KS ADVISOR BLOG

How to Structure a Related Party Lease to Your Benefit

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Structuring a related party lease to your benefit involves careful consideration of various legal, financial, and tax implications. Organizations looking to structure leases under common control as short-term leases to avoid capitalization must adhere to specific accounting guidelines and principles. There are some key strategies that should be considered when structuring these leases.

A related party lease agreement should have the following elements clearly defined to ensure that it is legally sound and aligns with accounting standards:

1. **Clear Identification of Parties**: Clearly define the parties involved in the lease, including their relationship. This is essential for related party transactions.
2. **Lease Term, Payment, and Conditions**: Specify the duration of the lease, renewal options, and any conditions for termination. Outline the payment schedule, amounts, and any escalations or adjustment clauses. The lease term and conditions should all be consistent with market practices to avoid scrutiny under accounting standards. Lease payments should be set at fair market value to avoid the perception of hidden profits or losses.
3. **Detailed Description of the Leased Asset**: Clearly describe the leased property or equipment, including its condition and any limitations on its use.
4. **Maintenance and Repairs Responsibility**: Define who is responsible for maintenance and repairs (if applicable). This can affect the accounting treatment of the lease.
5. **Compliance with Laws and Accounting Standards**: The lease should be structured in compliance with relevant accounting standards like Accounting Standards Codification (ASC) 842. This includes recognizing operating or finance lease assets and liabilities on the balance sheet and providing necessary disclosures. Additionally, ensure the agreement complies with all relevant laws and regulations in the jurisdiction where the property is located.
6. **Disclosure Requirements**: Related party transactions must be adequately disclosed in financial statements, including the nature of the relationship and terms of the transactions.
7. **Conflict of Interest Policy**: Address any potential conflicts of interest, especially in closely held businesses or family-owned enterprises.
8. **Specifications**: Specify how the agreement can be amended for modifications, while also ensuring that modifications are in line with legal and accounting standards. Define a clear mechanism for resolving disputes that may arise during the lease term. It might be helpful for an independent board member or advisor to approve the lease to ensure fairness and compliance.

By addressing these elements, the lease agreement can be structured to be both legally sound and in compliance with accounting standards, reducing the risk of financial misstatement and legal complications.

Since beginning January 1, 2022, all companies (both public and private) need to comply with the guidance in ASC 842 when recording leases in conformance with generally accepted accounting principles (GAAP);

including leases under common control leasing arrangements. This generally means recording both a right-of-use (ROU) asset and a lease liability. The exception to that rule is when a lease qualifies as a short-term lease, in which case the monthly payments are recorded as rent expense and no asset or liability calculation is required. For some entities, it may be worthwhile to try and structure their leases under common control as short-term leases to avoid the additional administrative costs of capitalizing the leases. Below is a breakdown of the potential pros and cons of that decision:

Pros:

1. **Simplified Accounting**: Short-term leases typically require less complex accounting compared to long-term capitalized leases. They are often recorded as expenses on a straight-line basis over the lease term, avoiding the need to calculate and amortize the corresponding asset and liability over time.
2. **Improved Financial Ratios**: Since short-term leases are not capitalized, they do not appear as liabilities on the balance sheet. This can result in better-looking financial ratios, such as a better current ratio. Under ASC 842, any lease liability will have a short-term component, whereas the ROU asset will only be long-term. For entities with current ratio covenants, structuring a short-term lease might be advantageous for meeting financial covenants or presenting financial statements to investors or lenders.
3. **Greater Flexibility**: Short-term leases offer more flexibility, allowing businesses to adapt more quickly to changing market conditions or operational needs without being tied to long-term commitments.

Cons:

1. **Lack of Capitalization**: Short-term leases avoid needing to calculate the ROU asset and lease liability, which also means the ROU asset will not be recorded on the balance sheet. While ratios that include liabilities will improve due to this, ratios that include assets will potentially be hurt.
2. **Operational Inefficiencies**: Short-term leases that are expected to be renewed will require annual updates to the lease document.
3. **Perception of Instability**: Externally, a reliance on short-term leases might be perceived as a lack of stability or long-term planning, which could affect the analysis of lenders or investors.

The decision to implement short-term leases should also consider any tax and regulatory implications, which can vary depending on the jurisdiction and the specific terms of the lease.

If you do decide that structuring your common control lease as a short-term lease is beneficial, be sure to consider the following when structuring your lease agreement:

1. **In Writing**: According to ASC 842, the lease agreement must be in writing. While this is always recommended, in this case it is required.
2. **Defining Short-Term**: A short-term lease has a lease term of 12 months or less. Ensure that the lease term, including any options to extend, if reasonably certain to be exercised, stays within this timeframe.
3. **Extension Options**: If the lease includes an option to extend, and it is likely that the option will be exercised, the lease term is technically beyond 12 months and requires capitalization. Avoid including extension options or structure them in a way that they are not reasonably certain to be exercised.

4. **Lease Term Flexibility**: Consider structuring leases with the flexibility to terminate without significant penalty. This can help in keeping the lease term under the 12-month threshold.
5. **Consultation with Accounting Professionals**: It is crucial to consult with accounting professionals or legal advisors to ensure that the lease structure complies with relevant accounting standards and laws. They can provide guidance on how to structure these leases properly.
6. **Transparency in Financial Reporting**: Be transparent in financial reporting. Clearly disclose the nature of these leases in financial statements to avoid any misunderstandings of lenders or investors, or potential issues with auditors or other regulatory bodies.

Remember, while structuring leases as short-term to avoid capitalization is a legal accounting strategy, it should be done in compliance with all relevant laws and accounting standards. Any perception of manipulating lease terms to avoid financial reporting requirements can lead to complications.
Have questions or want to discuss more? Contact our team today.