LEASE VS. PURCHASE: A CRITICAL DECISION

Assessing options to make the best financial decision in an improving economy

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WHAT YOU’LL UNCOVER:

• Pros and cons: leasing vs. purchasing
• Options for leasing and purchasing
• Understanding depreciation schedules
• Key accounting changes on the horizon
Executive Summary

Leasing vs. Purchasing: Equipment Procurement Options

Regardless of the industries in which they operate, companies need equipment. The cost of equipment—from vehicles and aircraft to medical devices and computer systems—can add up quickly. How a company handles those expenses is a critical decision that affects future growth and success.

Companies can purchase capital equipment with cash on hand, purchase it through a loan, or lease it. There is no “buyer’s profile” for companies better suited for purchasing or leasing. The decision truly transcends industries, equipment type, and overall cost.

Because companies have options for equipment procurement—each of which can significantly affect a company’s bottom line—they should be aware of the advantages and disadvantages of purchasing and leasing to make the most cost-effective decision.

In this white paper, Jud Snyder, President of the BMO Harris Equipment Finance Company (BHEFC), explores the advantages and disadvantages (see chart below), explains the various purchasing and leasing options available, and discusses potential accounting rule changes by the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB), as well as the upcoming accelerated depreciation phase-out.

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An Improving Economy Creates Opportunity

During and after the last recession, many companies slowed or stopped investing in new capital equipment, opting instead to get as much from their existing equipment as possible. As the economy has begun to improve, however, companies have once again started to acquire new equipment.

According to the 2010 U.S. Census Annual Capital Expenditures Survey, spending on new and used equipment totaled $677 billion, up $35.8 billion (5.6%) from 2009. Of this amount, $639.2 billion (94.4%) was for new equipment, an increase of $32.6 billion (5.4%) from 2009. Expenditures for used equipment totaled $37.8 billion in 2010, slightly above the 2009 total of $34.6 billion. The procurement trend appears to be continuing. BMO Harris Equipment Finance Company new business volume increased 73% in 2011 compared to 2010.

In addition, 55% of all capital equipment acquired in the United States in 2006 was financed, according to data from the Equipment Leasing & Finance Foundation’s Propensity to Finance study.

Companies ready to procure capital equipment have to decide whether to purchase or lease this equipment. Since this decision can have long-term financial impacts, companies should understand the benefits and drawbacks of each approach before making a decision.

Considerations When Determining to Purchase or Lease Equipment

Purchasing and leasing each offers advantages and disadvantages, so companies should consider several factors, including:

- **Opportunity cost of capital.** Companies should consider if they could reinvest the capital allocated for equipment purchases into other parts of the business to generate a higher rate of return.
- **Tax efficiency.** Companies should determine which is a more cost-effective, long-term approach—deducting lease payments, deducting total purchase cost, or deducting equipment depreciation.
- **Interest rate policy.** Companies should weigh the benefits of adding fixed-rate debt versus using a revolving line of credit with a variable interest rate.
- **Equipment replacement cycle.** A company also should consider for how long it plans to use the equipment, as this can affect the purchase-or-lease decision.

Purchasing Equipment: Consider Available Options

Companies have two options when purchasing equipment. They can either purchase the equipment with cash or secure a loan.

- **Outright purchase.** When purchasing equipment outright, companies gain tax and other benefits inherent with owning equipment. This might be the best option if companies have capital available to support the purchase or if they are unable to negotiate favorable loan terms.

- **Equipment loan.** When securing a loan, companies receive the same tax benefits as owning equipment while making lower monthly payments. A loan might be the most attractive purchase option for companies that want to buy equipment and get the tax benefits of ownership, but do not have the upfront capital to make the purchase or have a more advantageous use of their capital.

When purchasing equipment, whether with cash or through a loan, companies receive certain advantages and disadvantages.
The Advantages of Purchasing Equipment Include:

- **Tax advantages.** Companies can deduct the equipment costs pursuant to Section 179 of the Internal Revenue Service (IRS) Code or take depreciation deductions to lower its taxable income. With accelerated depreciation, a company can take large depreciations (up to 50% of the purchase cost) during the first few years to offset its taxes even more, but this depreciation decreases in later years.

  A company considering the purchase option should evaluate its projections for current and future profits to determine the best time for using this tax benefit, as they might not be as profitable now as they expect to be in the future.

- **Ownership.** Companies own the equipment and can do with it what they please, including selling and replacing it with newer equipment.

- **No maintenance requirements.** Lease terms usually require the lessee to maintain the equipment to pre-defined specifications. When purchasing equipment, companies can maintain it according to their own guidelines.

- **It’s easier.** The process of purchasing equipment is easy. When leasing equipment, companies often have to prepare detailed financial information for the lessor and might have to negotiate lease terms.

The Disadvantages of Purchasing Equipment Include:

- **Higher initial expense.** In the long run, purchasing equipment with cash may be less expensive than leasing, but companies will have to spend more upfront. When purchasing through a loan, companies typically have to make a down payment and will be responsible for interest payments.

- **Less available liquidity.** Because of higher upfront costs, companies that purchase equipment might have less cash available to reinvest in other parts of the business.

- **Obsolete equipment.** Equipment becomes obsolete, with some types—such as computer technology—aging faster than others, so companies might need to replace equipment earlier than expected, even if they are still paying against the loan. In addition, companies might find it difficult to sell outdated equipment once they pay off the loan.

  As with purchasing, leasing capital equipment creates advantages and disadvantages.
Potential Advantages of Leasing Equipment Include:

- **Tax advantages.** When a company leases equipment it can keep the equipment off its balance sheet and deduct the entire lease payment over the term of the lease. [NOTE: Under proposed new accounting standards scheduled to go into effect in 2015, companies will no longer be able to keep leases off the balance sheet. This will be discussed in more detail later in this paper.] Rather than taking varying depreciation expense, every payment a company makes is an expense item, which “straight lines” the depreciation and tax expense during the term of the lease.

- **Lower rate.** Borrowers can trade the depreciation benefits to the lender in return for a lower interest rate, which lowers the total cost of the lease.

- **Fixed rate.** Because the interest rate is fixed, companies can easily calculate lease costs for the lease term, making budgeting easier and effectively hedging some portion of their interest rate risk. This is especially important in a rising rate or inflationary environment.

- **No upfront costs.** Companies can finance up to 100% of the purchase price instead of making a down payment.

- **More available liquidity.** Companies that lease equipment won’t tie up cash and can instead reinvest this cash into other parts of the business to generate a higher rate of return.

- **More flexible payment options.** Companies can customize lease terms to match equipment use and life expectancy, as well as the company’s unique needs.

- **Easier to upgrade equipment.** Companies that lease equipment for a short period can pass the burden of unloading obsolete equipment to the lessor.

Potential Disadvantages of Leasing Equipment Include:

- **Payment obligation for the entire term.** Companies must pay the lease for the entire term, even if they stop using the equipment before the lease expires. Some leases allow companies to cancel the lease or pay it off early, but these options often come with expensive termination fees. (Some loans also contain fees for paying off the loan early.)

- **Higher overall costs.** While there are tax benefits to leasing equipment, companies usually have higher overall costs when leasing compared to purchasing outright. The variance depends on interest rates, the rate of inflation, and opportunity costs of the borrower.

- **Maintenance records.** Leased equipment often must be maintained to certain standards, and companies must keep accurate maintenance records to ensure they comply with these requirements.
Net Present Value and Benefits of Long-Term Financing

When procuring equipment, companies must consider equipment price, the interest rate of a loan or lease, the revenue the equipment can generate over a certain period, and the salvage value at the end of the equipment’s life.

Because future dollars are valued less than today’s dollars (based on the time value of money), companies should evaluate these terms in the present value of future income, or net present value (NPV). NPV is a universal appraisal method, and using NPV is one way companies can determine whether to purchase or lease capital equipment.

Leasing Options and Considerations

There are two major types of business leases—operating leases and capital leases. For accounting purposes, these leases are defined as:

- **Operating lease.** In an operating lease, the lessee does not own the equipment—the lessor still maintains ownership. The lessee treats the lease payments as an operating expense (or rent) and can deduct the payments from its corporate income. In an operating lease, the lessee must include the lease expense in the income statement, and the lease does not affect the balance sheet.

- **Capital lease.** A capital lease is recognized as an asset and a liability on the balance sheet, and the lessee can claim depreciation and deduct the interest expense component of the lease payment each year. Companies also should be aware of how the IRS views a company’s equipment lease, as this is important to determine the specific tax benefits of each approach. Generally, the IRS has two classifications for leases—tax leases and non-tax leases.

- **Tax lease (also called a true lease).** In a tax lease, the IRS considers the lessor to be the owner of the equipment and, therefore, the lessor has the right to the tax benefits of ownership. With a tax lease, the lessee has the right to deduct lease payments as capital expenses. The IRS generally treats operating leases as tax leases.

- **Non-tax lease.** With a non-tax lease, the IRS treats the equipment lease as if it were a purchase or loan for tax purposes. In this case, the lessee receives the tax benefit of ownership, including depreciation, but the lessee is unable to deduct lease payments as capital expenses. The IRS generally treats capital leases as non-tax leases.
A Look Ahead: Time-Sensitive Considerations When Leasing

There also are time-sensitivity factors with respect to leasing that companies should consider when making a decision. These are ongoing issues companies need to be aware of as they evolve.

Changes in Accounting Practices

In September 2002, the FASB and IASB began discussing the development of a common set of accounting standards that could be used for both domestic and cross-border financial reporting to create greater financial transparency. Both entities aimed to develop a new approach to lease accounting to ensure assets and liabilities arising from leases were recognized in the statement of financial position.

The proposals would result in a consistent approach to lease accounting for both lessees and lessors—a “right-of-use” approach. Among other changes, this approach would result in the liability for payments arising under the lease contract and the right to use the underlying asset being included in the lessee’s statement of financial position, thus providing more complete and useful information to investors and other users of financial statements.2

The new accounting standards could go into effect in 2015. Two significant changes could mean a substantial impact on operating leases:

- **Lessees must report all leases as assets and liabilities.** Lease contracts will appear on the balance sheet as an asset, representing the right to use the leased asset, and also as a corresponding liability, representing the rental payment value.

- **Eliminate rent from the income statement.** The lessee’s income statement will no longer show rent expense. Instead, the right-of-use asset will be amortized on a straight-line basis and interest will be added. [*NOTE: As of publication, the “right of use” accounting on the income statement is still being debated and may not make the final exposure draft.*]

As a result of the proposed changes, many equipment leases will return to the balance sheet, as will commercial real estate contracts and rental agreements. Banks and other creditors most likely will have to re-evaluate a company’s creditworthiness when extending financing.

Accelerated Depreciation Phase-Out

Another consideration for companies making a purchase or lease decision is the phase-out of accelerated depreciation.

The recent recession caused the U.S. government to create solutions to spur capital spending in an attempt to help stimulate the economy. One such solution was “Bonus Depreciation,” in which a company could immediately expense 100% of its equipment purchase in the first year. The government later modified this to 50% bonus depreciation, with the remainder of the expense drawn out according to the traditional Modified Accelerated Cost Recovery System (MACRS) schedule, the current tax depreciation system.

The 50% provision is set to expire at the end of 2012 (and at the end of 2013 for some equipment, such as transportation property and certain aircraft), at which time companies will return to the traditional depreciation schedule.

Under the traditional MACRS depreciation schedule, a company must depreciate equipment according to a varying rate, calculated based on the useful life of the equipment. For example, if a company purchases a piece of equipment with a MACRS life of 5 years for $100,000, pursuant to MACRS the company would depreciate the equipment at 20% the first year, 32% the second year, 19.2% the third year, 11.52% the fourth and fifth years, and the remaining 5.76% the sixth and final year. This varying depreciation can complicate tax accounting and, depending on the company’s profitability in any given year, may or may not be truly tax efficient.

In contrast, should a company lease that same piece of equipment, they would expense the rental payments for the lease (in essence straight lining the expense over the term of the lease). Companies using this method would expense equipment that was written on a five-year lease by simply expensing each monthly rental.
The Last Word

Determining whether to purchase or lease equipment isn’t an easy decision. Companies facing this decision should consider the NPV of the equipment, applicable tax breaks, preferred depreciation schedules, resale value, the useful life expectancy of the equipment, and if they will need to upgrade to newer equipment within a certain amount of time.

There are additional factors that can make the purchase or lease decision more complicated. Changes in accounting practices and the accelerated depreciation phase-out, which are set to take place in the next few years, can play a role in this decision. Once these changes take effect, companies will no longer be able to take advantage of certain benefits, so now might be the best time to consider a purchase or lease.

Every company is different, and those companies unsure of how to accurately assess their needs and navigate the purchase/lease decision should work with a non-biased equipment consultant who can evaluate all of the factors and help them make the most cost-effective decision. Equipment consultants can help companies determine a purchase or lease strategy by asking the questions that companies might not have considered. Companies also should consult with their tax professional to ensure they understand the specific tax benefits of their purchase or lease decision.

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About the Author

Jud Snyder is President of the BMO Harris Equipment Finance Company.

A Whitefish Bay, WI, resident, Jud graduated from the University of Wisconsin with a double major (BA) in Russian and Economics.

Jud joined M&I Bank after he graduated. His first position was Credit Investigator, from which he quickly moved on to Credit Analyst, a role he performed over the course of four years in three different parts of the company.

Jud then joined the M&I Equipment Finance Company. He progressed to a series of roles, culminating in his position as Head of the M&I Equipment Finance Company in 2009. After being acquired by BMO Financial Group, the name of Jud’s team changed to BMO Harris Equipment Finance Company.

Jud sits on the National Board of Directors of the Equipment Leasing Finance Association and has recently joined the Business Advisory Council at UW-Milwaukee’s Lubar School of Business.

In addition to this white paper, Jud has authored The Future of Equipment Finance, which appeared in the October 2011 issue of Perspectives, a quarterly newsletter from BMO Harris Bank that addresses the top issues facing mid-sized businesses. He is a contributor to the Insights blog on the BMO Harris Bank Commercial Banking Resource Center. He also was featured in July 2012 by the Monitor in its annual report, the Monitor 100.

Headquartered in Milwaukee, the BMO Harris Equipment Finance team is currently ranked in both the Monitor Bank 40 and Monitor 100 lists of the largest U.S.-based equipment finance companies.
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