

Lease vs. Purchase

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In the continuing assessment of whether leasing versus purchasing an asset is advantageous, practitioners are often confused by a plethora of commentaries that do not reflect reality.

The purpose of this brief assessment is to provide a very simple thumbnail sketch of the motivations that offer leasing versus purchasing alternatives.

Simply stated, the overriding, economic decision-making for whether a lease is more advantageous than the direct purchase of the asset and subsequent securing financing to fund the asset is simply a base of **incremental borrowing rate** is the stated rate of the lease in considering all costs, fees, and assessments less than the stated interest rate that would be required if that equipment is to be purchased and an amount was financed.

SIMPLE STEPS TO MAKE THE DETERMINATION

Engage your CPA. Your CPA will make a very quick present value calculation of the stream of payments with the estimated balloon buy-out or assessed fair market value of the equipment at the conclusion of the lease. In most veterinary practices, the leases are not true operating leases, but rather disguised purchase leases. The contracts usually recite a specified price for the purchase of the equipment at the conclusion of the lease. Don't be confused by financial accounting and tax-based assessments of whether an acquisition is characterized as a financing or operating lease, but rather make a very simple assessment: "What can I buy this equipment for at the conclusion of the lease term?"

The monthly payments, which include the sales tax component, the term of the lease, the details of whether the lease payment is to be made at the beginning or end of the period, any deposits that must be paid and the timing of those deposits either as payments at the beginning or end of the lease, and the filing of the residual value of the lease can all be compiled by the CPA in a very simple present value program to determine the incremental borrowing rate. Be sure to tell the CPA the sales tax that must be paid on that payment since sales tax in a lease is not only assessed on the underlying acquired portion of the fair market value of the asset but, in addition, the sales tax is assessed in most states and commonwealths on the interest expense component. This makes the incremental borrowing rate of a lease substantially higher. Look for all of the hidden fees associated with the lease including early termination, allocation of principal and interest, and basis of buy-out of the lease early.

Now, look at the purchase option. Ascertain, from the bank, the stated interest rate you must pay including any bank fees. Some of you may already have this known because of prior business relationships with a banker. Some of you may have a line of credit that is readily available. Whatever means you have, understand that you can easily determine the incremental borrowing rate. Ask the CPA to take the total cost of the asset, add to that the

sales tax component so that the fully absorbed cost of the asset is considered. Calculate the monthly payments to make sure they are affordable, and take the assessed incremental borrowing rate and compare it to the imputed calculated rate that the CPA makes through the lease. In most leases, the true incremental borrowing rate is never disclosed. Compare the incremental borrowing rate on the same basis. Many times, leases are calculated as if they were under payments that are made at the beginning of the month as opposed to payments that are made at the end of the month. The way the payment is made and how the interest is calculated has a bearing on the incremental borrowing rate.

If you have quite a few leasing versus buying decision-making transactions, a more appropriate activity might be to ask the CPA to set up a template in Excel that shows, through data input and subsequent calculation, the decision in the incremental borrowing rates. Your practice manager can then simply access that Excel spreadsheet to make the determined calculations.

One obstacle in leasing versus purchasing might be that you have no business buying the equipment in the first place. Bankers usually require some equity participation, known as a down payment. Some practices are so cash poor and the practice principals are so cautious with cash that they have no accumulated cash available. Those practices in such dire, cash flow strapped situations should avoid the acquisition of the equipment. Leasing the equipment may get the practice in even more significant difficulties.

Sometimes, leasing high-tech based equipment is a mistake. One example that comes to mind is the practice owner who leases an ultrasound in the hope an associate will soon learn to become adept and skilled in the activity. The associate fully assures the practice owner that effort will be taken to master the use of this diagnostic tool. The practice owner signs for a long-term commitment of acquiring the property through a lease. Unfortunately, the practice owner does not insist upon a residual contract obligating the associate to buy the equipment in the event that the employee leaves the employ of the employer. You guessed it! The employee does leave and the employer is stuck with a technologically obsolete piece of equipment and two to three years of additional payments to be made. The equipment stands idle while the payments are continually made. A practice should determine whether leasing the equipment is appropriate in relationship to the anticipated use of the equipment. Trying to get out of a lease often becomes a nightmare.

The lease is calculated based on the rule of 78s -- that is, a portion of the lease is front-loaded so that very little credit is given for early payments on the lease. The credit for the true payment of the acquisition cost of the equipment is credited at or near the conclusion of the lease. Accordingly, very little relief is given through premature disposition of lease prior to the concluding payment. On the other hand, most banks will now loan money for equipment on a simple declining balance basis. Banks, at one time, used also this installment calculation of the rule of 78s. Anyone involved in the decision-making process between lease versus purchase should be fully apprised of how the interest expense is calculated.

Now, let's look at the tax attributes. Buying property in today's economic and tax climate provides a greater acceleration of benefit than leasing property. At one time, prior to a series of tax amendments and adjustments, leasing may have had some attraction but now, with the availability of expensing under Section 179 as well as temporary relief provisions for terrorist-based activities and encouragement of American businesses to acquire capital assets, the depreciation method and the availability of deductible interest make buying assets far more attractive in terms of garnering accelerated tax benefits earlier.

One exception to the above comments can be made in the leasing of automobiles. There are some isolated instances where vendors will offer leasing programs in order to unload slow-moving inventory of automobiles. There are some isolated cases where leasing an automobile may be more advantageous than buying that vehicle. This statement adds even more validity when the vehicles are traditionally traded for newer models on a more frequent basis. Also, look at the mileage that the anticipated vehicle will be driven. There are limitations in lease agreements as to how many miles the lessee can drive the vehicle before penalty mileage is assessed.

In conclusion, consider the advice given by your grandparents or great-grandparent who probably emigrated from another country to the United States. You will find that their advice to you was to always save and buy only that which you can afford. Owning an asset was far more attractive than renting an asset. Many of these immigrants were forced, when they first came to this country, to rent because they had not acquired the necessary capital. Mere survival was the optimum business plan. Their children, grandchildren, and great-grandchildren do not have the same onerous burden of survival. However, survival may not be as much of an issue but good business sense is. Their instincts towards frugal acquisition of assets and only buying that which can be afforded is an attitude that should be potentially emulated in the generations that follow.

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