

IRS Form Series 8038 and Lease Purchase Financing

July 28, 2016

Introduction and Purpose

The use of capital leases at the University can be an additional source of funding for the needs of the University. Consideration of this alternative funding source must be undertaken with a basic understanding of factors unique to the University in order to effectively utilize this funding source alternative. At times, vendors will want to enter into a tax-advantaged leasing arrangement whereby they receive tax-exempt interest treatment. This treatment would require the University to complete an Internal Revenue Service (IRS) Form Series 8038 and otherwise adhere to restrictive covenants on the use of the property. Therefore, the University will only enter into these types of agreements under certain circumstances.

Capital Lease Financing

A capital lease is a transaction whereby the goods or property leased have the economic characteristics of asset ownership. A capital lease would be considered a purchased asset for accounting purposes and the leased property becomes property of the University at the end of the lease period. In these leases, a portion of the periodic payment will be treated as interest and a portion will be treated as principal payment on the acquisition of the equipment financed by the lease.

A lease falls into the capital lease category for accounting purposes if any of the following requirements are met:

1. The life of the lease is 75% or greater of the asset's useful life.
2. The lease contains a purchase agreement for less than market value.
3. The lessee gains ownership at the end of the lease period.
4. The present value of lease payments is greater than 90% of the asset's market value.

Tax-Exempt Interest Benefit

The University of Minnesota has tax status as an integral part of the State of Minnesota. This tax status enables entities that provide funds under a qualified capital lease to receive the interest portion of the lease free of income taxes if approved by the University. These tax favored leases create a burden upon the University because of the restrictive covenants contained in the leases and additional filing requirements with the IRS. In order for a vendor to receive this benefit, the terms of the lease contract will generally require that the University must file Form Series 8038 with the IRS shortly after the beginning of the lease.

Lease vs. Buy Analysis

When evaluating capital lease financing alternatives, it may not always be beneficial for the University to grant tax-exempt status on the lease arrangement. The University must ensure if it is going to enter into these transactions with tax-favored benefits going to the entity providing the funds, that the University is

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receiving a significant benefit in return to compensate for the additional compliance risks and IRS filing requirements. This compensation usually takes the form of a reduced interest rate on the transaction. The University should not grant tax-exempt status on any lease without first ensuring that the interest rate on the lease is the most advantageous rate available from the vendor. Furthermore, the costs of compliance incurred by the University on the lease should be commensurate with the amount of dollar benefits derived from the vendor.

It is important for University purchasing administrators and business units to understand that the University is in a powerful bargaining position in this matter. The University has an excellent credit rating and as such has available the most desirable rates when it seeks tax-exempt financing. Leasing vendors need to be aware of this condition when they quote a rate to the University. When a rate is quoted by a vendor that is not within an appropriate range given the University credit rating, the administrators should look at other alternatives in acquiring capital equipment.

Guidelines to be followed related to a lease/buy analysis include:

1. No IRS Form Series 8038 will be filed for capital leases with a present value less than \$250,000. This is because the amount of compliance work on the lease costs more than any value resulting from a reduced interest rate on the lease. As a result, the University should not agree to lease terms that contain any requirement for the completion of an IRS Form Series 8038 for leases not in excess of this \$250,000 threshold.
2. Lease agreements with a present value over \$250,000 that have provisions that require an IRS Series Form 8038 must be reviewed in detail by the Tax Management Office prior to anyone at the University executing (signing) the documents. In addition to verifying the tax terms of the lease and prior to approving the signing of the IRS Form Series 8038, the TMO will also determine whether the University receives a reduction in the interest rate charged on the transaction to justify the additional compliance efforts to be expended on the transaction.

Contact

If you have questions about lease purchase financing, please contact the Tax Management Office at taxhelp@umn.edu or 612-624-1053.