FARM MANAGEMENT

MACHINERY OWNERSHIP VS LEASING

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A common Question that is raised today is "Should I Lease or Purchase my next investment in machinery?" The answer doesn't come as easy as the question.

What is a Lease?

The first thing we should establish is the fact that the term lease is use to mean anything from a two day rental to a financing arrangement that passes ownership in an asset. The IRS views an operating lease and a finance lease as deductible on schedule F. A lease that is actually a conditional sales contract must be separated into interest and other charges, and principal payments. Each component of the lease purchase must be deducted or capitalized and depreciated as provided by the IRS Code.

Operating lease

An operating lease is a short term lease which does not transfer the ownership of the leased property. This type of lease can be very beneficial and economical. An operating lease is useful if you need the use of equipment for a short period of time. For example you may rent a no-til planter to try a field of no-til soybeans.

Finance lease.

A finance leases applies to farm leases entered into from July 1, 1982 to December 31, 1987. The finance lease set a safe harbor amount that allowed a farmer a deduction, as rent, even if a purchase occurred. The leased property had to be new and could not exceed $150,000. Finance leases applied only to property eligible for investment credit. The purchase option had to equal at least 10% of the original cost of the property.

New since January 1, 1988

Under current regulations a lease is considered a conditional sales contract if ownership changes or any equity toward ownership is gained. The mere right to buy the property after having made all the required payments creates a sales contract. The option to buy will now have to equal the fair market value at the time the option is exercised if IRS is to consider lease treatment.

Rent vs. lease example

Assuming that the lease arrangement qualifies as a rent deduction:

A farmer agrees to pay $40,000 for a new piece of farm equipment. The total amount plus $2000 for PCA stock will be financed at Farm Credit over a 5 year period. The interest rate is 11% variable. The cost per month is $913.18 as long as the rate does not change, or a total 5 year pay out of $54,791 less $2,000 from the sale of the stock for a net pay out of $52,791.

B farmer arrives at the same $40,000 agreement but elects to lease the equipment over a five year period. The lease at First Valley Leasing will cost $932.00 per month. At the end of five years B will have paid out $55,920. However, in order to own the equipment B will have to purchase it for it's fair market value. Assuming a $4,000 value on the equipment the total pay out grows to $59,920. Penn State Cooperative extension in using trade names makes no endorsement of individual products or services.

Leasing provides a tax advantage.

B farmer gains a $2210 tax advantage assuming a 31% tax rate (15% federal, 13% self employment, 2% state and 1% local). In addition an advantage in cash flow is realized by leasing in the third through fifth years. The cash flow advantage belongs to A in the first, second and sixth through eighth years. (see Cash Costs graph)

Taking a closer look.

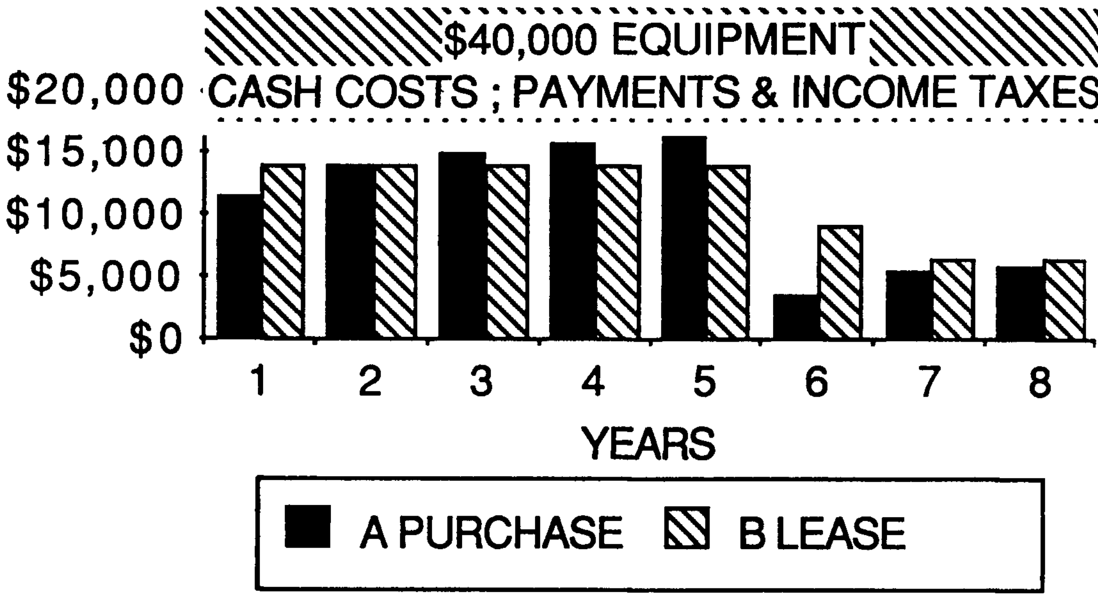
Making the assumption that farmer A & B are equal in all respects, except for the decision to lease vs purchase and their tax bill without the new equipment would be $6,467 at 31%, we can calculate the next effect of the lease vs purchase. If each farmer takes the excess cash flow and invests it in 5% tax free bonds A (purchase) increases his advantage to $5,871 over the eight year period. To lose this advantage due to the 11% variable interest rate the rate would have to exceed 16.5% for the life of the loan.

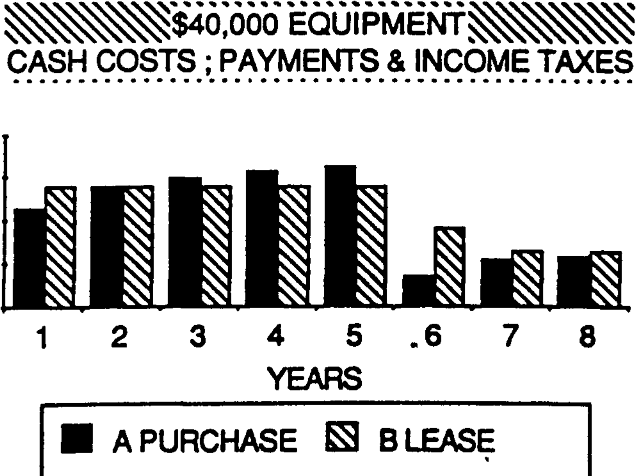
Be careful in shopping for financing of capital acquisitions. Many salesmen will tell you leasing has a tax advantage, a cash flow advantage and it will not tie up other capital. This, as shown in the example, is true to some degree, but the bottom line favors purchasing. Other factors must also be considered so each individual needs to examine the facts and calculate the advantages for each case.

Penn State Cooperative extension can now provide analysis through the use of a computer program called FINPACK. Examining alternatives under FINPACK may prove useful in making many farm financial decisions. More information about FINPACK can be obtained from your equal opportunity county extension office.

CASH FLOW PURCHASE A VS LEASE B

YEAR	A PURCHASE	B LEASE	A - B	IF INVESTED TAX FREE AT 5% A	B
1	$11,666	$14,184	-2518	2518	
2	$14,057	$14,184	-127	2898	
3	$14,974	$14,184	790	3043	790
4	$15,737	$14,184	1553	3195	2383
5	$16,401	$14,184	2217	3355	4719
6	$3,637	$9,227	-5590	9112	4955
7	$5,637	$6,467	-830	10398	5202
8	$6,052	$6,467	-415	11333	5462
TOTAL	88161	93081	-4920	11333	5462
A GAIN				5871	





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