An investment alternative:

municipal, commercial and federal lease obligations

By Lance Dominique

What does a municipality do when it needs equipment but does not want to purchase it for cash, rent it or issue bonds? It issues what is referred to as a municipal lease/purchase obligation.

Municipal lease/purchase financing is a form of tax-exempt financing often used by municipalities or other government entities that want to finance equipment over time. By making installment payments over usually a two to five-year period, occasionally six to 15, the municipality is able to purchase needed equipment and real estate. The types of equipment financed range from fire trucks to software.

There are several reasons why a municipality utilizes this kind of financing. Often the cost of the equipment being financed is not high enough to justify the expense of a municipal bond issue. Municipal lease/purchase financing terms take into the consideration the useful life of the equipment.

This type of financing also allows a municipality to acquire equipment when it is needed. Municipal lease/purchase financing can be completed in much less time than it takes for a bond issue.

Also the municipality is able to avoid creating debt, since this type of financing is a line-item expense. Each payment consists of principal and interest. By the end of the term the municipality owns the equipment outright, its last payment being for a dollar.

As with most types of financings, a tax-exempt loan/investment product is created as a result of municipal lease/purchase financing. That is the tax-exempt municipal lease/purchase obligation – or more accurately named the municipal installment purchase agreement. The latter is more accurate since this is not a true lease but an installment loan.

Due to this product's structure, it carries a high tax-exempt yield and short maturity. This unique and straightforward loan/investment is invested in by institutional and individual investors. As mentioned earlier, two to five-year terms are most common. Municipal leases are often originated in bank-eligible form and thus are treated favorably under TEFRA.

When a commercial credit, such as a private or public company, wants to finance its equipment needs, it utilizes what is referred to as a commercial lease financing. Entities ranging from medical practices to industrial and high-tech companies have utilized this form of financing for decades. A majority of the finance terms are two to five years, with usually a monthly principal and interest payment structure.

The product created with this form of financing is a commercial lease obligation. As with the municipal lease, investors generate their yields with the return of principal and interest in most cases, although sometimes there other tax advantages when the structure becomes more complex. In a large percentage of financings the commercial credit will own the equipment at the end of the term. In certain cases the financing may be structured with a "fair market value" (usually 10 percent), whereby the commercial credit must pay this off before being able to take ownership. The fair market value or residual payment does not have to be made if the intention is to not own the equipment at term's end.

Federal lease obligations are loans to federal government agencies or departments that want to acquire essential equipment over usually a two to five-year term. The departments that utilize this type of financing range from the United States Department of Agriculture to veterans' hospitals.

This type of financing has been around since World War II when large equipment needs existed. Ever since it has been a common method utilized to procure essential equipment for the federal government. The types of equipment financed range from telephone systems to medical equipment and modular buildings, among others.

The question of whether these are true leases or loans does arise. They can be structured as true leases or loans depending on how the government wants to finance the equipment. If it wants to own the equipment at term's end the government enters into a lease with intent to own financing or "LTOP." Under this structure the government makes the last payment for a dollar and owns the equipment outright.

If the government does not want to own the equipment at the end of the term it enters into a lease with the option to purchase financing, referred to as "LWOP" or a true rental structure. With a true rental structure the government has no desire to build equity, unlike a lease with the option to purchase financing where the equipment can be purchased term's end for usually a 10 percent residual payment.

As with the other forms of financing mentioned earlier, an investment vehicle is created called a federal lease obligation. Federal leases are two to five-year loans to the various federal agencies and departments that offer generous yields to investors and pay back principal and interest during the term, almost always monthly. Whether it is a municipal, commercial or federal lease obligation, community banks generate their expected yields with the return of principal and interest alone. Residual payments are not needed for investors to generate their returns.

Like municipal and commercial leases, federal lease obligations are invested in by community banks, insurance companies and individual investors. Since the credit is an agency or department of Uncle Sam, bank examiners review them favorably, as they should with municipal and commercial lease obligations. **BN**

Lance Dominique is principal of Dominique & Associates in Barrington, Ill.