Introduction *to* LEASING

Adapted, with permission, from The Canadian Institute of Chartered Accountants, Toronto, Canada, October, 1998.

COMMON LEASING TERMS

The following list comprises some standard definitions that are widely accepted in the accounting profession.

Capital Cost Allowance (CCA) is the annual depreciation expense allowed by tax authorities as a charge against taxable income. An important factor in leasing is the half-year convention that allows only one-half of CCA to be deducted by the owner of the asset in the year of acquisition.

Capital Lease is a lease that, from the point of view of the lessee, transfers substantially all the benefits and risks of ownership of property to the lessee.

Contingent Rental is a rental based on a factor other than the passage of time (e.g., percentage of sales, amount of usage, prime interest rate, and price indices).

Economic Life of the Leased Property is the estimated remaining period during which the property is economically usable for the purpose for which it was intended (factoring in normal repairs and maintenance).

Fair Value is the amount of the consideration that is agreed upon between knowledgeable, willing parties who are under no compulsion to act. The fair value of the property at the inception of the lease will usually be its cost to the lessor.

Inception of the Lease is the earlier of the date of the lease agreement and the date of a commitment, which is signed by the parties, and includes the principal terms of the lease (this is the effective date used for classification of the lease).

Initial Direct Costs are those costs incurred by the lessor that are directly associated with negotiating and executing a specific leasing transaction. Such costs include commissions, legal fees and costs of preparing and processing documents for new leases. Such costs do not include supervisory and administrative costs, and costs incurred in collection activities and provisions for non-collectible rentals.

Lease is the conveyance, by a lessor (owner) to a lessee (user), of the right to use a tangible asset for a specified period of time in return for rent.

Lease Term is the fixed non-cancellable period of the lease. The lease term is considered to be non-cancellable if cancellation is possible only: upon the occurrence of some unlikely contingency; with permission of the lessor; upon the lessee entering into a new lease for the same or equivalent property with the same lessor; upon payment by the lessee of a penalty sufficiently large that continuation of the lease appears reasonably assured at the inception of the lease.

Lessee's Rate for Incremental Borrowing is the interest rate that the lessee would have incurred to borrow the funds necessary to purchase the leased asset (over a similar term and with similar security).

Operating Lease is a lease in which the lessor does not transfer substantially all the benefits and risks of ownership of property.

Option Price is normally a fixed sum, expressed as a percentage of the initial equipment cost. This price should be a reasonable estimate made at the inception of the lease, of the FMV of the equipment at the time the option is to be exercised.

Option to Purchase allows the lessee to purchase the asset at a predetermined price after a specified number of payments have been made.

Residual Value of the Leased Property is the estimated fair value of the leased property at the end of the lease term.

Sale-Leaseback Transaction is the sale of property with the purchaser leasing the property back to the seller. Lessors generally have a preference for new equipment, but a sale/leaseback can be arranged for previously acquired equipment.

Settlement Value, also known as the Casualty Value or Stipulated Loss Value, is a percentage of the original cost of the asset being leased. The settlement value indicates the minimum amount the lessor would require from the lessee to terminate the lease and still maintain its economic yield on the lease, if it became necessary.

BENEFITS OF LEASING

COMPARED TO TRADITIONAL SOURCES OF FINANCING, LEASING CAN OFTEN PROVIDE:

- Fixed rates for the duration of the lease (often 3 to 5 years). Over 90% of all leases transacted in Canada are fixed rate leases.

- Flexible payment schedules: the term, payment, and purchase option of a lease are flexible. A lease can be structured to fit an operating budget or the company's cash flow cycle.

- Simplified budgeting: rentals can be structured from the outset of the lease to match the useful life of the revenue-producing asset, including technological obsolescence.

- Preservation of working capital and credit availability: working capital and credit availability often represent different entities. Leasing can provide up to 100% financing, thereby preserving working capital. Alternatively, when the lessee wishes to preserve an operating line of credit, leasing can be a viable financing option.

- Usually no additional collateral: typically, it is not necessary to pledge other assets, such as accounts receivable or inventory. Also, there usually are no restrictive covenants of the type found in loan agreements.

- Straightforward documentation: Lessors usually provide simple, standardized lease documentation.

- Cost deduction over lease term: The lessee can deduct 100% of the lease payments as a business expense. Deducting the entire rental payment may be advantageous when compared to expensing the interest costs of a loan and the asset's CCA.

LEASING IS OFTEN PREFERABLE TO BORROWING UNDER THE FOLLOWING CONDITIONS:

- CCA rate of the asset in question is low (i.e., 30% or less)

- The lessee is currently paying taxes

- The term of the lease is short (five years or less), or in the case of certain exempt property, where longer-term tax-oriented leases are structured.

- 100% financing is sought.

- The asset leased is highly susceptible to technological obsolescence.

Property has benefits and risks associated with its ownership. Benefits may be represented by the expectation of profitable operation over the property's economic life and of gain from appreciation in value or realization of a residual value. Risks include possibilities of losses from idle capacity or technological obsolescence and of variations in return due to changing economic conditions.

CLASSIFICATION OF LEASES

What is a Capital Lease? A Capital Lease (also called a financial or a full payout lease) is a contractual agreement that transfers substantially all the benefits and risks of ownership of property to the lessee. The lessee's payments cover the lessor's capital outlay and provide a return to the lessor.

The lessee usually: carries the maintenance and insurance; carries the acquisition and the payment obligation on its financial statements; has a fixed option to purchase the equipment at a specified time; and has fixed rental payments.

In other words, the total amount the lessor receives during the lease term (including the option price) is equal to the equipment cost, plus profit. The lease term is usually related to the estimated useful economic life of the equipment being leased.

A lease would normally transfer all of the benefits and risks of ownership to the lessee when, at the inception of the lease, one or more of the following conditions are present:

- ✓ There is reasonable assurance that the lessee will obtain ownership of the leased property by the end of the lease term.
- ✓ The lease term is of such duration that the lessee will receive substantially all of the economic benefits to be derived from the use of the leased property over its life span. Although the lease term may not be equal to the economic life of the leased property in years, it may be equal to a major portion of the economic life (usually 75% or more).
- ✓ The lessor is assured of recovering the investment in the leased property and of earning a return on the investment as a result of the lease agreement. This condition would exist if the present value of the minimum lease payments, at the beginning of the lease term, is equal to substantially all (usually 90% or more) of the fair value of the leased property.

What is an Operating Lease? An Operating Lease is a lease in which the lessor retains all the benefits and risks of ownership of the asset.

The present value of the minimum lease payments is usually less than 90% of the original equipment cost. The amount of the original equipment cost that is not recovered during the term of the lease is an exposure remaining to the lessor and is commonly described as "residual risk".

> ***Note:*** *The Bank Act places certain restrictions on bank-owned leasing companies which precludes them from taking a residual value greater than 25% of equipment cost on a specific transaction. Therefore, in certain instances, a creditworthy third party, usually the equipment supplier, may assume the residual risk of the leasing company.*

WHEN IS A LEASE A TRUE LEASE VS. A SALE?

In certain circumstances, a lease transaction may be deemed to be a sale. Revenue Canada establishes that a transaction is a sale rather than a lease if any one of the following conditions exists:

- The lessee automatically acquires title to the property after payment of a specified amount through rental payments.

- The lessee is required to buy the property from the lessor during or at the termination of the lease or is required to guarantee that the lessor will receive the full purchase option price from the lessee or a third party.

- The lessee has the right during or at the end of the lease to acquire the property at a price, which at the beginning of the lease is substantially less than the likely FMV of the asset at the purchase option date.

- The lessee has the right during or at the end of the lease to acquire the asset at a price or under terms or conditions that at the commencement of the lease would cause a reasonable person to exercise the option.

Editors Note: On June 14 2001, Canada Customs and Revenue Agency "CCRA" cancelled Interpretation Bulletin #233R "IT233R" stating that the determination of whether a contract is a lease or sale is based on the legal relationship created in terms of the agreement, rather than on any attempt to ascertain the underlying economic reality and in the view of the CRCA a lease is a lease and a sale is a sale. Furthermore the CRCA stated that this position applies to all leases including financing leases. The tests noted above reflect concepts that were contained in IT233R and as such, may not be applicable for differentiating between a Lease and a Sale.

LEASE VS. BUY ANALYSIS…

The major items to be considered in the analysis of the lease/buy decision are as follows:

- Ensure the after-tax savings of leasing compared to owning are analyzed.

- Ensure the lease/buy analysis is valid, in terms of residual/disposal assumptions, time line considerations, loan terms etc.

- Ensure all relevant costs such as sales tax, legal fees, installation costs and removal costs are included.

- Ensure an appropriate discount rate is used in the present value analysis.

- Ensure simple documentation, flexible structuring, 100% financing and other qualitative considerations are included in the analysis.

Note: There is no standard solution to lease versus buy analysis. Whether a lease is preferable to buying depends upon the particular circumstances of the potential lessee, the type of asset being acquired, the qualitative advantages of leasing, and the selection of the appropriate discount rate for present value analysis purposes. As well, lease/buy analysis differs in cases of sale-leaseback transactions, leases with Joint Election, etc.

HOW A LEASE DIFFERS FROM A TERM LOAN

Issue	Loan	Lease
Ownership of the asset	* Borrower owns * Bank has a collateral security interest	* Lessor owns * Lessee uses and maintains asset and needs no other collateral
Tax treatment of the payments	* Borrower deducts the interest part of the payment, and claims depreciation (CCA) * Bank considers only the interest portion as taxable income	* Lessee deducts as an expense the entire rental payment but not CCA unless a joint election is made * Lessor treats entire lease payment as taxable income, but can partially offset income with the CCA
How repayment relates to ownership and taxes	* Bank recovers investment through interest and principal payments	* Lessor recovers investment expense through the rental payments, the purchase option, CCA
The "rate" which is quoted	* A loan has an interest rate	* A lease has an implicit rate

Note: *The lessee can file a Joint Election to exercise an election to claim CCA and notional interest in a lease as an alternative to the deduction of rental payments.*

Potential lessees sometimes compare costs associated with a lease and a loan. For comparisons to be accurate, certain distinctions must be made:

1. The "implicit" or "lease" rate, is not the same as a borrowing cost or an interest rate.
2. In a lease, the full amount of the rental payment is expensed for tax purposes.
3. In a loan, only the interest portion of the payment is deducted for tax purposes and CCA is claimed on the cost of the equipment.