Determination of Operating or Capital Lease Classification for Budget Scorekeeping Purposes

1. General.

   a. This policy, jointly issued by the Assistant Commissioners for Real Property Asset Management and Real Estate Acquisition, provides mandatory instructions for determining appropriate budget scorekeeping treatment, either as an operating or capital lease for every real property lease transaction, as required by Office of Management and Budget (OMB) Circular No. A-11, Appendix B. Regional Offices of Portfolio Management in coordination with the realty contracting officer must undertake all lease scoring evaluations and determine whether a lease should be treated as an operating lease (annual operating expense) or capital asset lease (capital acquisition) for budget scorekeeping purposes.

   b. GSA must differentiate between operating and capital leases for purposes of budget scorekeeping in accordance with the Budget Enforcement Act of 1990 (Title XIII of the Omnibus Reconciliation Act of 1990), known as the BEA. The budgetary and accounting consequences of entering into a capital lease are serious. If a lease is a capital lease, GSA must allocate budget authority in the initial year of the lease that equals the present value of the triple net lease payments over the full term of the lease plus the cost of the associated annual real estate taxes.

c. This policy applies to all new, succeeding and superseding leases, and lease expansions and extensions.

   Note: A line in the right margin indicates a policy or procedure that is substantively revised.

2. Background.

   a. The BEA, as revised by the Balanced Budget Act of 1997, provides for assigning budget authority.

   b. OMB Circular No. A-11, *Preparation, Submission, and Execution of the Budget*, is issued annually. Its Appendix A, *Scorekeeping Guidelines*, and Appendix B, *Budgetary Treatment of Lease-Purchases and Leases of Capital Assets*, provide instructions for scoring lease transactions.

   c. OMB Circular No. A-94, Appendix C, *Guidelines and Discount Rates for Benefit-Cost Analysis of Federal Programs*, is updated annually with the President's budget submission to Congress and provides the discount rates to be used in all "90 percent" scoring calculations for the year.

   d. On March 31, 2006, the GSA Inspector General reported that lease scoring was not being performed in accordance with prescribed policy and concluded, "It is imperative that PBS associates adhere to all scoring guidelines and appropriately test all scoring scenarios." [1]

[1] Audit of PBS's Tenant Improvement Process (GSA Inspector General, Report Number A050063/P/R/R06005, March 31, 2006).

3. Explanation of Changes. EVERY lease action must be evaluated against the criteria detailed in OMB Circular No. A-11, Appendix B to determine whether it should be classified as an operating or capital lease. Under certain scenarios, we can presume that if a leasing transaction satisfies the criteria i-viii listed under paragraph 4d, it can be classified as an operating lease and that the "90 percent" scoring calculation is not required to make that determination.[2] The revised policy addresses the lease scenarios and project milestones where such an assumption may be made. This policy is dependent on lease scenarios and project milestones as detailed in the guidance below and summarized in the matrix attached.

4. Instructions/Procedures.

   a. For ALL lease actions, designated employees in each regional Office of Portfolio Management in coordination with the realty contracting officer, must make the determination that a lease is either an operating or capital lease and undertake all scoring evaluations. For the purposes of this policy, a designated employee is the Regional Director of Portfolio Management or designee.

   b. Use of Lease Scorekeeping Classification Workbook. The designated Portfolio Management employee and realty contracting officer must use the attached *Lease Scorekeeping Classification Workbook* to provide a determination of operating or capital lease treatment for each proposed lease action. The Workbook outlines the procedures for making such determination. Completion of the Workbook must be incorporated into the project schedule. A final determination of Operating or Capital Lease classification (part 2a of the Lease Scorekeeping Classification Workbook) must be completed and returned to the realty specialist no later than 3 days from the date of request for those lease transactions below the statutory prospectus level, and no later than 15 days from the date of request for those lease transactions that will meet or exceed the statutory prospectus level.

   c. Use of Circular No. A-11. The Regional Director of Portfolio Management or designated employee must follow the current OMB guidelines in Circular No. A-11, Appendices A and B, and use the current OMB discount rates provided in Circular No. A-94 Appendix C when making the determination of lease treatment for budget scorekeeping purposes. The most current version of Circular No. A-11, Appendices A and B and Circular No. A-94, Appendix C can found at http://www.whitehouse.gov/omb/circulars/a11/current_year/a11_toc.html and http://www.whitehouse.gov/omb/circulars/a094/a94_appx-c.html

   d. Operating Lease Criteria. Appendix B of Circular No. A-11 lists multiple criteria that a lease must meet in order to be considered an operating lease. If any one of these criteria is not met, the lease will risk being scored as a capital lease. EVERY leasing transaction must be evaluated against these criteria to

[2] To determine continued operating lease status for lease extensions, the realty contracting officer must complete and sign a Determination of Operating Lease Classification for Lease Extension Memorandum (Attachment 4). A copy of the signed memorandum must be included in the lease file.

distinguish capital leases from operating leases. (See paragraphs 6 and 7 for expedited evaluation scenarios.) If Circular No. A-11 is updated or modified, the leasing transaction must be evaluated using the most recent criteria and guidelines. The criteria to be applied are as follows:

i. 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 period.
ii. The lease does not contain a bargain-price purchase option.
iii. The lease term does not exceed 75 percent of the estimated economic life of the asset.
iv. The asset is a general-purpose asset rather than being for a special purpose of the Government and is not built to the unique specification of the Government as lessee.
v. There is a private sector market for the asset.
vi. The project should not be constructed on Government land.[3]
vii. There should be no provision of Government financing and no explicit Government guarantee of third party financing.
viii. Risks of ownership of the asset should remain with the lessor unless the Government was at fault for such losses.
ix. The present value of the minimum lease payments over the life of the lease does not exceed “90 percent “of the fair market value (FMV) of the asset at the inception of the lease.

e. The “90 Percent” Criterion. Among the criteria to determine an operating lease in Circular No. A-11 is that 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 inception of the lease.” To determine whether the 90 percent threshold has been reached or exceeded, the designated Portfolio Management employee must conduct a “90 percent” scoring calculation, using the Scoring Evaluation Spreadsheet available in eLease or on the Office of Real Property Asset Management InSite Web page. While all lease transactions are required to be evaluated against the above operating lease criteria, in certain scenarios (as detailed in paragraphs 6 and 7), where the likelihood of the lease scoring as a capital lease is remote, and the realty contracting officer and designated Portfolio Management employee provide sufficient facts about the specific lease transaction to reasonably conclude that it will not score as a capital lease, the “90 percent” scoring calculation is not required to make such a determination.

[3] All arrangements entered into using the authorities granted under Section 412 Public Law 108-447, 118 Stat. 2809, 3259 and 40 USC 585(c) must be reviewed by GSA Office of General Counsel and the Office of Management and Budget.

5. <u>"90 Percent" Scoring Calculation Required</u>. In addition to evaluating the proposed lease action against the operating lease criteria defined above (i-viii), the "90 percent" scoring calculation is required for new, succeeding, and superseding lease projects under the following scenarios:

   a. Planned Lease Construction

      i. Regardless of the size of the requirement or the proposed term, the designated Portfolio Management employee must perform a "90 percent" scoring calculation for all planned lease construction leases at the planning phase of the project (requirements development) and perform a reanalysis on the apparent successful offer. While it is not required, it is prudent to perform the "90 percent" scoring calculation on the top two offers.

      ii. Each "90 percent" scoring calculation for a planned lease construction proposal must include a documented and defensible value for site acquisition in the estimate of FMV.

   b. Leases Below the Statutory Prospectus Level with a lease term of greater than 5 years and an RSF of 10,000 or less.

      i. A "90 percent" scoring calculation is required for all leases below the statutory prospectus level that have a term of greater than 5 years and a square footage requirement of 10,000 rsf or less. The calculation must be performed on the apparent successful offer. If a site value is not readily available,[4] the site value can be assumed to be ZERO. In such cases, it should be noted that the FMV figure is based on the total Estimated Construction Cost (ECC) plus the costs of design and management and inspection and a zero cost for site.

   c. Leases Below or Above the Statutory Prospectus Level with a lease term of greater than 5 Years and an RSF greater than 10,000.

      i. A "90 percent" scoring calculation is required for all leases below or above the statutory prospectus level that have a term of greater than 5 years and a square footage requirement greater than 10,000 rsf. For leases below the statutory prospectus level, the "90 percent" scoring calculation must be performed at the planning phase of the project (requirements development) and on the apparent successful offer. For leases above the statutory prospectus level, the "90 percent" scoring calculation must be performed at the planning phase of the project (requirements development), at the time of the submittal of the prospectus package to Central Office, and then once more on the apparent successful offer prior to lease award.

      ii. Each "90 percent" scoring calculation for leases below or above the statutory prospectus level with a term of greater than 5 years and an RSF of

[4] Where a site value is not readily available, the use of a zero value for site generates the most conservative estimate for Fair Market Value. If, while using a zero value for site, the FMV generated results in an operating lease, any value added for site would only serve to solidify the operating lease status. The FMV can be entered into the scoring model as is. If the project scores as a capital lease when using a zero value for site in the FMV calculation, a defensible value for site should be entered and the FMV calculation repeated.

greater than 10,000 must include a documented and defensible value for site acquisition in the estimate of FMV.

6. <u>"90 Percent" Scoring Calculation Not Required</u>. If a lease, regardless of square footage or if it is below or above the statutory prospectus level, has a term of 5 years or less, and the designated Portfolio Management employee has ascertained sufficient facts about the lease transaction (including satisfaction of the criteria in paragraph 4d. i-viii), it can be concluded that the lease will not score as a capital lease and that the "90 percent" scoring calculation is NOT required to make such a determination as long as the rental rates are consistent with prevailing market rates for comparable facilities in the community in which the leasing action is to occur. The Lease Scorekeeping Classification Workbook must still be completed to document that the proposed action satisfies the criteria in paragraph 4d. i-viii.

7. <u>Other Leasing Actions</u>. When dealing with special leasing actions such as extensions, expansions, and free space, the following guidelines must be observed:

   a. <u>Extensions</u>. If the Government seeks to extend a lease for a temporary term (less than 3 years), the realty specialist must confirm continued operating lease status for the proposed extension. To confirm operating lease status, the short-term extension must satisfy the following criteria: the base lease being extended already underwent a full Lease Scoring evaluation (in accordance with criteria set forth in Appendix B of OMB Circular No. A-11) and scored as an operating lease, with the lease file containing all required scoring evaluation documentation; the term of the lease extension does not exceed 3 years; the annual rent of the lease extension term either remains unchanged or decreases; all terms of the base lease remain unchanged, and no additional terms are included, either in a prior SLA or as part of the lease extension, that would become applicable during the term of the lease extension and would cause the lease to score as a capital lease; and the rent to be paid under the extension is below the statutory prospectus threshold applicable at the effective date of the extension. If all the above criteria are met, the Realty Contracting Officer shall complete and sign a copy of the Determination of Operating Lease Classification for Lease Extensions Memorandum, and include a copy in the lease file. No further action with regards to lease classification for budget scorekeeping purposes is required.

   b. <u>Expansions</u>. If expansion space is requested for a location already under lease to the Government, the entire square footage (total existing plus total expansion) must be analyzed as a whole in accordance with the scoring criteria set forth herein. This analysis must occur prior to the acceptance of any expansion space to determine that operating lease status is maintained when factoring in the expansion space. Caution should be exercised so that the expansion space does not affect the below statutory prospectus level status of a lease or exceed the available authority for an existing statutory prospectus level lease.

   c. <u>Free Space</u>. When an offer proposes to provide, at no charge to the Government, a contiguous block of space that exceeds the maximum amount for which GSA has solicited, at no additional charge to the Government, and the agency agrees to accept the extra space, the free space square footage is not added to the solicited square footage of the lease for “90 percent” scoring calculation purposes.

d. Options. Lease options must be addressed as follows:

   i. If a lease agreement contains an option to renew that can be exercised without additional legislative authority, it is presumed that the option will be exercised. If, for example, a prospectus authorizes a term of 20 years and the proposed lease deal is structured as 10 years firm with two 5-year options, the “90 percent” scoring calculation must reflect a 20-year lease term. If, however, a lease prospectus is authorized for a term of 10 years, but the lessor offers a 10-year firm lease with two 5-year options, the “90 percent” scoring calculation only needs to reflect a 10-year lease term. The two 5-year options cannot be exercised without additional legislative authorization and therefore do not need to be calculated at the time of the analysis. All options that are included in the lease agreement for leases below the statutory prospectus level that do not require prospectus authority to exercise must be included in the lease term for the “90 percent” scoring calculation. If such an option(s) is not factored into the base lease’s original “90 percent” scoring calculation, the scoring requirements as defined in this RSL must be applied before the option(s) is exercised.

8. Scoring Calculation Results above 80 percent. Calculation results above 80 percent are sufficiently high to be cause for concern and must have the signed concurrence of the Regional Director of Portfolio Management. This concurrence must not be delegated.

9. Determination of Operating or Capital Lease Classification Request. The lease contracting officer or designated realty specialist must use the attached *eLease Lease Scorekeeping Classification Workbook* and sign it. The Regional Director of Portfolio Management or designee must also sign the document. The signed document, with the determination of operating or capital treatment, along with all backup documentation [“90 percent” scoring calculation worksheet, General Construction Cost Review Guide (GCCRG) lookup table, and site value calculation], must be kept in the official lease file with a scanned copy uploaded into eLease by the realty contracting officer or designated realty specialist.

10. Calculations. Instructions for the “90 percent” scoring calculation are provided by the Office of Real Property Asset Management on the following Web site:

    http://pbsportal.pbs.gsa.gov:7777/portal/page?_pageid=84,120677&_dad=portal&_schema=PORTAL.

    a. For all “90 percent” scoring calculations, the designated Portfolio Management employee must develop inputs for the scoring worksheet using the most current GCCRG or data taken from a current market appraisal (if available). If using the GCCRG, the employee must enter the total project ECC into the most current Look-Up Table +20 percent to determine the design and management and inspection fees applicable to the proposed action. To determine FMV, the designated Portfolio Management employee must add the total ECC to the design and management and inspection costs, and to the site acquisition costs (zero where allowed). The value for land should be provided by the employee(s) responsible according to regional policy/practice and can be determined through site comparables based on recent sales; market values if developed for the geographic area based on land values per Floor Area Ratio (FAR) foot; or any other suitable method as long as sufficient documentation is provided.

b. Every time the Portfolio Management employee performs a “90 percent” scoring calculation, they must use the discount and inflation rates that are included in the most recent President’s budget document. These rates are posted on the Portfolio Management Web site shortly after the President’s budget is released. These are normally updated in February-March each year. Rates for 2007, which are based on the economic assumptions for the 2008 budget, can be found at http://pbsportal.pbs.gsa.gov:7777/portal/page?_pageid=84,119730&_dad=portal&_schema=PORTAL

11. Notification of Capital Lease. For any proposed leasing action that is determined to be a capital lease transaction, and for which no feasible alternative appears to exist, the following PBS officers must be notified prior to any action be taken:

   i. Regional Director of Portfolio Management
   ii. Regional Realty Services Officer, or other individual responsible for leasing activities as identified by the ARA;
   iii. Assistant Commissioner for Real Property Asset Management;
   iv. Assistant Commissioner of the Office of Budget and Financial Management; and
   v. Assistant Commissioner for Office of Real Estate Acquisition.