



Bulletin

Purchase vs. Lease Considerations

INTRODUCTION

Leasing personal property, which includes jet planes, ocean-going vessels, railroad cars, computers, furniture, equipment, machinery, trucks, cars, cows, hogs, and the like, came into existence shortly after the end of World War II. By the late 1950s, leasing was blossoming, and by the mid-1960s, it was in full bloom. Today, leasing is an established industry, which plays a major part in the economic life of this country.

Before discussing leasing as a business concept, it is wise to understand some of the terms used, such as:

- *Lessor*, which denotes the owner of the equipment to be leased, and *lessee*, which denotes the user of the equipment.
- *Renting* is an arrangement whereby the lessor makes equipment available to the lessee. It may be automotive or contracting equipment, leased on a long-term or short-term basis to meet temporary requirements, emergency conditions or peak load needs.
- *Leasing* is an arrangement whereby the lessor makes equipment available to the lessee. The equipment may be of the lessee's own specifications, for his use exclusively, and leased full-time on a year-round basis, as if it was lessee-owned.

TYPES OF LEASES

Beyond this definition of leasing, there are additional variations available. In automotive leasing, the lease can be either an *open-end* or a *closed-end lease*, a *full-service lease* or a *net lease*. In equipment leases, it is either a *finance lease* or an *operating lease*.

Under an automotive *open-end lease*, the lessee is responsible to the lessor for an agreed upon value of the automotive equipment at the expiration of the lease term. Further, the lessee guarantees to reimburse the lessor should any deficiency occur. In turn, the lessor guarantees the lessee a refund of any amount collected over and above the specified residual value at the time the equipment is returned.

A *closed-end lease* is one in which the lessor assumes the responsibility for the value of the equipment upon its return, and no further charges are made other than damage, which is covered in the lease agreement itself.

A *full-service lease* is an automotive lease in which the lessor includes in his rental charge the cost of license, tax, safety inspection fees, insurance (collision, comprehensive, and liability), and agrees to pay all maintenance, except for gas, washing and garaging. A *net lease* is the furnishing of automotive equipment to a lessee with no services

included. This lease may be either an open-end or closed-end lease. In fact, both a full-service and a net lease could still be either open-end or closed-end.

A *financial lease* is the acquisition of equipment without purchase. Under a financial lease, the rental payments are spread over a period usually equivalent to the useful life of the equipment to the lessee. The time is usually shorter than the total useful life of the equipment. The lessee pays the lessor a series of payments, the amount of which exceeds the purchase price of the equipment. In addition, during the term of the lease, the contract cannot be cancelled, and the lessee is committed to continue leasing the equipment for the full term of the lease.

An *operating lease* permits the use of equipment without the risk of ownership. Operating leases are such that the lessee, upon giving notice to the lessor, can cancel the lease and return the equipment. In this case, the lessor is assuming the responsibility of ownership because the lessee does not guarantee any residual value collected by the lessor.

VEHICLE LEASING

If a company wishes to lease vehicles, one should be aware that automobile leasing is sold on the basis of service rather than on cost of benefits. Many lessees will not have an accurate record of the actual cost of the vehicles and will be inclined to make a snap judgment in favor of ownership without taking into consideration such items as full depreciation costs or the cost of executive time spent managing details.

The prime reason for considering leasing vehicles should be the advantage of not having to make capital investment in automotive equipment.

Another advantage is being assured of the predetermined cost of equipment and operations for budgeting purposes. All companies have some kind of budget. However, accurate budgeting of transportation costs is more difficult when automotive equipment is owned. Repairs are not often anticipated, and charges against a fleet are usually not tabulated until possibly 10 days after the end of the month in which they occur. In leasing, the monthly payments can be set up in the budget, and even if the lessee provides gasoline and oil, average mileage figures will permit a reasonably accurate determination of the costs involved. At the same time, leasing eliminates the need for a multitude of records to support tax deductions.

A leasing firm and an automotive dealer can each make a good case for lease versus purchase costs. The contractor can make a reasonable evaluation of what the costs mean by tabulating, for example, the costs of owning and leasing vehicles in the form of a chart. It is intended to be only a sample and not necessarily applicable to all concerned. Each contractor should tailor this chart to his/her own accounting procedures.

EQUIPMENT LEASING

Profits are made by the use of assets, not by ownership. The potential lessee should be reminded that the asset is still available to him/her, and the freed working capital can be used elsewhere in the most timely, effective and profitable manner. The leased equipment brings its own return in production dollars. If a company must delay the purchase of equipment because of a strained capital position, the benefits to be realized from the equipment must also be postponed. In today's competitive market, it is essential to replace worn out or obsolete equipment. The increased efficiency in productivity may more than pay the cost of the lease.

The tax advantage of leasing is pointed out often. A true lease (without a purchase option) has the advantage of a rapid write-off of equipment costs. The entire leasing cost may be deducted as a business expense. If equipment is leased for a 5- or 10-year period, the leasing cost can be written off during the leasing period—5 or 10 years. The Internal Revenue Service regulations explicitly permit the tax payer to deduct all lease payments that are ordinary and necessary to its business. However, this rapid write-off is not available if the equipment is purchased for use on an installment basis, since the installments are not lease payments. Therefore, leasing might possibly result in tax savings. Tax timing and cash flow may not make leasing attractive for certain concerns.

These and all other matters concerning a lease should be reviewed with a tax counsel. (In certain instances, it may also be advisable to get a ruling in advance from the Internal Revenue Service. This should be checked also with tax counsel.)

LEASING PROBLEMS

By way of caution, leasing does not work for every company. As in any case where it seems you can “eat your cake and have it too,” there are some conditions that would make leasing disadvantageous. Leasing is not good medicine for a sick company. It does not help a declining business because you must be able to use conserved capital intensively.

In relation to an improved cash flow situation, many leasing companies sell services, which offer merchandise on short-term leases. These feature lease payments, which far exceed the depreciation that would have been allowed had the asset been purchased. Instead of causing the least drain of cash in earlier

years, the accelerated payments required by this plan actually compound the problem, and the Internal Revenue Service views the accelerated cash flow provisions as tax postponement devices.

Another point to consider is that the courts are interpreting lease contracts according to the intent of the parties. This means that care should be taken when drafting the contract to correctly reflect the intent. The concept of intent must be separated from the concept of desire. While the parties may desire to have their contract construed as a lease, the terms of their lease may show that the real intent in the legal sense is to negotiate a conditional sale.

Purchase options should be examined closely. Remember that equipment helps make profits because it is used, not because it is owned. If a purchase option must be included, it should be based on the fair market value of the asset at the time it is believed the option will be exercised.

Rental agreements that cover a relatively short part of the expectant life of the equipment involved, with a rental cost that approximates the price at which it could have been purchased (and where the leesee may continue to use the equipment for an additional period at a relatively nominal payment) might be held legally to be a sales contract. Such a condition might apply even though passage of title is not expressly provided in the agreement. This is another example of where care must be taken to assure that the intent and desire of the parties are reflected correctly in the agreement. c

SUMMARY

Although leasing may improve the appearance of a balance sheet,

companies should footnote their lease commitments on their balance sheet. These should show the firm's lease contracts that have an effect on the company's cash position for future years.

One of the main advantages of leasing from the lessee's standpoint is the cost. A lessee may determine that he can finance equipment or operate his fleet for less cost than a comparable leasing program. If this is true (i.e., the advantages of reduced cost of owning outweigh the previously stated advantages of leasing), then perhaps the contractor may choose to own vehicles or equipment or he may elect to use both systems (i.e., own equipment and lease vehicles).

Please note this final word of caution. Have your regular counsel and a competent tax counsel (if your regular attorney is not well versed in tax law) and your independent certified public accountant check all aspects of your proposed lease and its resultant effects on your operating statement and balance sheet before concluding any leasing operations.