

## LEASING CAPITAL EQUIPMENT

### SUMMARY

Leasing represents an alternative to the outright purchase of capital equipment. Under the right circumstances, leasing offers many advantages over purchasing equipment, particularly for the small contract tooling and machining company.

Profits are generated by the use of equipment and not by mere ownership. Leasing, therefore, can provide financial and tax advantages.

Leasing can be used to acquire any type of capital equipment, including machine tools, vehicles and computers. A wide variety of leasing plans are available from various sources. This BMA will discuss some of the more popular types of leases currently in use and describe some of the advantages and pitfalls of leasing.

#### WHY LEASE?

There are many advantages to leasing over purchasing. The primary advantage to most is the *low initial cash outlay* and the increased *cash flow*. Typically, leasing requires only a payment or two in advance. Many other forms of financing will require a down payment of 10% or more. In most states a lease can be structured such that the sales tax is paid over the term of the lease in the form of use tax. A down payment and sales tax can easily top 18% of the purchase price. This is 18% you do not need to pay up-front with a lease.

#### Leasing Can Be Used To Help Improve Cash Flow

By utilizing a residual value or purchase option at the end of the lease your monthly payments can be minimized. A lease can be structured so the lessor owns the equipment and depreciates the equipment for tax purposes. These "tax benefits" are passed on to you, the lessee, through a lower monthly payment. Typically the lessee can also expense the payment for this type of lease. In cyclical businesses a lessee's payments can be structured to better match their seasonal cash flows, such as, quarterly payments, uneven payments, skip payments, etc.

#### Leasing Can Be Used To Minimize Your Tax Consequences

A true lease will help avoid Alternative Minimum Tax (AMT). The leasing company, or lessor, owns the equipment.

Therefore, the lessee avoids Depreciation Preference associated with AMT. The company still gets the benefits of depreciation in the form of the "tax benefits" being passed on to them by the lessor through lower lease payments. Leasing will also help avoid Mid-Quarter Convention. If the lease is structured as a true lease, the Mid-Quarter convention concerns are eliminated. A Sale/Leaseback can possibly help a company to get out of AMT or Mid-Quarter Convention if they have already gotten into these situations.

#### A Lease Can Be Used As A Hedge Against Obsolescence

If the lease is structured with a purchase option at termination, the equipment can be returned to the lessor at the end of the lease. This will work to the lessee's advantage if the payments are significantly lower than they would be in a full payout lease or loan. In this case the lessee is able to use the equipment for the lower payment. At the end of the lease they can return the equipment and upgrade to the latest and greatest without the consequences of disposition or write off. These leases can be structured with a fixed early purchase option to protect the lessee against having to pay too much for the equipment if it turns out not to be obsolete at the end of the lease term. This same structure can be used if the equipment is being acquired for a specific contract. If a company has a three-year contract to produce parts on a special machine, they may want to go with a three-year lease. The lessee can increase cash-flow and profitability through the lower lease payments for the three years. If at the end of the three years the contract is not renewed and the lessee no longer needs the

machine, they can simply return it to the lessor. If they extend the contract, the lessee can negotiate a renewal with the lessor.

### **Increase Or Protect Your Borrowing Capacity**

All lending institutions will have a level of comfort with a given customer. By tying up these bank lines with equipment, a company can limit their borrowing capacity for working capital, etc. By going with a lease, a company protects itself from over utilizing their bank lines and finding themselves without borrowing capacity.

### **DEAL WITH AN ESTABLISHED, REPUTABLE LEASING COMPANY**

Common sense? Yes, but it is more than that. When you are arranging a lease, you are, in effect, using someone else's money to acquire the equipment you want. Who you deal with in this situation is all important. Make sure your leasing source has the experience, financial strength and resources to meet all your needs--short term and long term. It also helps if your leasing source has specific knowledge of your industry.

Leasing and finance companies? There are all types and you should carefully investigate each source you are considering before you sit down to talk business. Find out how long they have been in business, how large their assets are, get the names and phone numbers of some of their current clients and find out how satisfied or dissatisfied they are with the service they have received. Watch out, too, for leasing companies that deal in only one brand of equipment. They will limit your options.

### **KNOW THE DIFFERENCES BETWEEN VARIOUS TYPES OF LEASES**

Do not assume that every lease will be "off balance sheet" . . . or that all lease payments are tax deductible. Some lease payments are tax deductible, but some are not. Before you commit to anything, discuss the lease terms with your tax accountant to make sure you are getting what you need. Many different types of leases are available: operating leases, capital leases, dollar option leases, fair market value leases, early buyout leases and more. Compare the various types of leases on a "total-cost" basis, including your monthly payments, residual payments, tax benefits, and protection against Alternative Minimum Tax (AMT) liability. Plus, you also need to understand how financial ratios and bank covenants will impact you. It takes a little work on your part, but it is well worth the effort in potential savings. Find out how much you will be penalized for early termination. Many leases are written so that there is no advantage (to you) for early payoff. In fact, there may be a substantial penalty. You could get stuck with a piece of equipment you do not need or cannot use, because you are committed to a long-term lease obligation with no flexibility. Worse, it could even cost you more to get out of a lease early, than to continue paying your monthly

obligation. Always be sure to read and understand your lease. If you feel you may want to end the lease early, be sure to ask for a lease with an early purchase option alternative.

### **DON'T BE FOOLED BY LOW-PAYMENT LEASES WITH HIGH PURCHASE OPTIONS**

Watch out for very high purchase options. Often, purchase options are set artificially high, in order to lower your monthly payments. Lower monthly payments may seem like a good deal, but if your lease requires a guarantee of an unrealistic purchase price, you may end up paying more for the equipment than it is worth at the end of the lease. You may want to consider a Fair Market Value purchase option which allows you to purchase the equipment at the end of the lease for an amount determined to be the value of the equipment on the open market at the time the lease expires. There are also leases available that offer a fair market value purchase option when the lease expires and a one time fixed price purchase option during the term. Reputable leasing companies will always fully disclose all purchase option requirements.

### **FIND A LESSOR WHO UNDERSTANDS YOUR BUSINESS**

Some lessors have no idea of the nature of the business you are in. Other lessors may only have "canned" lease plans that make no allowance for the special terms you need. Find a lessor who understands the business, who knows the equipment, and can respond with an appropriate lease structure. Take command of the situation and do not be afraid to ask for special terms you may need --skip payments, monthly or quarterly payments, accelerated payments, etc.

### **LOOK FOR AND UNDERSTAND TAX INDEMNIFICATION CLAUSES**

If your lessor is using the tax benefits of equipment ownership, the lease contract should include a "Tax Indemnification Clause." This clause may require you to reimburse the lessor for changes beyond the lessor's control-- for example: if there is a tax increase, or if you do something to disturb those tax benefits. Most lessors include this clause in some form, but these clauses may differ substantially. Make sure you understand this clause so you will have no surprises.

### **ALWAYS CONSULT YOUR ACCOUNTANT OR TAX ADVISOR BEFORE YOU SIGN A LEASE**

Leasing can provide powerful, money-saving tax advantages. Depending on your situation and the type of lease you arrange, your entire lease payment could qualify as an expense. The key work is could. Current tax laws are such that, today, the very same type of lease may qualify as a tax lease for one company but not for another. The reason? No two companies have exactly the same tax structure and liability. To be sure your lease payments may be expensed, always consult your accountant or tax advisor before you sign your lease.

## QUESTIONS YOU SHOULD ASK YOURSELF WHEN CONSIDERING A LEASE

- Is the machine for a short term job, with little application for future use?
- Is it a replacement machine that is essential to the business?
- Is it a machine that you have immediate need for, but a moderate need for in the future?
- Is cash flow a major concern?
- Is there cash available to purchase the machine?
- Is there adequate availability for financing under current Bank Lines?
- Will this purchase affect finance ratios?
- Will this purchase affect bank covenants?
- Can the depreciation be fully utilized?
- Will this purchase trigger an Alternative Minimum Tax?
- Will this purchase trigger Mid-Quarter Convention?
- Will this purchase trigger a Capital Gain?

## COMMON LEASE TERMINOLOGY

### Lessor

Usually the owner of the equipment being leased. The finance company who purchases the equipment, in order to lease it to an end user for a fee.

### Lessee

User of the leased equipment. A lessee will lease/rent a piece of equipment from the lessor in order to utilize the equipment. The lessee pays the lessor a fee for using the equipment in the form of rent.

## Operating Lease

This is an accounting term for a fixed-term lease wherein the lessee acquires the use of an asset, for a portion of the assets useful life. Generally, lease payments are expensed and, accordingly, the lease transaction is not reflected on the balance sheet.

## Capital Lease

This is an accounting term for a lease which includes among its characteristics, a bargain purchase option or an initial term equal to 75% or more of the useful life of an asset or which has a present value of lease payments equal to 90% or more of the equipment cost. Generally, this lease is capitalized on the balance sheet.

## Dollar Option Lease (Bargain Purchase Option)

Allows the Lessee to purchase the asset at the end of the lease term for a nominal or bargain amount, usually one dollar. These types of leases are always capital leases (see above).

## Fair Market Value Lease

Allows a lessee to purchase the asset at the end of the lease for an amount determined to be the value of the asset on the open market at the time the lease expires. This is called the Fair Market Value Purchase Option.

## Tax Lease

A lease that qualifies, by meeting certain IRS guidelines, to have lease payments treated as an expenses for Income Tax purposes.

## Early Purchase Option

A one time, fixed price purchase option offered at a specific date during the lease term and estimated to be equal to the Fair Market Value of the equipment at the Early Purchase Option date.

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