

# LEASING FACTS

## Introduction and History

- [Most Companies Lease](#)
- [Leasing is Not New](#)
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### **Most Companies Lease**

About eight out of ten U.S. companies now lease some or all of their equipment according to the Equipment Leasing Association of America (ELA). This is up from 64% in 1984 and the numbers are even higher in relation to emerging companies and/or high tech equipment.

ELA reports that annual leasing volume in the U.S. in 1996 was 168.9 billion (up from 128.9 billion in 1992). That's about 31% of all capital equipment acquired (up from 27% in 1985).

### **Leasing is Not New**

Leasing has been around for centuries. Records of lease transactions date back to before 2000 b.c. Early leases were for agricultural tools, oxen, land and water rights. References to leasing laws go back to Babylonian king Hammurabi in 1700 b.c.

In 450 b.c. the Murahu family of Nippur (near Babylon) began a banking and leasing house that dealt with land, oxen, agricultural equipment and seed. Leasing references can be found in the Greek, Roman and Egyptian societies as well. Even medieval knights were known to have leased armor.

The first recorded leases of personal property in the U.S. occurred in the 1700's and provided for the leasing of horses, buggies and wagons.

With conventional financing hard to come by for expansion (sound familiar?), the growing railroads leased locomotives and rail cars from equipment trusts that sold shares to investors. The most widely used form of railroad financing was called the Philadelphia Plan, which allowed the transfer of ownership to the user on completion of the lease. This was the forerunner of conditional sale contracts and "lease-purchase" arrangements.

In the early 1900s, railroad leasing companies realized that some of their clients didn't want long term control or ownership of rail cars, but rather short term use, and so provided shorter term contracts. Thus the operating, or "true" lease.

### **The Modern Era**

Another interesting trend that developed was the desire of companies to protect their technologies by leasing, not selling their equipment. Bell Telephone provided phones on this basis as early as 1877, with others like Hughes tool (drill bits), U.S. Shoe Machinery (manufacturing equipment), IBM (computers) and Xerox (copiers) following. Eventually, however, the enforcement of federal antitrust legislation forced manufacturers to offer their equipment for sale.

Independent lessors then sprung up to buy such equipment from the manufacturers and offer it for lease, often competing with the manufacturers themselves for customers. Many of these independent lessors formed alliances with equipment vendors to lease that vendor's equipment to their customers.

Eventually these independent leasing companies began providing leasing services directly to the lessee for a wide variety of equipment, not just those items that were formerly under manufacturers' rental programs. Some manufacturers, not wanting to make the investment necessary to fund their own leasing programs, sought out these new "third party" leasing companies to provide lease programs for their equipment. A significant portion of the leasing done in the U.S. today continues to be done by such vendors referring customers to independent lessors.

## **The Benefits of Leasing for the Customer**

- [Leasing is Flexible](#)
- [Leasing Frees up Cash](#)
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- [Leases Offer Better Terms than Bank Loans](#)
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### **Leasing is Flexible**

*A lease can be structured in a variety of ways to match specific challenges.*

For instance, lease payments can be "seasonally varied" to match uneven cash flow. They are made lower in the "off seasons" and higher the rest of the time, a consideration in business such as commercial photography, agriculture and hospitality.

Payments can be tied to specific "project funding," with the bulk of the investment covered during the term of the committed project (at rates consistent with the cost of short term rentals on similar equipment), and the remainder at greatly reduced levels over an extended term after the initial project is completed.

This type of program is valuable to companies in the film and television fields, for instance, or for those dealing with defense or other contract bidding environments where the ability to maintain capacity in the absence of cash flow while "between contracts" can mean the difference between survival and failure.

"Step down" leases, where the payments reduce each year, are popular for high tech equipment because they better match the value curve of the equipment, enhance difficult credit situations and facilitate upgrades.

Leases with "step up" (lower payments to start) schedules come in handy for expansions where cash flow from the new equipment may take a while to develop or when costs must be kept low to match a limited budget near the end of a fiscal year.

Leasing allows you to customize a variety of terms your particular circumstances. As long as they are a good credit risk, lessors will consider virtually any special request.

### **Leasing Frees up Cash**

*Leasing provides 100% financing. There are no down payments and no compensating balance requirements.* Furthermore, almost everything may be covered by a lease including shipping, installation, software, related equipment, furniture and even training costs. There is no need to tie up valuable working capital.

Because payments are matched closely to cash flow, excess cash isn't tied up in equipment, so it is available for use in more profitable investments. Companies with available cash can add sales people, increase marketing, take advantage of quantity buying opportunities, make acquisitions or invest in appreciating assets such as real estate.

### **Leasing Preserves Bank Lines**

*Leases do not generally impact your bank lines of credit.* Those lines of credit are invaluable for short term needs and must be preserved for that purpose. Financing equipment on a bank line of credit, or even on a separate installment loan agreement with the bank, cuts into the availability of cash from that bank.

Leasing, on the other hand, is like opening an additional and separate line of credit, expanding, as opposed to restricting, the customer's financial resources.

### **Leases Offer Better Terms than Bank Loans**

*Leases do not require substantial down payments and are for generally longer terms than bank loans.* There are no compensating balance requirements, floating interest rates or restrictive covenants, and as long as payments are being made as agreed, the leasing company, unlike the bank can not arbitrarily call the loan if it suddenly feels uncomfortable in your client's industry.

In addition, bank loans often contain clauses cross collateralizing all business and personal assets, allow the filing of blanket liens to tie up all company assets (either owned at the time of the loan or acquired in the future) and permit periodic rate increases based on fluctuations in the bank's cost of money.

### **Leasing can Save on Taxes**

*Because lease payments are a direct operating expense, they come out of pre-tax dollars, not after-tax profits.* Direct expensing leased to faster write-offs, freeing up more cash sooner than on a corresponding depreciation schedule.

This conserved capital can then be re-invested in the business with the profits from that investment further offsetting the net cost of the equipment acquisition.

### **Leasing Hedges Against Rapid Obsolescence**

With product life cycles shortening for most equipment, the ability to acquire new technology in order to remain competitive becomes extremely important. Leasing facilitates these upgrades because there are usually no penalties for the actual upgrade and because a large portion of the investment in the existing equipment has already been written off.

Also, "step down" leases can be structured to match the equipment value curve to the lease payout curve, so that the sale of the existing equipment provides proceeds to pay off the first lease obligation and the customer simply starts leasing the new equipment without substantial additional payments.

### **Leasing Fights Inflation**

Even with the government fighting a constant battle to control inflation, costs keep rising. And,

inflation both reduces the value of funds while raising the cost of new equipment. By committing to a fixed payment lease now, your customer locks in a lease payment for up to five years, no matter how much prices rise in the future.

Thus leasing allows you to pay for today's equipment with tomorrow's potentially cheaper dollars.

**Leasing keeps Equity Intact**

Many growing companies consider the sale of stock to finance expansion, thereby diluting owners' equity.

Leasing can often make it possible for to acquire the same equipment without having to give away part of your company to do so.

**Leasing is Easy and Convenient**

Budgeting, bookkeeping and tax computations are simplified with leasing. Even the application process is much simpler. Most lease transactions for less than \$75,000 worth of equipment require only a one page credit application.

Also, cost analysis is simplified with leasing. A sample of a Lease Cost Analysis computation follows. Note the ease in computing the investment down to cost per hour, or even cost per unit produced.

Lease Cost Analysis	
1. Equipment	\$
Cost.....	11,182.50
2. Monthly Lease Payment Equipment	\$
Cost.....	294.10
3. Annual Gross Cost (line 2 x	\$ 3,
12).....	529.20
4. Tax Deduction (40*% of line	\$
3).....	1,411.68
5. Net Annual Cost (line 3 minus line	\$
4).....	2,117.52
6. Net Cost per Month (Line 5 divided by	\$
12).....	176.42
7. Net Cost per Day (Line 6 divided by 22**	\$
days).....	8.02
8. Net Cost per Hour (Line 7 divided by 8	\$
hours).....	1.00
9. Net Cost per Unit (Line 8 divided by	\$
***)	_____
<p><i>* Federal + California tax rates. Adjust for your state.</i></p> <p><i>** Twenty two is the average number of business days in a month.</i></p> <p><i>Adjust for actual schedule.</i></p> <p><i>*** Divide by number of units produced per hour.</i></p>	

## Types of Leases

- [True Leases](#)
- [Capital Leases](#)
- [Master Leases](#)
- [Is it a Lease or purchase? -Tax Purposes](#)  
[Legal Details](#)

### True Leases

This lease format is often called a "Tax Lease" because it is accepted by the IRS for direct expensing of payments.

In order to be accepted for such treatment by the IRS, the true lease must not pass title as part of the contract, nor offer bargain purchase or renewal options, nor be for disproportionately long terms. It is ideal for equipment whose value will drop rapidly due to use or technological advance (computers, for instance).

Because the payments on such a lease are directly expensed for tax purposes, the write-off of the investment is generally much faster than under a sale agreement or with outright purchase. The resultant reduction of short term tax liability frees up cash, which is invested to offset a portion of the equipment cost. In a sense, the government "pays" for its portion of your investment faster.

### Capital Leases

This lease is sometimes called a "Pseudo Lease" (or the "Lease to Own" program) because it does not meet the requirements of a True Lease and is treated as an installment sales contract for tax purposes. Thus the equipment cost must be capitalized and depreciated over acceptable guideline periods, resulting in generally slower write-off.

These "Capital Leases" are most often advantageous when the equipment is expected to have substantial value at the end of the lease term (a machine tool, for instance). You pay for the equipment over the lease term, after which you have the option to purchase the equipment or renew the lease at pre-determined bargain prices.

These "leases" may not be directly expensed for tax purposes. Leases with fixed dollar amount purchase options (\$1, \$101, etc.) or those with fixed percentage of original equipment cost purchase options (5%, 10%, etc.) usually fall in this category.

### Master Leases

A lease program can be structured to finance your customer's projected equipment needs for many months in advance. Rates are often based on the total amount of the commitment and are thus lower than those that a series of smaller transactions would offer. Schedules are then added as new deliveries occur. Paperwork is simplified and each schedule can be written for different terms and with different payment schedules to match the needs for that particular piece of equipment.

Selling add-on equipment becomes much simpler for you, as you know the financing is already in place to cover it.

Master leases can range from as low as \$50,000 and for up to several million dollars, and there are few limitations on equipment location or type.

A small fee is usually required to secure the commitment which can cover your needs for the rest of your fiscal year.

### Is it a Lease or Purchase?

#### Tax Purpose

*The distinction between the two types of finance leases, true lease (sometimes called "fair-market-value lease") and quasi-lease (sometimes called "lease-purchase"), is important because one of the potential tax advantages of leasing rather than purchasing is that lease payments can be deducted as operating expenses, a deduction that is generally greater and faster than that for depreciating equipment. The deferral of taxes typically results in lower cost on a present value basis.*

<p>Under the true lease, the lessor owns the equipment and the lessee expenses lease payments. Under a quasi-lease, the lessee expenses interest and depreciation.</p> <p>There are four key requirements for treating a contract as a lease rather than as a purchase for tax purposes.</p> <ol style="list-style-type: none"><li>1. Title cannot pass during or at the end of the lease term.</li><li>2. There can be no bargain purchase option, defined as a sum significantly less than fair market value.</li><li>3. There can be no bargain renewal option.</li><li>4. The term of the lease cannot exceed 75% of the useful economic life of the equipment.</li></ol> <p>Frequently, the term "lease purchase" is incorrectly used to refer to a true lease. A true lease can offer to sell the equipment to the lessee at the end of the lease for a sum consistent with its then current fair market value, but any attempt to fix that amount in advance puts the burden of proof as to reasonableness on the lessee.</p> <p>Financial reporting purposes:</p> <p>The rules for reporting lease under GAAP (Generally Accepted Accounting Principles) are governed by the Financial Accounting Standard Board (FASB).</p>	<p>GAAP requires that in order to treat a lease as a lease for financial reporting purposes (an "operating lease"):</p> <ol style="list-style-type: none"><li>1. Title cannot pass during or at the end of the lease term.</li><li>2. There can be no bargain purchase option, defined as a sum significantly less than fair market value.</li><li>3. There can be no bargain renewal option.</li><li>4. The rental payments committed under the agreement, when present value at the lower of the lessee's incremental borrowing rate and the lessor's implicit rate do not exceed 90% of the equipment cost.</li></ol> <p>If the lease meets FASB requirements, the rental payments can be treated as an operating expense and there is no necessity to show the total lease commitment as a liability (rather it is simply entered as a footnote). This improves the financial ratios and avoids running afoul of other loan covenants.</p> <p>If the lease fails to meet the tests, it is classified as a "financial lease" and must be capitalized and depreciated for balance sheet purposes in the same way as a purchase.</p>
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## The Lease Application

- The first step to a "yes"
- Filling out the Lease Application
- Bank Accounts
- Other Loans or Leases
- Trade References
- Lessee Name
- Signature
- Personal Data
- Larger Transactions

### The First Step to a Yes

There are several factors that any credit analyst considers when reviewing a lease application. First and foremost is the question of whether the customer has the ability to pay. On larger transactions, the analyst can review financial statements and tax returns in an effort to determine that customer's financial strength. On smaller applications (under \$75,000), they must usually rely primarily on the information contained on the application form itself. Of course, if that information raises questions about the customer's credit standing, they are free to ask for more information to complete the package.

The second question asked is whether the customer does, in fact, make a habit of paying his bills in a timely manner. To answer this question, inquiries are made to their bank and with those companies with whom they do business (trade references) to verify payment history. Information available from public reporting agencies such as Dun & Bradstreet or TRW is also used for this purpose.

Because the lease application information is so heavily relied on, it is particularly important that it contain complete and detailed information from which an intelligent decision can be made.

***Note: Improperly filled out applications are the single biggest cause of lease approval delays.***

### Filling out the Lease Application

*Special attention should be given to the following items:*

#### *- Bank Accounts*

Account numbers of bank accounts and, where possible, the name of the bank officer familiar with the account are most important. If the account has been at the bank for less than two years, information on the prior bank relationship should also be provided.

#### *- Other Loans or Leases*

These should also be included together with account numbers and contact names. Include accounts which have been paid off in full as well as those currently open. These "comparable credits" go a long way to establishing credit history

#### *- Trade References*

Complete information, including account numbers and contract names of major trade suppliers. A favorable reference from these key suppliers is a positive. Favorable references from several small suppliers that together total 10% of your purchases, are simply not sufficient. The more the better.

- *Lessee Name*

Be sure that you have written the *exact legal name* of the company and whether it is a corporation, partnership, or proprietorship.

- *Signature*

A company representative, preferably an officer must sign the declaration section of the application. This gives the lessor the authority to check credit and is particularly important because some banks will not rate by phone. Being able to fax a copy of a signed declaration often secures the needed information.

- *Personal Data*

Particularly on proprietorships, partnerships, and closely held corporations, it is important to have the home address and social security numbers of the principals. These are necessary to obtain certain credit reports. If someone has been at their present address for less than two years, be sure to include their previous address as well. Particularly on smaller transactions, personal credit history is an integral part of the decision making process.

**Larger Transactions**

On transactions over \$75,000, or where the proposed lessee has been in business for less than two years, a complete credit package is usually required.

The "complete" credit package will include two or three complete years of company financial statements and, if those statements are not audited, copies of the corresponding tax returns. It will also include personal financial statements on the principals and their personal tax returns.

If this material is insufficient to get a good picture of the applicant, then your leasing company may also ask for copies of business plans, copies of contracts with customers, references from customers and suppliers and other additional information.

But, obviously, the more complete the package the first time, the less the possibility of delay in the approval process.

## NOTES