Ag Decision Maker

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Machinery Leasing - Is it for you?

While the vast majority of farm machinery is still acquired for cash or with a conventional loan, leasing is also a popular choice. Leasing plans offer a large degree of flexibility of payment terms. Both farm machinery manufacturers and independent companies offer lease opportunities.

Types of Leases

Two general types of lease plans are available. The major factor that distinguishes these plans is by how they are treated for tax purposes.

Operating lease

An operating (or true) lease calls for a series of regular payments, usually annual or semi-annual, for a period of years. At the end of the lease period, you have the option of purchasing the machine at a price approximately equal to its fair market value. The option price may be set when the lease is signed or it may depend on the accumulated use and condition of the machine when the lease expires.

Alternatively, the machine can be returned to the dealer or lease company, or the lease can be extended. The lease payments are reported as ordinary expenses on your tax return. If the purchase option is exercised, the machine is placed on your depreciation schedule with a beginning basis equal to the used purchase price.

Finance lease

A finance lease is treated as a conditional sales contract by the IRS. You are considered to be the owner of the machine so it is placed on your depreciation schedule. Payments made to the lease company must be divided into interest and principal, with the interest being tax deductible. Many finance leases are essentially installment loans with balloon payments after three to five years. The difference is that at the end of the lease period, you have the choice to either return the machine to the dealer (and give up ownership), or make the balloon payment (and take ownership). Since the finance lease is not taxed as a true lease, the final buy-out price (balloon payment) can be quite variable, depending on the length of the lease and the size of the payments.

Advantages of leasing

Although leasing may not be for everyone, there are several advantages.

- Lower payments, compared to most conventional loans. Of course one reason the payments are lower is that you are building little or no equity in the machine. At the end of the lease period you have nothing except the right to exercise the purchase option.
- Machinery leasing utilizes operating capital instead of investment capital. Payment schedules can be matched to periods of high cash flow. Cash requirements for machinery are constant and known in advance. This is particularly beneficial for high volume, low equity operators who can't afford large capital outlays at a point in time.
- If you routinely trade major machinery items every few years, you will find that leasing generally offers lower payments than the payments on a loan used to purchase the machine.
- If you are near retirement, you may prefer to lease equipment so that it can be easily liquidated in a few years with no income tax recapture.
- Leasing also offers you the chance to try out a particular machine for a few years without buying it.

Not for everyone

Lease companies are in business to earn a return on their capital. If you have enough money to purchase machinery outright, you will usually spend less in

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the long run by owning it. This is especially true for machinery that will be owned for five to ten years or more. In addition, you build equity through ownership.

Expense method depreciation

In addition to regular depreciation, you may be eligible for expense method depreciation during the first year. This deduction is available for machinery purchased or leased under a finance lease, but not under an operating lease. So, you may prefer to acquire the machinery by an outright purchase or a financial lease and take full advantage of the early depreciation option. However, if you buy other property that can also utilize the expense method depreciation, you may have already reached your limit for the year.

Include on the balance sheet

Sometimes leasing is touted as "off balance sheet financing". However, while an operating lease is not a loan, it does represent an obligation to pay and a cash flow commitment is incurred. The Farm Financial Standards Council does not recommend that leases of capital assets be shown as a liability on your balance sheet. Likewise, the leased equipment should not be shown as an asset. However, adding a footnote to the balance sheet that explains the terms of the lease is a good idea.

Questions to ask

As with any contract, read the fine print and ask questions before signing. The following provisions should be discussed and understood.

- Who is responsible for maintenance and repairs? Generally, you are, although leased machines often carry the same warranty as purchased equipment. Clarify who is responsible for insuring the leased equipment, as well.
- What are the purchase option terms at the end of the lease? How will the buy-out price be determined if it is not specified in the contract? Are there adjustments for wear and tear?
- Is it possible to terminate the lease early, if you are not satisfied? Often there are penalties for doing so. There may also be extra charges for high usage rates.
- What is the timing and frequency of payments? Does this match your cash flow pattern? Can these be modified? When is the first payment due? Often the first payment is due when the machine is delivered or placed in service.
- Does the lease meet the requirements to be taxed as an operating lease, or will it be considered as a finance lease by the IRS? Either choice could be preferred, depending on your tax situation.
- Compare each financing option by laying out the cash payments side by side over the life of the lease or the loan. Estimate the tax savings for each one, and then compare the after-tax cost of each option. AgDM *Information File A3-21, Acquiring Farm Machinery Services* can be used to make this comparison.
- Make your decision based on total after-tax cost as well as near-term cash flow requirements.

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