“TRUE LEASE” OR SECURITY AGREEMENT

The information in this advisory will assist counties in distinguishing a “true lease” from a security agreement. This distinction is necessary to determine the ownership of personal property when the lessee is a government entity or a nonprofit organization that may be entitled to an exemption. This distinction is also important because the owner of personal property is the “taxpayer” when non-exempt parties are involved in the lease. A lease intended to be a security agreement is a financing arrangement in which the credit of the lessor is used by the lessee to finance the purchase of property. In the case of a “true lease,” the lessor (e.g., a leasing company) is typically the owner, while in the case of a security agreement, the lessee is the owner.

A lease intended as a security agreement transfers substantial ownership of the property to the lessee and, in most instances, requires the lessee to pay personal property taxes. A true lease does not transfer ownership, and the personal property taxes remain the responsibility of the lessor (owner). A 1981 Court of Appeals case\(^1\) sets forth a number of factors for determining whether an agreement was intended to be a true lease or security agreement. These factors include, but are not limited to, whether:

1. The lessee is given an option to purchase the equipment, and, if so, whether the option price is nominal;
2. The lessee acquires any equity in the equipment;
3. The lessee is required to bear the entire risk of loss;
4. The lessee is required to pay all charges and taxes imposed on ownership;
5. There is a provision for acceleration of rent payments; and
6. The property was purchased specifically for lease to this lessee.

The court went on to discuss each of these factors. The first factor recognizes that there may be a true lease with an option to purchase; in other words, the parties do not intend to have a financing agreement.

However, if the lessee is allowed to purchase the property “for no or only nominal consideration” at the end of the lease or at some other specific time, then the lease is intended as a security agreement. Nominal consideration may be $1 or may be relative to the value of the property. For example, consideration of $1,000 for a machine worth $10,000 would be minimal. Cases from other jurisdictions have held that a nominal amount is less than 25 percent of the fair market value of the purchase price at the time of the option. On the other hand, if the purchase option price is approximately equal to the market value of the property at the time the option is exercised, the lease is likely a true lease.

The second factor described by the court arises when the lessee acquires an enforceable ownership interest in the property. This can happen when, by crediting earlier payments of rent to the purchase price, the lessee is accorded an equity or pecuniary interest in the subject matter of the lease that the lessee may recover at the lessee’s option.

Factors 3, 4, and 5 are also to be considered, but the court cautioned that costs associated with the risk of loss, insurance, taxes, and the like will be borne by one party or the other in most contracts, and the lessor is either going to include them in the rental charge or lower the lessee’s rent payment for the property. Rental payments that indicate an intention to compensate the lessor for loss of value over the term of the lease due to aging, wear, and obsolescence suggest that the parties intend a true lease.

The sixth factor arises when the leased property is purchased by the lessor specifically for lease to the lessee. This factor indicates that the transaction is a sale rather than a lease, because the property might not be suitable for another party or potential lessee. This factor is more important when the lessor is not the actual supplier of the leased property, since in that situation, the lessor would presumably be even less inclined to want the property returned.

Factors that have been considered by courts in other jurisdictions include whether the lessor disclaims all warranties and the lessee agrees to hold the lessor harmless from all liability associated with the leased property. Provisions such as these are indicative of a sale to the lessee rather than a true lease. Two additional factors to be considered are whether a security interest has been extended to other equipment of the lessee and whether the lessee treats the lease as a lease for tax purposes.

Whether a lease agreement constitutes a “true lease” or merely a disguised security agreement is determined by the intent of the parties as evidenced by the provisions of the agreement between them and, when necessary, by the facts and circumstances surrounding the transaction. The criteria as set out above will help to make this determination.

The lease agreement dealing with personal property leased to a government entity or a nonprofit organization must be read carefully to determine whether it is a true lease or a security agreement. Property that is the subject of a security agreement is considered to be owned by the lessee and, if a government entity is the lessee, the property would be entitled to exemption pursuant to the provisions of RCW 84.36.010.
The following are examples of true leases; therefore, the leasing company/lessor is the owner/taxpayer:

**True Lease #1**

Lessor: Farm machinery dealer

Lessee: Farmer

Title: Remains with leasing company during the period of rental.

Maintenance & Repair: Lessee is not responsible for normal wear and tear or depreciation.

Lessee is responsible for all risk of loss or damage.

Lessee is responsible for all taxes including personal property taxes.

Notes: This lease was not being depreciated on the taxpayer’s depreciation schedule and the provision for buyout (option to buy) was one additional annual lease payment.

**True Lease #2**

Lessor: Leasing company affiliated with a bank

Lessee: Farmer

Title: Title may pass to farmer at the end of the lease at farmer’s option.

Lessor is responsible for all taxes

Option to Purchase is 10 percent of the original cost of the property and is the residual value stated in the lease and not a nominal amount.

This could also be a security agreement. Some of these types of leases require that the lessee purchase the property at the end of the lease, and some of the leases do not. In either case, the purchase price is 10 percent of the original cost of the equipment. If the price is nominal, this may be regarded as a security agreement.