CLASSIFICATION AND SCORING OF FEDERAL LEASES

I. INTRODUCTION

The financial impact of every lease entered into by a Federal agency must be properly reflected in the agency's budget. The manner in which the lease is accounted for depends on whether the lease is classified as an operating lease, a capital lease, or lease-purchase. An *operating lease* represents temporary rental of general-purpose space without substantial recovery by the owner of construction or acquisition costs. A *capital lease* represents a rental of such long duration or high payment that all or most of the owner's construction or acquisition costs are in fact recovered during the term of the lease. And a *lease-purchase* includes leases in which ownership is to be transferred to the Government during or shortly after the end of the lease period, or if the Government has the option to purchase the property at a price that is less than fair market value.

It is important to note that in June 2005, the Office of Management and Budget issued an amendment to OMB Circular A-11, specifically mandating Federal agencies to submit to their OMB representatives for review of the scoring impact of a wide range of proposed leasing and financing activities (and must do so at the conceptual and planning stage). The list is a long one, but among them are:

(i) Any proposed lease of a capital asset where the total Government payments over the full term of the lease would exceed $50 million;

(ii) All financing proposals that are non-routine in nature involving leasebacks, public-private partnerships, third-party debt or Government guarantees, special-purpose assets for which there is no real private sector market, projects constructed or located on Government land, special tax status, conveyable lease options, and enhanced-use leases with annual payments exceeding $2.36 million in 2005, $2.41 million in 2006, or $2.60 million in 2007.

Part II of this document outlines the criteria by which real estate contract officers can determine whether a given lease is an operating lease, a capital lease, or a lease-purchase. Part III shows how the expenditures for each lease type are then counted towards the agency's budget over the term of the lease in accordance with the directives specified by the Office of Management and Budget. Part IV illustrates the year-by-year scoring assuming a hypothetical lease was respectively classified as an operating lease, a capital lease, or a lease-purchase. Part V contains a precise leasing questionnaire covering virtually every circumstance for the classification and scoring procedures of Federal leases.

Because of the often severe burden of the financial obligations involved, real estate contracting officers should avoid entering into capital leases and lease-purchases whenever and wherever possible. If this appears unavoidable, headquarters staff should be consulted to review the terms of the lease to see if it can possibly be restructured so as to meet the criteria of an operating lease and, if not: (1) perform or verify the complex budget authority scoring computations required under OMB Circular A-11, (2) determine whether budgetary resources are sufficient enough to meet the requirements of the scoring rules, and (3) if there are insufficient resources, either withdraw the proposal or postpone its submission to OMB for review and approval until they do become available.

PART II: CLASSIFICATION

Because such phrases as "long duration" and "high payment" are subjective, the Office of Management and Budget sets forth in OMB Circular A-11 the six criteria listed below to be used by Federal agencies in distinguishing between an operating lease, a capital lease, or a lease-purchase. If either of the first two criteria is not met, the lease is classified as a *lease-purchase.* If the first two criteria are met and one or more of the other four criteria listed below are not met, the lease is classified as a *capital lease*. If and only if all six criteria are met is a lease classified as an *operating lease.*

1. Ownership of the asset remains with the lessor during the term of the lease and is not transferred to the Government at or shortly after the end of the lease term.

2. The lease does not contain a bargain-price purchase option.

3. The lease term does not exceed 75 percent of the estimated economic life of the asset.

4. The present value of the minimum lease payments over the life of the lease does not exceed 90 percent of the fair market value of the asset at the beginning of the lease term.

5. The asset is a general purpose asset rather than for a special purpose of the Federal government and is not built to unique specification of the Government as lessee.

6. There is a private sector market for the asset.

Although the foregoing criteria are simply stated, additional clarification is needed in order to apply them.

(a) For purposes of the 90 percent test, the *minimum lease payment* is the annual net rent (full service rent less all fixed and operating expenses) and specifically does not include real estate taxes. The discount rate to be used in doing the present value computations is specified in the annual update to Appendix C of OMB Circular A-94, as typically published each February. Discount rates are specified for terms of 3, 5, 7, 10, and 30 years, and are used over the next 12 months independent of interest rate fluctuations. Discount rates for lease terms other than 3, 5, 7, 10, and 30 years are established through straight-forward interpolation. The lease term used in performing the 90 percent test is to include the firm term of the lease plus all options and extensions.

(b) Any project constructed or located on Government land is presumed to be for a special purpose of the Government, and is therefore ineligible for classification as an operating lease. However, as part of the 2003 amendment to OMB Circular A-11, if the Government ground leases property to a non-Federal party and then subsequently leases back the improvements, the leaseback may be treated as an operating lease if it otherwise meets the criteria for an operating lease.

(c) The test for bargain-price purchase options contains no time restrictions as to when the option might be exercised, whether prior to or years after the expiration of the lease. This can be particularly problematical in situations where the improvements themselves are leased for, say, 20 years, but then revert to the Government at little or no cost upon expiration of an associated ground lease after 50 years or so.

PART III: SCORING

Whether the lease is classified as an operating lease, capital lease, or lease-purchase, the Government's financial obligations under that lease must be accounted for in the agency's budget over the lease term involved. Although a lease may call for uniform payments over its entire term, depending on its classification and other factors, the impact of that lease on the agency's budget authority over the term of the lease can be far from uniform. *Budget authority* is the technical term for the authority provided by Federal law to incur financial obligations. Whether on a line-item or aggregated basis, annual budget authority is then compared against the legislative spending caps imposed by congressionally mandated appropriations. Should these spending caps be exceeded, an *authorizations breach* will have occurred. *Outlays* is the technical term that reflects the projected annual amounts paid or imputed interest borrowed to finance the project. The process by which the financial obligations under the lease are counted against budget authority and outlays is called *scoring*.

A. Scoring Operating Leases

It is important to note that operating leases are not automatically scored in accordance to their payment schedules over the term of the lease. Only if the lease contains a cancellation clause is budget authority scored annually in accordance with its lease payment schedule. Although not spelled out in OMB Circular A-11, cancellable operating leases have historically included those that (a) can be cancelled at will or for monetary compensation, (b) are subject to annual appropriation, or (c) can be terminated if the leased space no longer meets the specified needs of the Government. If the lease can be cancelled for monetary compensation (called liquidated damages), budget authority is scored annually, with additional budget authority in the amount of the potential liquidated damages scored up-front.

If the lease does not contain a cancellation clause, the full (undiscounted) amount of the minimum lease payments is scored up-front in its entirety. It is to be emphasized that for scoring purposes, the minimum lease payment includes real estate taxes as well as the net rent. Note, however, that operating leases that are paid from funds that are self-insuring under existing authority, whether cancellable or not, are scored year-to-year in the amount of the annual lease payment. Funds that are self-insuring include, for example, the Federal Buildings Fund administered by the GSA and the Airport and Airway Trust Fund administered by the FAA.

For operating leases with or without cancellation clauses, outlays are recorded over the lease term in an amount equal to the annual lease payments.

B. Scoring Capital Leases

A capital lease is scored on its very first day in an amount equal to the present value of the agency's minimum lease payments (net rent and real estate taxes) over the term of the lease, using the appropriate discount rate in Appendix C to OMB Circular A-94. The present value figure calculated in this manner is called the ***asset cost***. Additional score is assigned each year in an amount equal to the Treasury's cost of financing the asset cost on an annual basis over the term of the lease. To calculate this cost of financing, the asset cost is amortized over the term of the lease at an interest rate that is equal to the discount rate. The interest component of this amortization schedule, called the ***imputed interest***, becomes the additional budget authority involved. Thus, the first year's score of a capital lease which commenced on October 1st is the sum of the asset cost, and the first year's worth of imputed interest and operating expenses.

For capital leases, outlays are recorded over the lease term in an amount equal to the annual lease payments.

C. Scoring Lease-Purchases

The scoring for a lease-purchase follows the same formula as prescribed above for a capital lease. For lease-purchases in which the private-sector lessor bears substantial risk, outlays are recorded over the lease term in an amount equal to the annual lease payments.
For lease-purchases in which the ownership risk is shifted to the Government (because, for example, the Government provides the land or financing, or explicitly guarantees third-party financing), outlays are recorded in a manner that closely follows the scoring formula for budget authority: the asset cost is distributed over the construction period (instead of all up front), and imputed interest on that asset cost distributed over the term of the lease.

D. Scoring Services and Utilities

Services and utilities are always scored on an annual basis over the term of the lease.

PART IV: CASE EXAMPLES

Consider a full-service lease calling for an annual rent payment of $400,000 for five years. Of this amount, $300,000 is the net rent, $25,000 is for real estate taxes, and $75,000 is for operating expenses. Suppose the 5-year Treasury rate is 6 percent and that the lease goes into effect on October 1st, the first day of the fiscal year. The cases below show how this lease would be scored assuming it was classified as (1) a non-cancellable operating lease, (2) a cancellable operating lease, and (3) a capital lease (or lease-purchase)

Case 1. Non-Cancellable Operating Lease

The budget authority for a non-cancellable operating lease is scored on day one of the lease with regard to net rent and real estate taxes, as shown in Table 1.

TABLE 1: BUDGET AUTHORITY FOR A NON-CANCELLABLE OPERATING LEASE

Year	Outlays (Payments)	Budget Authority			
		Net Rent	R.E. Taxes	Operating	Total Score
Day 1	-	$1,500,000	$125,000	-	$1,625,000
1	$400,000	-	-	$75,000	$75,000
2	$400,000	-	-	$75,000	$75,000
3	$400,000	-	-	$75,000	$75,000
4	$400,000	-	-	$75,000	$75,000
5	$400,000	-	-	$75,000	$75,000
Totals	$2,000,000	$1,500,000	$125,000	$375,000	$2,000,000

Case 2. Cancellable Operating Lease

The budget authority for the cancellable operating lease is scored in accordance with the annual lease payments, as shown in Table 2.

TABLE 2: BUDGET AUTHORITY FOR A CANCELLABLE OPERATING LEASE

Year	Outlays (Payments)	Budget Authority			
		Net Rent	R.E. Taxes	Operating	Total Score
1	$400,000	$300,000	$25,000	$75,000	$400,000
2	$400,000	$300,000	$25,000	$75,000	$400,000
3	$400,000	$300,000	$25,000	$75,000	$400,000
4	$400,000	$300,000	$25,000	$75,000	$400,000
5	$400,000	$300,000	$25,000	$75,000	$400,000
Totals	$2,000,000	$1,500,000	$125,000	$375,000	$2,000,000

Case 3. Capital Lease (or Lease-Purchase)

The budget authority for a capital lease is scored on its very first day in an amount equal to the present value of the minimum rent (net rent and real estate taxes), called the asset cost. As shown in the table below, the asset cost for the capital lease is $1,369,018 at the discount rate of 6 percent. The asset cost of $1,369,018 is then amortized over the 5 years of the lease term at the same rate of 6 percent. The interest component of this amortization schedule, called the *imputed interest*, becomes the additional budget authority involved. The first year's score of a capital lease which commenced on October 1st is thus the sum of the asset cost of $1,369,018 plus the first year's worth of imputed interest of $82,141 and operating expenses of 75,000, or $1,526,159. The total budget authority calculated in this manner again sums to the total leasing payments of $2 million.

TABLE 3: BUDGET AUTHORITY FOR A CAPITAL LEASE (OR LEASE-PURCHASE)

Year	Minimum Rent	Discount Factor	Discounted Rent	Principal Payment	Imputed Interest	Operating Expense	Total Score
Day 1	-	1.000000	-	-	-	-	$1,369,018
1	$325,000	0.943396	$306,604	$242,859	$82,141	$75,000	$157,141
2	$325,000	0.889996	$289,249	$257,430	$67,570	$75,000	$142,570
3	$325,000	0.839619	$272,876	$272,876	$52,124	$75,000	$127,124
4	$325,000	0.792094	$257,430	$289,249	$35,751	$75,000	$110,751
5	$325,000	0.747258	$242,859	$306,604	$18,396	$75,000	$93,396
Totals	$1,625,000		$1,369,018	$1,369,018	$255,982	$375,000	$2,000,000

PART V: LEASING QUESTIONNAIRE

There are essentially just ten questions which determine whether a lease is classified as an operating lease, a capital lease, or lease-purchase. From this information, the scoring matrix can be set up for both budget authority and outlays.

LEASING QUESTIONNAIRE

Project Name: _________________________ Location: __________________________

Annual Lease Payment: ____________ Lease Term: ______ Total Lease: ___________

Prepared by: ___________________________ Date: ________________

Approved by: ___________________________ Date: ________________

A. Checklist

1. □Yes □No Does ownership transfer to the Government at any time during or shortly after the end of the lease term?

2. □Yes □No Does the lease contain a bargain-price purchase option (i.e., where the purchase price would be less than the Fair Market Value at the time of exercise)?

3. □Yes □No Does the lease term exceed 75% of the estimated economic life of the asset? (Use the worksheet in Section D below to establish the answer.)

4. □Yes □No Does the present value of the minimum lease payments over the life of the lease exceed 90% of the fair market value of the asset at the beginning of the lease term? (Use the worksheet in Section E below to establish the answer.)

5. □Yes □No Is the leased asset a special- rather than general-purpose asset?

6. □Yes □No Is the leased asset built to unique specification of the Government?

7. □Yes □No Is there a private sector market for the asset?

8. □Yes □No Is the leased asset built on Federal government land? If the answer is "No," skip Line 9 and go to Line 10.

9. □Yes □No Is the land ground leased to a totally non-Federal party and the subsequent improvements leased back to the Federal government?

10. □Yes □No Is there any provision for Government financing or explicit Government guarantee of third-party financing?

B. Classification

11. If either Line 1 or Line 2 is a “Yes,” the lease is a ***lease-purchase***. Skip Lines 12 to 16, and check Box “C” in Line 17.

12. If any answer in Lines 3 through 6 is a “Yes,” the lease is a *capital lease*. Skip Lines 13 to 16, and check Box “B” in Line 17.

13. If Line 7 is a “No,” the lease is a *capital lease*. Skip Lines 14 to 16, and check Box “B” in Line 17.

14. If Line 8 is a “Yes,” and Line 9 is a “No,” the lease is a *capital lease*. Skip Lines 15 to 16, and check Box “B” in Line 17.

15. If Lines 1 through 6 are all “No,” Line 7 is a “Yes,” and Line 8 is a “No,” the lease is an *operating lease*. Skip Line 16, and check Box “A” in Line 17.

16. If Lines 1 through 6 are all “No,” and Lines 7 through 9 are all “Yes,” the lease is an *operating lease*. Check Box “A” in Line 17.

17. □A. Operating Lease □B. Capital Lease □C. Lease-Purchase

C. Scoring Considerations

18. □Yes □No Does the lease contain any type of termination or cancellation clause? If “Yes,” indicate which clause(s) apply:

(a) □Yes □No Can the lease be cancelled at will by the Government?

(b) □Yes □No Can the lease be terminated for cause (e.g., low traffic counts)?

(c) □Yes □No Is the lease made subject to annual appropriations?

(d) □Yes □No Can the lease be cancelled for monetary compensation? If so, enter the amount of the liquidated damages specified: ___________

19. If the lease is a *cancellable operating lease without liquidated damages* (Box 17A is checked, Line 18 is a “Yes,” and Line 18(d) is a “No”), budget authority and outlays are scored annually. Enter zeros in Lines 25 and 27, and enter the annual amount of the minimum lease payment and real estate taxes in Lines 26 and 28.

20. If the lease is a *cancellable operating lease with liquidated damages* (Box 17A is checked, Line 18 is a “Yes,” and Line 18(d) is a “Yes”), budget authority and outlays are scored annually, with additional budget authority in the amount of the potential liquidated damages scored up-front. Enter the annual amount of the minimum lease payment (net

rent and real estate taxes) in Lines 26 and 28, and enter in Lines 25 and 27 the amount of potential liquidated damages specified in Line 18(d).

21. If the lease is a *non-cancellable operating lease* (Box 17A is checked and Line 18 is a "No"), budget authority is to be scored up-front in its entirety (and outlays annually). Enter the full (undiscounted) amount of the minimum lease payments (net rent and real estate taxes) over the term of the lease in Line 25, and zeros in Lines 26 and Lines 27. Enter the annual amount of the minimum lease payment (net rent and real estate taxes) in Line 28.

22. If the lease is a *capital lease* (Box 17B is checked), budget authority in an amount equal to the present value of the minimum lease payments over the term of the lease is to be scored up-front (but outlays annually). Enter the present value of the minimum lease payments (net rent and real estate taxes) over the term of the lease in Line 25. Enter zero in Line 27, and enter the annual amount of the minimum lease payment (net rent and real estate taxes) in Line 28. In lieu of Line 26, attach a spreadsheet showing the imputed interest over the term of the capital lease reflecting the budget authority in the out years of the lease.

23. If the lease is a *lease-purchase without substantial private risk* (Box 17C is checked and Line 10 is "Yes"), budget authority is scored in the same manner as for capital leases, and outlays are essentially identical to budget authority. Enter the present value of the minimum lease payments (net rent and real estate taxes) over the term of the lease in Lines 25 and 27. In lieu of Lines 26 and 28, attach a spreadsheet showing the imputed interest over the term of the lease-purchase in the out years of the lease.

24. If the lease is a *lease-purchase with substantial private risk* (Box 17C is checked and Line 10 is "No"), budget authority and outlays are scored in exactly the same way as for capital leases. Enter the present value of the minimum lease payments (net rent and real estate taxes) over the term of the lease in Line 25. Enter zero in Line 27, and enter the annual amount of the minimum lease payment (net rent and real estate taxes) in Line 28. In lieu of Line 26, attach a spreadsheet showing the imputed interest over the term of the lease-purchase reflecting the budget authority in the out years of the lease.

25. Budget Authority to be scored up-front: ____________________

26. Budget Authority to be scored annually: ____________________

27. Outlays to be scored up-front: ____________________

28. Outlays to be scored annually: ____________________

D. Worksheet for the 75% Test

Step 1: Enter Basic Lease Term in Years: ________________

Add Option Period(s) if any: ________________

Overall Lease Term in Years: ________________

Step 2: Enter the Estimated Economic Life of the Asset ________________

Multiply the Estimated Economic Life by .75 ________________

Step 3: If the Overall Lease Term from Step 1 is greater than the result in Step 2, enter "Yes" in Line 3. If the result of Step 1 is less than or equal to the result in Step 2, enter "No" in Line 3.

E. Worksheet for the 90% Test

Step 1: Enter Annual Full-Service Rent: ________________

Less: Service, Utilities and Reserves included in the Rent: ________________

Less: Real Estate Taxes included in the Rent: ________________

Annual Net Rent: ________________

Step 2: Enter the Overall Lease Term from Section D, Step1: ________________

Enter the appropriate Discount Rate: ________________

Step 3: Determine the Present Value Factor for that Discount Rate: ________________

Step 4: Enter the annual Net Rent from Step 1: ________________

Multiply by the Present Value Factor from Step 3 (this is the Present value of the Minimum Lease Payments): ________________

Step 5: Enter the Fair Market Value of the Leased Space: ________________

Multiply the above by .90 ________________

Step 6: If the result of Step 4 is greater than the result in Step 5, enter "Yes" in Line 4. If the result of Step 4 is less than or equal to the result in Step 5, enter "No" in Line 4.