BUSINESS PRACTICES FOR SUSTAINABLE CONTRACTORS

Part Three—Buying New Equipment: Lease vs Buy

The method you use to finance your new equipment purchase can have a significant impact on your bottom line. Should you lease or buy? This is another area in which I find many contractors struggle to make a confident decision. There is no right or wrong answer—and in some cases it makes little difference to the end result—but it is a decision every contractor needs to make at some point. Here are some things to consider that may help you decide what is best for you.

The decision to purchase or lease a piece of equipment involves several factors: available financing options; the lowest overall cost when tax and discount rates are considered; and the cash flow and tax situation of your company. If your company has different lenders with different financial covenants, it is important to understand how purchasing and leasing could impact your financial statements in order to ensure that your decision will not put you offside with one of your lending institutions.

Tax and cash-flow considerations

When you lease an asset, 100 per cent of the payments are considered tax-deductible when they are paid (exceptions apply in the case of a large downpayment). This gives you a good match between the cash outflow to the tax deduction.

When you purchase an asset, it will be recorded for tax purposes and the associated capital cost allowance (CCA) deducted from taxable income, with only half of the depreciation allowed in year one; the interest paid will be deducted from taxable income for the period as well. Since a purchase normally requires a downpayment, and since principal payments are not tax-deductible in year one, there is often a mismatch between the cash outflow and the tax deduction received in that first year. With large equipment purchases, this mismatch can tie up significant amounts of cash without an immediate, matching tax deduction. In the ideal cashflow world, you would receive a $1 tax deduction for every $1 that leaves your bank account.

For major capital purchases such as a loader, feller buncher or excavator, the tax works out roughly the same; however, the timing of the deductions is not the same. If you buy these assets, you receive a tax advantage in the early years because the tax deduction will normally exceed the lease payment amounts for those first three years. After about three years, the scale tips the other way, and the tax deduction becomes less than the lease payment. If you are looking for a quick tax deduction, you typically get more in the short run by purchasing. If you find a deal where the downpayment is low, or nothing at all, you will be ahead if you buy the asset. However, if you were required to make a large downpayment, the tax deduction may never exceed the cash outflow. Therefore, if your goal is to match cash outflow with tax deductions, a lease may be a better option.

Be cautious if you have always purchased your assets in the past and are now switching to a lease. Your trade-in must be disposed of for tax purposes, but your new asset is not added to your tax pool, so you could end up with a negative tax consequence in year one.

Service life considerations

If you are a contractor who wants to run new equipment all the time, we are finding that owning it can cost you more cash when you factor in the downpayment, amortization and interest. In this case, leasing may have its advantages. Just pay careful attention and watch out for those lease administration and other hidden fees. When factoring those in, the interest rate can go from the advertised 5 per cent to much higher—in some cases closer to 12 per cent.

If you are a contractor who likes to keep machinery for the long haul, owning is almost always going to be cheaper, as the interest rates associated with leasing are typically higher.

Timing of acquisition

The purchase of a piece of equipment allows for the full amount of capital cost allowance to be deducted from taxable income in the year of purchase, regardless of the timing during the year. For operating and capital leases, only the lease payments paid during the year are deductible for tax purposes. This fact may influence your decision based on whether the lease or purchase option provides the lowest overall cost.

Final thoughts

Remember, leasing companies are in business to make money, as are those that finance purchases (notwithstanding that financial institutions are now offering some very attractive leases). Your decision will not only affect your current bottom line and tax position, but also has the potential to influence your company's ability to obtain financing in future years. To ensure that you are not limiting your company's opportunities, be sure to consult your primary lending institution. A good business advisor can also help you determine which deal is the best for you, and help you keep as much of your hard-earned money in your pocket as possible.

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