

the keep rate conundrum

Rental dealers have a plethora of things that they count and analyze. They count customers, BOR, accounts, deliveries, pick-ups, SMSAs, SEs, SEOs, SLAs, RNAs, idle inventory, APUs, percentage of dollars collected, five-day accounts, 30-day accounts, skips, stolens and on and on. They count and compare and analyze these things to help them run their businesses better. One of the things that they do not calculate is keep rate. Calculating keep rate does not seem to improve the business in any discernible way—and yet this calculation, beyond all the others, has had enormous legal and political implications for rent-to-own almost since its inception. Keep rate has often loomed large when policy-makers have decided how to regulate the industry. Rental dealers, can, of course, accurately calculate keep rate when called upon to do so, and they do measure things closely associated with keep rate, e.g., deliveries versus pick-ups per month, average and mean length of agreements. It is paradoxical that this aspect of the business—so argued over, so debated, so misunderstood—is so unimportant inside rent-to-own businesses and, at the same time, so overwhelmingly important to those looking at the industry from the outside.

By Ed Winn III



WHAT IS KEEP RATE?

Reasonable minds differ over how to calculate keep rate, although those same minds probably generally do agree as to what the term means. Keep rate is the percentage of customers who do, indeed, rent-to-own divided by the total number of customers who rent during a given period. Or, it may be the percentage of rental units that are rented to term divided by the total number of units rented during a given period. Or, it may mean the number of rental agreements that go to term divided by the total number of agreements entered into during a given period of time. Or, it may mean the number of deliveries that go to term divided by the number of deliveries during a given period. Dealers will begin to get a sense of what keep rate means from these different ratios.

If the keep rate were 100 percent, it would mean that no product ever came back to the store, plus no skips and no stolens and every customer either paid to term or paid off early. That store would never rent any used product, because it would never *have* any used product to rent. If a store had a keep rate of 0 percent, it would mean that everything came back and no customers kept any product to term.

If the overall keep rate were 100 percent, the industry would have lost the recharacterization argument long ago and would be regulated like other retail credit sellers. If the keep rate were 0 percent throughout the industry, then rent-to-own would really be the rent-to-rent industry and the recharacterization argument never would have arisen. After all, rental yards have never had to fight the “disguised credit sale” battle.

KEEP RATE HISTORY

Keeep rate has been a legal and political issue for a long time. In 1979, then-Representative Frank Annunzio (D-Illinois) introduced an amendment to the *Truth-in-Lending Act* to redefine the term “credit sale” to include terminable rental agreement with a nominal purchase option—i.e., rent-to-own transactions. The congressman did not know what the industry keep rate was, but presumed that it was very high and therefore he included language in his bill presuming that the consumer makes all payments necessary for ownership for the purposes of calculating APR. While the *Truth-in-Lending Act* ultimately was amended in serious fashion with the *TILA Simplification Act of 1981*, the Annunzio bill died a quiet death in committee with no hearings and no vote on the rent-to-own issue.

In 1981, when Congress was simplifying the *Truth-in-Lending Act*, the Federal Reserve Board sent staffers out to study the rent-to-own industry to determine whether it should be covered by the law. Those staffers visited rent-to-own stores in Maryland. They spent time observing how the business worked and talked to industry insiders about, among other things, keep rates. The FRB staff concluded that rent-to-own transactions were not, in fact, disguised credit sales needing coverage by the *Truth-In-Lending Act* and added an important parenthetical to the definition of credit sale in *Regulation Z*. Credit sale includes a lease “(unless terminable at any time without penalty by the consumer)...” The FRB inserted this language because it was persuaded that most customers—more than half, anyway—returned their rent-to-own merchandise and were not using the transaction as a means of acquiring ownership. In fact, the keep rate in those Maryland stores at the time was around 25 percent.

In 1982, the industry had a scare when, in *Clark v. The Rent-It Corp.*, the U.S. Eighth Circuit Court of Appeals wondered whether rent-to-own transactions might be credit sales after all, depending upon whether “most customers [of the defendant] kept their TV sets for 78 weeks and exercised the option to become its [sic] owner,” as alleged by the plaintiff. The rent-to-own company had won in the trial court and the customer appealed. The circuit court sent the case back down to the lower court for more evidence on, among other things, the defendant company’s keep rate. The company went out of business before any further proceedings could occur.

KEEP RATE AND TAXES

During the next decade plus, state legislatures debated the rent-to-own issue and most concluded that RTO transactions were fundamentally different from credit sales. These legislatures proceeded to regulate the industry accordingly with their own, separate rent-to-own statutes. Keep rates *were* an issue in those debates, but neither side presented hard evidence of keep rates in any systematic fashion.

Then, the Internal Revenue Service attacked the industry in the mid- and late-1990s. During one period, there were active IRS audits of more than 90 rent-to-own companies, all focusing on how dealers were booking their revenues and treating their rental inventory. The IRS maintained that rent-to-own transactions should be taxed as conditional sales with dealers booking the total RTO sales price as income when the agreement was initiated. Rental items were really retail inventory whereby

original costs could be deducted from gross revenues as costs of goods sold, but whose value could not be depreciated. The industry was facing a tax liability of \$1 billion—if the IRS had prevailed in its position.

All of these audits, while painful and time consuming for the rental dealers involved, did have the beneficial effect of causing IRS agents to examine hard statistical data from rental company records. As a result of these audits and what they showed about how the business really works, the IRS backed off its original position in 1995 and issued *Revenue Procedure 95-38* defining rent-to-own

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transactions as leases rather than installment sales. In the background statement of the *Revenue Procedure*, the IRS stated: “Typically, a substantial portion (and in many cases, a majority) of a rent-to-own dealer’s contracts terminate with the return of the property to the rent-to-own dealer.” This language, without the parenthetical, made its way into the *Taxpayer Relief Act of 1997*, an amendment to the federal tax code, and established rent-to-own transactions as leases for tax purposes.

The implication of the parenthetical is that rent-to-own companies with keep rates above 50 percent can still treat their transactions as leases and use a three-year modified accelerated cost recovery system (MACRS) to depreciate their rental units without being challenged by the IRS. No one knows how high a keep rate can be, as “substantial portion” isn’t defined anywhere. There have been no challenges to rent-to-own companies on the installment sale issue by the IRS since the code was amended in 1997.

If the IRS’s scrutiny of rent-to-own industry records and the resulting conclusion should have been the end of the recharacterization issue, it was not. In 1999, consumer advocates published an article after interviewing 58 rent-

to-own customers and concluded that 76 percent of those customers ended up owning the items that they rented by completing the term. While possible, the sample was small, the procedures badly defined and the findings suspect. That 76 percent keep rate quickly made it into the anti-RTO literature and was often quoted (Zikmund-Fisher and Parker, “Demand for Rent-to-Own Contracts: A Behavioral Explanation,” *Journal of Economic Behavior and Organization*, volume 38, pages 199–216, published in 1999).

The next time keep rate became a hot topic was in 2000, when the Federal Trade Commission published its “Survey of Rent-to-Own Customers.” The FTC’s study involved telephone surveys of 532 people who had done business with a rent-to-own store at some time during the previous five years. To get this sample, the FTC staff called more than 12,000 people. The interview questions sought a lot of information about these customers’ experiences with, and attitudes toward, rent-to-own, including whether they ever rented long enough to own. The study reported that, indeed, 67 percent of the merchandise rented was “purchased by the customer.” This finding led to a policy conclusion in the report that “most rent-to-own merchandise was purchased by the customer.” This finding was a huge surprise to rental dealers who instinctively knew better. The industry immediately criticized this aspect of the report as being based on faulty memories and self-serving statements; some customers probably claimed that they rented to own to avoid the embarrassment of having to admit that they ran out of money and had to return the products before ownership (*Progressive Rentals*, May–June 2000, page 44–49).

The FTC survey asked participants to self-report their recollections of what happened to them during the past five years. The commission made no effort to verify the responses with outside information and, instead, accepted them unquestioningly as accurate. There was no pre-testing of the questions to measure their validity. The methodology of the survey, particularly with regard to what happened to customers’ rental property over five years, was so flawed as to be statistically useless. Not surprisingly, consumer advocates leapt upon this finding in the FTC study—a study that otherwise was favorable to the industry—and added it to their anti-RTO arsenal.

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A rebuttal to the FTC's study came, not from the industry, but from academia, in an article published in 2003 in the *Journal of Applied Business Research*, "Rent-to-Own Agreements: Purchases or Sales?" Michael H. Anderson and Raymond Jackson, two University of Massachusetts finance and economic professors, analyzed statistical data from 100 rent-to-own stores in 46 states. Their study examined more than 350,000 transaction records. The conclusion of this study was that the keep rate in those

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rent-to-own stores was less than 39 percent. This study remains the most comprehensive to date. Other academic studies involving fewer stores and fewer customer records have found a keep rate of 24 percent, measuring keep rate by rental product, and 32 percent, measuring keep rate by customers. This was a study involving four stores in the south and some 75,000 rent-to-own transaction records (Anderson and Jaggier, "Rent-to-Own Agreements: Customer Characteristics and Contract Outcomes," *Journal of Economic Business*, published in 2008).

CALCULATING KEEP RATE

So, if one were interested in doing so, how *would* one calculate the keep rate in a rent-to-own store or company? APRO formed an accounting committee in the 1990s when the IRS audits were underway. The committee consisted of in-house and out-of-house CPAs, attorneys and rental dealers. Ultimately, the committee couldn't agree on the one correct method for calculating keep rate after trying to do so over a three-year period. That is one of the reasons that the percentages vary so greatly. Keep rate can very much depend upon who is doing the calculating.

A quick-and-dirty keep rate calculation is to divide the pick-ups by the deliveries in a month. One hundred minus that percentage is the keep rate.

A more accurate, albeit cumbersome, methodology is to go back in time long enough to look at a group of

transactions that have been completed. Take a period of several months at least two years in the past (assuming all agreements have terms of 18 months or less). Count the transactions initiated, either by customer, product, or agreement. That is the denominator for the keep rate percentage. Count the number, by the same measure, of transactions that resulted in the customer owning the property. Correct this number for rewritten agreements. For example, if a television was delivered, that transaction goes in the denominator. If the TV agreement was rewritten for that same customer, such rewrites do not count as new agreements, or new deliveries in the denominator of the fraction, no matter how many times the agreement may have been rewritten. Finally, the original transaction terminated either in the customer obtaining ownership or not—a return, swap-out, skip or stolen. If the customer obtained ownership, the transaction goes in the numerator of the fraction; otherwise, not. When all transactions for the trial period have been analyzed this way, the result is a fairly accurate picture of what the keep rate was in that store or company two years ago. Of course, the keep rate may have changed since then, depending upon store growth, change in product mix (furniture and appliances have a higher keep rate than electronics), change in weekly/monthly agreement mix (the higher the percentage of monthly accounts, the higher the keep rate) or other changes.

Few dealers, if any, use keep rate as an operational tool at the store level. Employees are not being paid bonuses on keep rates. Computer systems are not programmed to calculate it. Keep rate is, finally, more of a political tool than anything. It is a useful calculation because it proves that rent-to-own dealers are really and truly in the *rental* business. RTO dealers know this instinctively without bothering to calculate keep rates, because of all of the merchandise they have to go out and pick up every day. If they were selling, the stuff would be sticking; but, try as they might, units keep coming back into the stores, the ululations of consumer advocates be damned. Every day, stuff comes back. Too much. Every day. It is, for better or worse, the rent-to-own business. Stuff goes out; most of it comes back. Some of it sticks: keep rate. ✱

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