Leasing and the Internal Revenue Service

The definition of a true lease for tax purposes was established by the Revenue Ruling 55-540 in 1955. The IRS regards a lease as a true lease only if none of the following conditions is true:

1. Any portion of the lease payments is used to acquire an equity position in the asset.
2. The lessee automatically acquires ownership of the asset at the end of the lease term.
3. Adopting a schedule of payments such that the lessee pays a high proportion of the cost over a short period and thereafter is able to use the asset for a nominal rent.
4. Rental payments are substantially higher than the fair market rental.
5. The lessee has the option to acquire the asset for, say, $1 when the lease expires. (Such a provision would effectively give the asset's salvage value to the lessee.)
6. Any portion of the lease payment is designated as interest.

A lease may also not qualify as a true lease for tax purposes if

1. The agreement includes a so-called hell-or-high-water clause that obliges the lessee to make any payments regardless of what happens to the lessor or the equipment.

2. The agreement limits the lessee's right to issue debt or pay dividends while the lease is in force.

3. The equipment has limited use – for example, a machine which is custom-designed for the lessee and which therefore has scant secondhand value.