LEASING MEDICAL EQUIPMENT?

It's as Easy as ABC.

By Edward G. Detwiler, ASA

The pleasantries of a newly signed lease often include smiles, handshakes, and conversation describing an agreement in which both sides feel mutually satisfied. Yet, five years and a dispute or two later, many lessors and lessees are ending their lease on unpleasant terms. Why? Unforeseen and undiscussed contract terms surface, causing hard feelings and resentment to build on both sides.

Therefore, it is important to understand the rules of the leasing game to prevent such disputes or, at least, to bring them to the surface <u>before</u> the lease is signed. Although some misunderstandings cannot be avoided, many can when a lease is properly understood, read, and negotiated. Warning: there *are* deals that are too good to be true. However, by considering some basics about leasing, and then progressing to more complex issues, you'll be able to make better leasing decisions for yourself.

<u>The Basics</u>

Leasing is a business. The lease company is in business to make a profit for its investors. If a lease company does not make a reasonable return on investments, investors find other investment opportunities that they feel will bring them greater financial rewards. On an individual lease basis, lease companies have a target internal rate of return. If they are faced with negotiating a lease at less than this rate, there must be compelling reasons to do so.

Leasing is a tool to be considered in any capital equipment acquisition, along with other methods of financing. There are potential tax benefits that can be enjoyed by the lessor or lessee, depending on the need for such benefits. These tax benefits can outweigh variations in the basic quoted rates and should be carefully studied. Lease contracting is a complex issue. Leases take on many forms with the intention of meeting the needs of a variety of lessors and lessees, while remaining competitive with other leases and with other forms of financing. A careful review of leases will consider more than just a simple monthly payment plan for the term. Actual rates can be lowered by paying quarterly instead of monthly or by a variety of prepayment plans. New business or service budgets can be eased by negotiating lower payments in the early part of the term. As payments inflate over time, revenues will hopefully increase as well to offset payment increases. While this generally results in greater interest, it may make equipment acquisitions possible, where other financing methods would not be feasible.

The Lessors

More and more medical facilities (hospitals, imaging centers, radiation therapy centers, lithotripsy and surgery centers and primary care physicians' offices) are turning to leasing. This move is not only a way of meeting financial needs, but now has been legislated as one of the "safe harbors" under the Omnibus Budget Reconciliation Act of 1993 (OBRA), which includes expanded physician self-referral rules commonly referred to as "Stark II."

In many industries, leasing has become the nation's preferred way to finance capital equipment. This is because leases can be tailored to satisfy many different needs. There is no one lease form that is right for all, and there are few standards, except those written by the Financial Accounting Standards Board, commonly referred to as "FASB-13" and used by the Internal Revenue Service, to determine the type of lease and who can take advantage of certain tax benefits.

Medical equipment acquisitions have slowed considerably under health care reform. Lease companies are merging, consolidating or dropping out of the medical business altogether. The highly competitive and aggressive ones left are offering leases with a variety of payment options, end-of-lease options, and other tailored features.

Who Has the Upper Hand?

The typical lease company writes several lease proposals a day, while the typical department manager or chief financial officer is likely to see leases only occasionally. Lease companies, striving for a competitive edge, frequently offer leases containing terminology foreign to the lessee. This terminology is not necessarily intended to confuse the issue, but an attempt to meet the needs of the lessee while still maintaining the profit objectives of the lessor. Here are some common terms and explanations:

The True Lease

In a true lease situation, the lessee typically contracts to use equipment during the major part of its useful life. The lessee will usually obtain an option to purchase the asset at its fair market value at termination of the contract. This lease is noncancellable. The lease company usually recoups most of its investment in the equipment during the contract period. The profit risk in the true lease is in the forecast and realization of the residual, or fair market value, of the equipment at the end of the lease. True leases are usually of the net variety in which:

- the lease payments during the basic term of the lease are calculated to cover the debt service, or most of the total cost related to the equipment, plus a profit, and
- The lessee pays all property taxes, sales taxes, use taxes, fees, maintenance, insurance, etc., and assumes all liabilities connected with the use of the asset.

Many leases written by the major equipment manufacturers do include service and other costs involved in the operation of the equipment. The advantage of this type of lease is that lease payments are fixed (all inclusive payments) over the term. The disadvantage is that it is often difficult to sort out the various costs in order to compare this type of lease with a non-maintenance lease plus a service contract. Another potential disadvantage is that no reasonable options are available if the manufacturer does not provide the level of service needed to properly operate the equipment. This part of the decision is technical, not financial, and must be considered by those responsible for the availability of the equipment for its use.

Options at Termination

Upon termination of the lease contract, the equipment is technically owned by the lessor. True leases frequently include a purchase option, a provision which grants the lessee the right to purchase the equipment at its then fair market value, and stipulates the method in which that figure will be determined.

In some cases, separate appraisers for the lessor and the lessee agree on a fair market value. Should a dispute arise, a third-party appraiser or arbitrator may determine the asset value (this usually occurs only in substantial transactions). If the lessee does not wish to purchase the asset but would rather continue to lease it, the lessor may then negotiate a new lease based on the estimated fair market value and remaining economic life at the time of renegotiation, unless the amount was negotiated at the time the lease was signed. As a final alternative, the lessor may sell the asset to another party, usually at far less than the fair market value.

Much of the attraction of a "true" lease stems from the lessor's desire to enjoy the tax benefits of ownership, which accrue to a lessor. To realize these advantages, it is essential that the IRS considers the contract to be a true lease and not a conditional sale or installment sale contract. In general, the IRS looks for four basic characteristics set forth in FASB-13 to distinguish a true lease from a conditional sale contract or any other lease form.

It is not a true lease if:

- The lease transfers ownership of the property to the lessee by the end of the lease term;
- The lease contains an option to purchase the leased property at a bargain price;

- The lease term is equal to or greater than 75 percent of the estimated economic life of the leased property; and/or
- The present value of the rental and other minimum lease payments equals or exceeds 90 percent of the fair value of the leased property, less any investment tax credit retained by the lessor.

New ending for Part One:

Leasing medical equipment has become more than a trend in the medical field. Understanding what motivates the lessors, what constitutes a true lease, and what options are available for upgrading leased equipment or renegotiating a contract, is critical to this industry.

SUGGESTED OPENING PARAGRAPH FOR BEGINNING OF PART TWO:

In last month's column we described the true lease and continued with the need for determining an asset's fair market value when a lease is terminated.

Appraisals

The most common use of appraisers is in conjunction with true lease expirations. The IRS requires that the equipment, if being sold to the current lessee, be sold at a price determined as the then current fair market value of the equipment. The IRS guidelines give only a very basic definition for fair market value, which is the old real estate definition of value. Many leasing companies have modified the specific definition to try to more clearly define the concept of value required, often changing it to suit their needs. For this reason, I have come to the conclusion that the half-life of a Chief Financial Officer (CFO) is the length of his or her first true lease.

Independent appraisers cannot act as advocates for any client. This means that they must arrive at the same conclusion of value for a client whether that client is a lessor or lessee. In fact, they perform valuation services for both the lessor and the lessee and sometimes work as arbitrators, settling disputes that usually occur at the end of a lease contract, or when substantial upgrades need to be made during the term.

Definitions of value that have been generally accepted by the appraisal profession and adopted by both the American Society of Appraisers and the Appraisal Foundation are as follows:

Fair Market Value

Fair market value is the amount expressed in money, as of a certain date, that may be expected to to be exchanged between a willing buyer and a willing seller, with equity to both, neither under any compulsion to buy or sell, and both fully aware of all relevant facts.

Fair Market Value In Place And In Use

The fair market value in place and in use of an item includes the installation and the contribution of the item to the operating facility. This value presupposes the continued usage of the item in conjunction with all other installed items.

Some leases contain the preceding definition, followed by "...as determined by lessor." If there is any possibility that the equipment will be purchased at the end of the term, or re-leased at its then fair market value, the wording of this definition and its method of implementation is crucial.

Orderly Liquidation Value

If, at the end of the term of a true lease, the lessee elects to return the equipment, the lessor must find a new home for it. Not only is this costly to the lessee (who must usually pay for the de-installation and return of equipment) but it is also costly to the lessor, who must bear the cost of selling the equipment. Some lease companies have the ability to recondition, re-sell, and re-install the equipment, but most face the prospect of selling the equipment "as is" on the wholesale or broker market. This last option is costly to the lessor, as it usually means that the lessor must realize much less than the residual value projected when the lease was originated.

Care and Return of Equipment

A clause concerning the care and return of equipment is always included in the lease. The intent is usually to ensure that the equipment will be properly maintained during the lease term and will be returned in reasonable condition. A careful reading of these statements can reveal potential future problems. I was once asked by a hospital to intervene when it could not negotiate a fair market value buy-out price. In this case, no provisions were made for disputes, and the return provision required that the equipment be returned in its original condition and configuration. All upgrades had to be removed, downgrading the equipment at a great expense to the hospital lessee (who won't be leasing from that company again).

Residual Value Appraisals

Lastly, when determining lease rates for proposals and in valuing portfolios, lease companies writing true leases will usually obtain a forecast of residual value to be realized at the time of lease termination. Residual value is nothing more than an educated guess of an asset's future fair market value.

Forecasting an asset's residual value allows lease companies to base their profits on that made in payments as well as the profit realized from the residual value at the termination of a lease. When lease companies guess low, they make more money; if they guess too high, they lose.

In addition to the true lease, there are other available options for financing medical equipment. The type of financing best for a facility depends on its appetite for rapidly changing technology and its tax status.

The Finance Lease

This is a form of leasing that provides the lessor with full title rights to the asset, but is realistically considered a "conditional sales contract" by the IRS. The taxable income attributable to the lessor is computed to be the rental income, less the interest factor in the total payment, and the operating and interest expenses.

One advantage (or disadvantage) of the finance lease can be in the form of fixed payments over the term, whereas most bank commercial financing is done at a rate floating with the prime rate. If the prime rate is very low at the time the lease is written, this lease usually fixes that rate; although there are some variations available here.

A finance lease is invariably a full-payout type and the lessee can, under these conditions, acquire the asset at the expiration of the lease period, usually for one dollar. These types of leases are generally more liberal in their adaptations and available options such as renewals, upgrades, and outright purchase plans.

Another feature of the finance lease is that the lessee, not the lessor, has the right of depreciation. The decision here must include thorough tax consultation, as the lessor will typically need a higher rate to offset the depreciation tax deduction available in a true lease.

The Installment Sales Contract

This is really nothing more than a time-payment-purchase plan. We do not even use the terms "lessor" and "lessee" in this category, but substitute the terms "buyer" and "seller." As such, a buyer purchases an asset from the seller (manufacturer, dealer, etc.) and agrees to pay for the asset over an extended period of time. This generally includes an interest cost built into the original purchase price. The title rights of an asset remain with the seller until the buyer has met all of the terms of the sales contract, including the total payment costs (at which time the title passes to the buyer). It is also the kind of contract that specifically provides for the title to pass to the buyer upon completion of the term, sometimes with additional or balloon payments at the expiration of the term.

SUGGESTED PAT ENDING:

This concludes a two-part series discussing basic terms and information for financing and leasing medical equipment. For further questions regarding this topic, please contact Edward G. Detwiler, president of Edward G. Detwiler & Associates, Ltd. in Schaumburg, Ill. at (800) 995-9003. Detwiler & Associates, Ltd. specializes in appraisals of high value and high technology medical products and in practice mergers and acquisitions.

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