PP-O4-11 LEASE OF EQUIPMENT

I. OVERVIEW

Equipment may be procured through a lease or lease-purchase transaction in accordance with Education Code section 81550.

A lease of equipment occurs for a fixed term of greater than one year, up to 10 years. Agreements for one year or less are considered rentals. Leases for longer than 10 years are legally prohibited under the Education Code.

All leases, regardless of the underlying dollar value of the equipment or furnishings, are handled by the Contracts and Purchasing Section at the District Office. Rental agreements (i.e., agreements with terms of one year or less) in which the sum of the rental payments is less than the statutory bid threshold are transacted by the colleges or by the College Procurement Specialist. Rental agreements in which the sum of the rental payments exceed the bid threshold are handled by the Contracts and Purchasing Section.

In a lease transaction, the supplier or assignee maintains title ownership to the equipment, but the lessee has physical possession of the equipment throughout the lease period. In a lease-purchase, the lessee has the option of purchasing the equipment before the lease ends.

A lease for equipment is entered into the finance and procurement database as an RFC document type.

II. PROCESS

A. Leasing vs. Purchasing

Leasing is a method of acquiring use of equipment for a specified period of time without the intent of owning it. In a lease-purchase, the user has the option to buy the equipment before the lease expires.

Leasing is an appropriate alternative to purchasing when the equipment sought has a short useful life. For example, computer equipment that becomes obsolete quickly due to rapidly evolving technology and the intent is to replace the equipment frequently. Leasing also may be used as a means of financing the acquisition and maintenance of expensive equipment over time. Since the cost of a lease includes financing and other charges not incurred in
a purchase, leasing is almost always more expensive than buying and should be used only when it offers clear advantages over purchasing the equipment outright.

B. Consultation

If the equipment requires electrical installation the purchase requestor must consult the Director of College Facilities to confirm that the desired item is appropriate and acceptable for use. Before procuring audio-visual or technology equipment, the requestor must consult the local information technology department to ensure the same.

C. Parties to a Lease

The party that leases the equipment to another is called the “lessor.” The party that leases the equipment from the lessor is called the “lessee.” Therefore, when acquiring equipment through a lease or lease-purchase, the District is the lessee.

In some transactions, the owner of the equipment may sell the title to the equipment to a third party, either before or after the lease commences. If done before the start of the lease, the third party becomes the lessor of the equipment at lease inception. If done after the lease commences, the transaction is known as an “assignment.” The party selling the equipment is called the “assignor” and the party receiving title is referred to as the “assignee.” At the conclusion of the assignment, the assignee becomes the lessor. Assignments also occur when the original lessor’s business is acquired by another entity. Generally, lease assignments may not occur without the prior notification from the lessor to the District and board approval is issued on the assignment.

The right of the lessor to assign its interest is a common provision in leases. It has a significant impact for the District, as lessee, because the supplier from which the equipment is originally acquired may not end up being the entity that services the lease and receives payments.

D. Lease Term

As noted above, agreements of one year or less are defined by the District as rental agreements rather than leases. Under Education
Code section 81552, an equipment lease is limited to a *maximum* term of 10 years or the useful life of the equipment, whichever is shorter. The following table provides general guidance on the useful life of various types of equipment that may be leased by the District.

<table>
<thead>
<tr>
<th>Equipment</th>
<th>Useful Life</th>
</tr>
</thead>
<tbody>
<tr>
<td>Furniture</td>
<td>7 years</td>
</tr>
<tr>
<td>Computers/other IT</td>
<td>3-5 years</td>
</tr>
<tr>
<td>Photocopiers</td>
<td>5 years</td>
</tr>
<tr>
<td>Vehicles (passenger)</td>
<td>5 years</td>
</tr>
</tbody>
</table>

*Useful life based on Government Accounting Standards Board (GASB) published figures.

Unlike real property (land and buildings), which tends to appreciate in value, equipment generally *depreciates*, or loses its value over time. Excessive wear and tear on the equipment can accelerate this process. One of the reasons for leasing instead of buying equipment is to not be left with an obsolete or fully depreciated asset at lease-end. For this reason, leases should be structured with a lease term that does not exceed the reasonable useful life of the equipment.

### E. Capital vs. Operating

A lease may be either a capital lease or an operating lease. Generally (although not always), a capital lease culminates in the purchase of the asset at lease-end, while an operating lease concludes with the return of the asset to the lessor.

If at its inception a lease meets one or more of the following criteria, the lease is a capital lease by the lessee. Otherwise, it is an operating lease.

1. The lease transfers ownership of the property to the District by the end of the lease term.
2. The lease contains a bargain purchase option, defined as a provision allowing the District, at its option, to purchase the leased property for a price which is sufficiently lower than the expected fair market value of the property at the date the option becomes exercisable such that the exercise of the option appears, at the inception of the lease, to be
reasonably assured. For example, an option to purchase a photocopier for $1 at the end of a (60) month term is a bargain purchase option.

3. The lease term is equal to 75 percent or more of the estimated economic life of the leased property. However, if the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, this criterion shall not be used for the purpose of classifying the lease.

4. The present value at the beginning of the lease term of the minimum lease payments, excluding that portion of the payments representing executory costs such as insurance, maintenance, and taxes to be paid by the lessor, including any profit thereon, equals or exceeds 90 percent of the excess of the fair market value of the leased property to the lessor at the inception of the lease over any related investment tax credit retained by the lessor and expected to be realized by the lessor.

A lessor shall compute the present value of the minimum lease payments using the interest rate implicit in the lease. The District, as lessee, shall compute the present value of the minimum lease payments using the incremental borrowing rate, unless (i) it is practicable for it to learn the implicit rate computed by the lessor and (ii) the implicit rate computed by the lessor is less than the lessee’s incremental borrowing rate. If both of those conditions are met, the lessee shall use the implicit rate.

Capital and operating leases are tracked by the Contracts and Purchasing Section. Information on capital and operating leases is provided annually by the District Office Accounting Department for fiscal year-end accounting purposes.

F. Negotiating Lease Terms

When negotiating a lease, particular attention should be paid to the following deal points:

1. **Purchase price**: Any lease begins with an assumption on the part of the lessor as to the value of the equipment as if it were to be sold to the lessee. Verify that this value is acceptable to the District.

2. **Lease term**: The length of the lease may not exceed the useful life of the equipment or 10 years, whichever is shorter.
For equipment that becomes obsolete quickly (e.g., computers), choose a lease term that corresponds to your timetable for changing out the equipment.

3. **Maintenance:** Determine whether the maintenance of the equipment is included in the lease payments or is handled separately outside the lease. For equipment that requires consumable supplies (e.g., photocopiers), ask whether these are included as part of maintenance. Establish whether maintenance services can be obtained from another vendor without invalidating the equipment warranty or violating the purchase agreement, or will maintenance by the equipment supplier be a requirement throughout the entirety of the lease term.

4. **Interest rate:** Leasing is inherently a method of financing the acquisition of equipment. Ask the lessor what the assumed interest rate is for the lease and compare that against market rates for similar transactions.

5. **Purchase option amount:** Capital leases typically specify the exact amount the lessee must pay at lease-end to buy the leased equipment. Add this amount to the sum of the payments over the lease term to determine if this is a fair amount to pay to own the equipment, finance charges and other lease expenses considered. For fair market value (FMV) leases, in which the lessor agrees to sell the equipment to the lessee at the FMV, ask what the lessor’s assumption is the FMV will be at lease-end.

6. **Exchange/trade:** Some leases include an option for the lessee to exchange or trade the leased equipment for a higher-end like-kind piece of equipment during the lease term. Ask if such an option exists in the lease, when it can be exercised, the amount of the credit to be given by the lessor for the value of the traded equipment, and any transaction expenses that would be charged for the exchange.

7. **Conditions for assignment:** Ask if the lessor has the unilateral right to assign the lease to a successor lessor and the effects of such an assignment on the rights and obligations of the parties. Refuse conditions whereby the new lessor (“assignee”) assumes all the rights of the original lessor but the District does not have the right to withhold lease payments to the new lessor for failure to perform.
When available, requestors must provide information on these deal points to the Contracts and Purchasing Section for inclusion in the lease agreement.

II. LEGAL AUTHORITY AND CITATIONS

Education Code section 81550 et.seq,
04-02 Types of Transactions
Administrative Regulations B-10