valuing such properties.

Over the years, LKE has survived multiple rewrites of the tax code as well as several major law changes. In 1991 the IRS issued deferred exchange regulations that provided taxpayers with the basic mechanisms needed to affect an LKE Program. Most recently, in May of 2003, the IRS indicated its understanding, if not its full support, for LKE Programs when it promulgated safe harbor rules for LKE “Program” exchanges under Revenue Procedure 2003-39 and subsequently issued a supportive ruling (PLR 200450005) in August 2004.

In addition to the favorable guidance provided by the IRS, the courts have also been consistently supportive of LKE in numerous decisions at every level of the federal and state judiciary. Supporting decisions involv-

ing LKE include *Biggs v. CIR*, 632 F.2d 1171 (5th Cir. 1980), *Brauer v. CIR*, 74 T.C. 1134, *Barker v. Comm.*, 74 TC 555 (1980), *Comm. v. Northshore Bus Co.*, 143 F.2d 114 (CCA2 1944), and *Garcia v. Commissioner*, 80 T.C. 491 (1983), *acq.* 1984-2C.B. 1 to name just a very few. Based on this broad support and the growing body of legal and regulatory guidance, LKE for equipment lessors has never been more flexible and secure.

HOW DOES AN LKE PROGRAM WORK?

Taxable Gain Deferral — Under the general rule, no taxable gain (or loss) is recognized where property held for use in a trade or business (including tax leased property) is exchanged *solely* for like kind property that is also to be held for trade or business purposes. Fundamentally, if you dispose of a business asset and reinvest your sales proceeds to acquire a “like kind” replacement asset of equal or greater value, then the recognition of taxable gain (along with the lessor’s obligation to pay tax on that gain) is deferred.

In regard to lease conversions/dispositions that generate tax losses, it is important to note that LKE is accomplished on an exchange by exchange basis. As a result, lessors may be able to structure their LKE Programs to systematically defer the recognition of tax gains while simultaneously allowing the recognition of tax losses (*ie*, structure their LKE Programs in order to qualify those dispositions of assets that typically generate tax gains while simultaneously disqualifying those dispositions of assets that typically generate tax losses).

Indefinite/“Permanent” Deferral — In terms of the more familiar “episodic” land or building exchange, LKE tax deferral is temporary, lasting only until the taxpayer subsequently disposes of its replacement asset for a taxable gain. However, in the case of an equipment lessor’s LKE Program where the lessor is continuously buying and selling successive assets as part of its ongoing lease origination, conversion, and disposition processes, the deferral can be more permanent.

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In an LKE Program, lessors can carry-over their deferral from one replacement asset into the next replacement asset and then into the next replacement asset and so on. Theoretically, this continuation of gain deferral into successive replacement assets can continue for as long as, and to the extent that, the lessor maintains its tax investment in “like kind” assets.

Impact on Financial Earnings — LKE gain deferral has no impact on a lessor’s financial earnings. Gain deferral under an LKE Program serves only to reduce taxable income. Generally, the only direct impact to a lessor’s financial statements is in regard to the income tax liability reported on the lessor’s balance sheet where an LKE tax deferral results in a shifting of the lessor’s tax obligation from a current to a deferred liability.

How Much Time Do You Have to Complete an Exchange? — Assuming certain procedural rules are met in regard to the “identification” of potential replacement assets, deferred exchange rules allow equipment lessors to acquire replacement assets up to 180 days after they dispose of an old asset. Typically, these deferred exchanges are accomplished with the services of a “Qualified Intermediary” (“QI”). However, in modern LKE Programs, created pursuant to recently issued IRS safe harbor rules, the QI basically functions as a trust or bank account. These LKE bank accounts (which are frequently established as joint QI/lessor controlled accounts and are frequently adapted from the lessor’s existing bank account structure) hold proceeds from the disposition of old assets until such time that taxpayers can direct the QI to dis-

burse those funds for qualified LKE purposes including the following:

- Acquisition of like kind replacement assets;
- Payment of debt in regard to old assets;
- Payment of certain exchange expenses; or
- In the case of an unsuccessful exchange, disbursement of LKE proceeds to the lessor upon expiration of the subject assets’ exchange period.

Understandably, most lessors are concerned that sales proceeds might be tied up in restricted accounts for an extended period of time. However, in many situations, LKE best practices have been developed that minimize or even eliminate the need for lessors to maintain large cash balances.

What Is “Like Kind” Property — For LKE Program purposes, “Like Kind” is generally construed under IRS safe harbor rules. Under those rules, old assets must be replaced with like kind assets categorized within the same General Asset Class (as described by the IRS in Rev. Proc. 87-56) or the same NAICS (North American Industrial Classification System) class. Many of these safe harbor classes are broadly construed. For example, regardless of grade, quality, or age, all construction equipment is considered like kind with all other construction equipment. Accordingly, a 30-year old bulldozer is considered like kind to a brand new backhoe/loader that is like kind to a 10-year-old motor grader that would be like kind to a 3-year-old excavator, etc. Other classes of assets are more narrowly construed. For example, over the road tractor units are only like kind to other over the road tractor units.

The success of an equipment lessor’s LKE Program is dependent on the lessor’s ability to acquire replacement assets (*ie*, originate new tax leases) within the same like class of dispositions. However, leasing is driven by

customer demand that is outside lessors’ control. Economies, industries, and lease portfolios are continuously cycling through boom and bust, and to the extent customer demand for new assets is less than disposition proceeds from the sale of like kind old assets, a lessor may have difficulty in consistently accomplishing a tax-deferred exchange. This difficulty is usually mitigated by the following factors:

- Value of old assets relative to new — taxpayers need only “replace” the value of old assets with an equivalent value of new. On a unit by unit basis, the cost of new assets are typically much greater than proceeds attributable to the sale of old assets, frequently allowing lessors to replace multiple units of older, lower value assets with fewer, higher value new assets;
- Matching flexibility allowed under IRS safe harbor rules — IRS safe harbor rules give corporate lessors up to 8 1/2 months after year-end to finalize their matching of sales proceeds to like replacement dollars. Given a deeper understanding of LKE industry best practices and sufficient technological capability, this matching flexibility can often be used by lessors to adjust their matching in order to maximize their gain deferral relative to limited replacement dollars.

LKE Technology — Using the like class safe harbor rules, it is not unusual for equipment lessors to buy and sell machinery and equipment across 30 or more different like classes. Multiple classes make the task of identifying, tracing, and matching sales proceeds from old assets to acquisition costs of replacement assets within the same like class a difficult if not impossible task. Fortunately, technology has been employed to automate the tracing and matching processes as well as all the required number crunching and reporting, making the administration and maintenance of newer LKE Programs seamless and invisible to equipment lessors’ employees, customers, and vendors.

THE OPPORTUNITIES OF LKE FOR EQUIPMENT LESSORS

Cash flow advantages — The primary benefits of an LKE Program

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Table 1

Tax Portfolio Size in \$s	7 Yr Cumulative Net Gain Deferral	7 Yr Cumulative Net Tax Deferral
\$ 250,000,000	\$ 70,851	\$ 26,923
\$ 500,000,000	\$ 141,701	\$ 53,846
\$ 1,000,000,000	\$ 283,402	\$ 107,693
\$ 1,500,000,000	\$ 425,104	\$ 161,539
\$ 2,000,000,000	\$ 566,805	\$ 215,386
\$ 3,000,000,000	\$ 850,207	\$ 323,079

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derive from the lessors' ability to defer tax payments in regard to realized gain on the sale of off-lease equipment. This retention of cash that otherwise would have been used to make tax payments effectively results in a substantial interest-free source of funding that can be used for any number of purposes including:

- Debt reduction;
- Business expansion;
- Stakeholder distributions;
- Pricing/competitive advantages.

A detailed numerical analysis of an LKE Program's impact on a lessor's

tax liabilities and cash flows is beyond the scope of this article. However, based on the authors' experience in implementing LKE Programs for several equipment lessors, one might expect to achieve the 7-year cumulative net gain (net of depreciation) and tax deferral for various levels of a typical (if there is such a thing) equipment lessor's tax portfolio as forth in Table 1 on page 4.

Note: In this instance, the tax deferral as a percentage of portfolio size is 11%; therefore, the LKE program will lower funding costs by 11%, as it is an interest-free source of funding.

Avoiding Recapture of "Bonus" Depreciation — For certain assets

placed in service between Sept. 11, 2001 and Dec. 31, 2004, Congress allowed tax lessors to dramatically accelerate depreciation deductions utilizing 30% or 50% "bonus" depreciation. These "bonus" deductions gave lessors the advantage of large, immediate tax write-offs. Unfortunately, they also condemned lessors to recognize extraordinary levels of taxable gains in the form of "bonus" depreciation recapture when these same assets were disposed of as they came to term.

Fortunately, bonus depreciation need only be recaptured where taxable gain is recognized and in those instances where lessors have

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Early computer models requested the data mentioned above from a user, and the model accurately calculated the lease rate factors to be quoted to a customer. This could be done at the back office or on the spot at a customer's desk.

This is all very good in and of itself in that sales representatives can give quotes to a customer in real time and leave the office knowing they have left behind a viable bid for a transaction.

The problem with this is that in a world of fast changing interest rates and corporate policies regarding yields, etc., many sales representatives may be quoting off of an old rate card or out-of-date yields, etc. In addition, giving the sales representative the control over the quote may enable him or her to manipulate the system to get the sale, rather than do what may be the most profitable to the corporation.

To solve this problem, new technology has been developed that allows a corporation to control how much data the sales person is given and how much leeway he or she has in posting quotes. There are many possible problems that may arise when a sales representative is in the field giving quotes to a customer. A few of those problems

are discussed below along with how technology helps solve them.

Out-of-date rates: Many representatives will use rate cards to determine what yield the home office believes it needs to make a profit. These rates may vary by a variety of things. If the representative, however, uses the wrong rate, this could have unexpected negative consequences for the corporation. To deal with out-of-date rates, the sales person may be required to sync his or her local computer with the corporation mainframe at least once a day in order to ensure that the latest rate schedules are on his or her machine.

Erroneous residuals: Many times the sales representative will not know which assumptions to use for a given piece of equipment. While at a customer location, the representative may make a guess that will probably be incorrect. Newer computer models will enable the corporation to hard code a given residual for a given piece of equipment and eliminate any erroneous guesswork.

There are numerous other possibilities that may arise where technology can be used to ensure that the sales representative/pricer will maintain corporate policies in pricing transactions.

The above leads to a final point about technology that is often overlooked by customers in today's world. Simply stated: Technology is a tool to help you in your business. The user should be the driver of the tool, not the other way around. In the above admittedly simplistic examples, some real-world problems were mentioned and

solutions were offered.

There are many other solutions offered by technology, but the user should not feel obligated to use all of them, especially if he or she does not have a problem. All too often, it happens that a user will purchase the latest technology and discover some new features that he or she did not know existed. But if the user does not need those features, he or she should let them lay dormant. If there is a feature that the user can use, but the software does not have it, by all means ask the vendor for it.

Users of technology should also be aware that the computer can only do what it is told to do by a programmer or another human being. As lease pricing grows more complex, many people can interpret regulations in different ways. This is particularly true in the case of Internal Revenue Service regulations. The user should absolutely not assume that the model he or she is using will agree with tax counsel's interpretation of the rules until checking with the counsel.

CONCLUSION

Technology is a wonderful thing. It can be used by a corporation to control how pricing is done, enable pricers to use the latest rates, and keep track of bids and put appropriate expiration dates on them. The thing that must be remembered by all users of technology, however, is that it is only as good as the programmer who told the computer what to do, and the user has the ultimate responsibility for ensuring the accuracy of the results.



Great Wall

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standards are more far-reaching, comprehensive, and more in line with international standards.

Chinese accounting standards, like standards in the rest of the world, recognize two types of leases. The classification of these lease types, referred to as financial and operating leases, is based on the economic substance of the transaction, rather than its form.

Leasing Law

In 2004, the National People's Congress started drafting a new leasing law that will eliminate the duplication of effort between the China Bank Regulatory Commission ("CBRC") and the Ministry of Commerce ("MOFCOM"), which regulates all other lessors. The new leasing law (expected adoption date in early 2007) will authorize, regulate, and govern financial leasing operations. The conditions for setting up a financial leasing company will include the following:

- 1) Minimum registered capital of Rmb80,000,000 (equivalent to slightly less than US\$10,000,000);
- 2) A management team with professional knowledge of financial leasing and the law;
- 3) Adequate organization, management, internal management systems, and systems for risk control and handling;
- 4) The business premise, safety measures, and other required facilities corresponding to the business operation.

The ongoing regulatory requirements for a financial leasing operation under the proposed law include the following:

- 1) Assets/debt ratio
 - Risk assets, including contingent liabilities, shall not exceed 10 times the total assets;
 - Investment in industries other than the financial lease industry cannot exceed 30% of the total assets;
 - The leased assets under the financial leases cannot be less than 60% of the total assets;
- 2) Management of leased property. The leasing company shall set up separate accounts for leased property under sublease and entrusted lease business;

3) Cost control for leased-back property. In a sale and leaseback transaction, the acquisition cost for the leased property shall not exceed 20% of the actual value or the book value of the leased property.

The concept of paying over time is relatively new in China.

PARTICULAR CHALLENGES

Many of the risks lessors face in China are the same as those in the United States, except they are compounded by time and distance. There also are uniquely Chinese challenges that go beyond differing tax and accounting rules.

Regulatory

China's regulatory agencies (MOFCOM or CBRC) may intervene, regulate, or otherwise restrict leasing companies' activities on different grounds at any time. Because there is little or no education about leasing in certain areas, confusion or misunderstanding may trigger unfair government actions or negative regulations.

Documentation

Any time a new language is introduced into the business process, there is an opportunity for a broader range of interpretation. Furthermore, since leasing is a relatively new concept, it is important to use local counsel. Other risk factors include the recent adoption of contract law and negotiation tactics.

Collections

The concept of paying over time is relatively new in China. Along with an increased risk of nonpayment, it also creates problems in the collection process. Furthermore, the rigor as to performance and metrics is not at the same level in China as it is in the United States and Europe. Lessors will have to work very closely with local resources to understand the payment mindset and find adequate collection staff.

Repossession and Recourse

The enforceability of the lease agreement is a primary concern in China. The components necessary to

enforce leasing transactions include 1) the rule of law, 2) the efficiency of the legal system, and 3) a corruption-free environment; in China, for the most part, these are still variables.

ESTABLISHING A Foothold

All foreign leasing companies in China are regulated by the government and, as such, must receive authorization to conduct business. Authorization to establish a foreign leasing company is obtained through MOFCOM. There are several structural alternatives available to foreign leasing companies, including representative offices, branches, joint ventures, and WFOEs.

The easiest way for a vendor to increase sales in China is by referring leasing opportunities to existing lessors, although this approach should not be considered as entering the market. Establishing a representative office can facilitate these referral activities. This structure allows the office to be a liaison between the foreign company and its Chinese clients. The representative office cannot perform profit-making activities such as executing sales contracts or directly billing customers. This business form does, however, allow the foreign leasing company to perform cross-border leasing, mainly for large-ticket items like aircraft, rail, power plants, etc.

China's Company Law, which has been in effect since July 1, 1994, permits the opening of branches by foreign companies but, as a policy matter, China still restricts this entry approach to selected banks, insurance companies, and accounting and law firms. [Note, the first PRC Company Law was adopted by the Standing Committee of the NPC on Dec. 29, 1993. It is effective since July 1, 1994 and was amended on Dec. 25, 1999.] While representative offices are given a registration certificate, branch offices obtain an actual operating or business license and can engage in profit-making activities. It should be noted that there are significant restrictions as to the activities representative and branch offices can conduct.

Joint ventures, another organizational option, can be formed as equity joint ventures, cooperative joint ventures, or foreign invested joint stock companies.

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Legislative Update

By Bill Bosco

At its Feb. 15, 2006 Board Meeting, the Financial Accounting Standards Board affirmed decisions on the remaining issues concerning the proposed FASB Staff Position FAS 13-a, "Accounting for a Change or Projected Change in the Timing of Cash Flows Relating to Income Taxes Generated by a Leveraged Lease." These issues had been discussed at the Board's Feb. 8 educational meeting.

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effectively implemented an LKE Program prior to the disposition of bonus affected assets; bonus depreciation recapture (like all taxable gain) is deferred, not recognized.

Internal Allocation of LKE Benefits to the Business Unit — For those equipment leasing businesses constituting subsidiaries or divisions of larger organizations, LKE deferrals should be allocated to the business unit where they should reduce the amount of your intercompany borrowings by the amount of the deferred tax balance. At the very least, this allocation of deferred tax balances should reduce the amount of internal interest charged to your business unit.

Profitability and Pricing Advantages — When lessors retain a higher portion of sales proceeds in the form of deferred tax payments, their profitability (ROA, ROI, MISF, etc.) is enhanced. In addition, interest-free funding of new leases with deferred tax dollars can give lessors a significant basis point advantage for pricing purposes. Obviously, every lease

ISSUES DISCUSSED AND AFFIRMED

Issue 1: The Board affirmed that advance payments and deposits made to the IRS or other taxing authorities should not be included in the recalculation of the leveraged lease.

As further clarification, the FASB staff said that when it is determined that cash flows will change, as in an IRS settlement, the settlement amount is included as a cash flow in the rerun, and advance payments are ignored. This is contrary to what I had thought and reported before.

Issue 2: The Board affirmed the decision to not require a threshold for determining when a change in timing should trigger a recalculation in the final FSP.

In the discussion, the Board and staff said that the determination of materiality is an entity-by-entity decision.

Issue 3: The Board affirmed that changes in state apportionment factors should be included as a trigger for recalculating a leveraged lease.

must be evaluated based on its own unique terms and conditions. However, in order to give the reader a better feel for the benefits of LKE, the advantages for a 5-year truck lease with a 20% residual using a 6% cost of funds are detailed below:

- MISF yield enhanced by 41 basis points;
- ROA enhanced by 25 basis points;
- Lessee implicit rate reduced 34 basis points (if MISF yield is frozen and rents are reduced).

THE CHALLENGES OF LKE FOR EQUIPMENT LESSORS

Administrative Complexity — In its simplest form, IRC §1031 contemplates a direct exchange (or "trade-in") of one business asset for another of like kind. Unfortunately, equipment lessors are rarely able to make such a direct exchange. They frequently dispose of their assets to one party, take possession of sales proceeds (typically in the form of property which does not qualify for LKE like cash and buyers notes), and purchase their replacement asset from a different party often at a much later date.

In these more complex situations, equipment lessors may strive to imple-

The Board wondered why this was an issue, as it has nothing to do with timing. The staff said it was an issue as several respondents asked the question. The Board asked that it be included in the basis for conclusions. In the discussion, the Board and staff said that the determination of materiality for a change in composite tax rate due to apportionment changes should be made using the same judgment as would be applied if a state tax rate changed.

Issue 4: The Board affirmed the decision that the effective date and transition in the proposed FSP be modified to be consistent with the Board's Uncertain Tax Position ("UTP") Interpretation project.

The staff will complete drafting and submit a final draft for a Board ballot. This will be done in conjunction with the UTP project final draft. No timing was predicted.



ment an LKE Program as described above. However, the administrative, business process and other procedural requirements necessary to comply with the exchange rules can be so burdensome and complex that taxpayers are often reluctant to utilize this provision. It is precisely because of these procedural complexities that many equipment lessors have not taken full advantage of the LKE tax strategy.

LKE Cannot Be Applied Retroactively — An LKE Program is not something that can be implemented overnight. The LKE opportunity is prospective, frequently requiring several weeks or months of implementation effort before lessors can begin to capture LKE benefits going forward.



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IN THE MARKETPLACE

The **Financial Accounting Standards Board** has released a statement and response to the SEC's study on arrangements with off balance sheet implications, special purpose entities, and transparency of filings by issuers. In the statement, FASB reaffirmed "its commitment to improving transparency and usefulness of financial reporting to better serve investors and the capital markets." FASB's response to the SEC's "Off Balance Sheet Report" discusses a number of "fundamental structural, institutional, cultural, and behavioral forces that it believes cause complexity and impede transparent financial reporting." The response provides an update on FASB's activities and projects intended to address and improve outdated, overly complex accounting standards. These areas include accounting for leases; accounting for pensions and other post

employment benefits; consolidation policies; accounting for financial instruments; accounting for intangible assets; and conceptual and disclosure frameworks. The FASB has also "undertaken several initiatives aimed at improving the understandability, consistency, and overall usability of existing accounting literature, through codification, by attempting to stem the proliferation of new pronouncements emanating from multiple sources, and by developing new standards in a 'principles-based' or 'objectives-oriented' approach." The full text of FASB's response is available at www.fasb.org/fasb_response_sec_study_obs.pdf.

Interpool, Inc. of Princeton, NJ, has announced that its wholly owned subsidiary, Interpool Containers Limited, has entered into an agreement to sell a

substantial majority of its operating lease portfolio of standard dry marine cargo containers to a newly formed subsidiary of an investor group based in Switzerland. Following the sale, Interpool and its 50%-owned subsidiary, Container Applications International, Inc., will perform management services on behalf of the purchaser for the containers being sold, and Interpool will continue its active businesses of leasing cargo containers and container chassis to shipping lines and other customers. The container sale involves a total of approximately 273,000 standard dry marine cargo containers, as well as an assignment of all of ICL's rights under existing leases for this equipment. The purchase price is approximately \$515 million, and sale is expected to close on March 31, 2006.



Great Wall

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Historically, foreign companies were not allowed to own 100% of leasing companies in China, so joint ventures were very popular. Effective March 5, 2005, MOFCOM amended its existing rules by promulgating new measures regarding the administration of foreign investment in the leasing industry. These new rules effectively open up the leasing market to foreign investment by allowing WFOEs to operate as leasing companies. There currently are five leasing WFOEs in China — Caterpillar Financial, GE Capital, Hitachi Capital Leasing, Siemens Finance and Leasing, and Xerox Leasing.

Even though a WFOE gives ownership control of the company to the for-

eign investor, the need for local alliances and know-how is critical for the success in this market. The newly created WFOEs are captive companies whose parents have years of experience in the market. Their extensive networks of local dealers and distributors let them know their end-users' behavior better than a bank-owned or independent leasing company.

Lessors seeking expansion opportunities must consider the Chinese market, given its scope and transition to a market-based economy. This is particularly true for larger lessors with ambitious growth goals. Even so, much of the infrastructure needed for a viable equipment leasing industry in China is not yet in place. As a result, it is critical that lessors be armed with adequate and accurate information regarding the opportunities and pitfalls in this market.

The next installment compares and contrasts several organizational structures, based on real-world experience.

For more information on the subject, the "Knocking Down (Great) Walls" study may be downloaded from www.LeaseFoundation.org.



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3038-2006