A new lease of life

A substantial part of UK balance sheets are still made up of physical assets. These can represent a considerable source of risk in terms of depreciation in their market value on account of use or obsolescence. Although insurance provides day-to-day risk transfer on upkeep and replacement costs, the core financial – or residual value – risk remains attached to the title of the asset. As such, treasurers are increasingly seeking to avoid taking on title in the first place, instead taking out operating leases on the new equipment demanded by the expansion or evolution of their business.

Indeed, this is being encouraged by the effective closure of one of the other main avenues for big-ticket asset procurement – finance leases. This is expected to be enacted by a reform to be introduced with the 2006 Finance Bill, scheduled for early next year. Although the attendant refocus on operating leases should pay substantial dividends in terms of financial planning, organic growth and balance-sheet management, gearing up for a future in which banks own substantial portfolios of assets and companies lease them on renewable contracts will require a range of responses from both sides. And given that leases commence not when equipment is ordered but when it enters use, next year's reform may yet affect ongoing procurement programmes with deliveries scheduled for next year.

RESPONSE TO TAX REFORM At the heart of the reform is the issue of capital allowances, whereby expenditure on new assets is deductible from taxable profits. This was first introduced in order to encourage investment in industry – but many companies found their year-on-year taxable profits were, in fact, not large enough to take advantage of the tax break. Banks, by contrast, were more usually in a position to offset the tax advantage against tax paid on profits from their wider activities. Hence finance leasing, whereby the bank purchases the asset and leases it to the company – making use of its capital allowance on the purchase cost to offer cheaper overall finance.

But since the 1980s, the amount of the capital cost generally eligible for a tax break has been whittled down from 100% in the first year to 25% per annum on a reducing balance basis. Now the UK government is going a step further – reversing the tax treatment on higher-value asset leasing deals in order that the capital allowance accrues to the company and the bank is taxed as it would be for a normal loan (i.e. on its interest earnings). This is to make sure the party that takes on the residual risk on an asset is also the one that benefits from the tax break. Capital allowances for operating leases – whereby the bank retains ownership of the asset at the close of the lease – are therefore still expected to accrue to the bank.

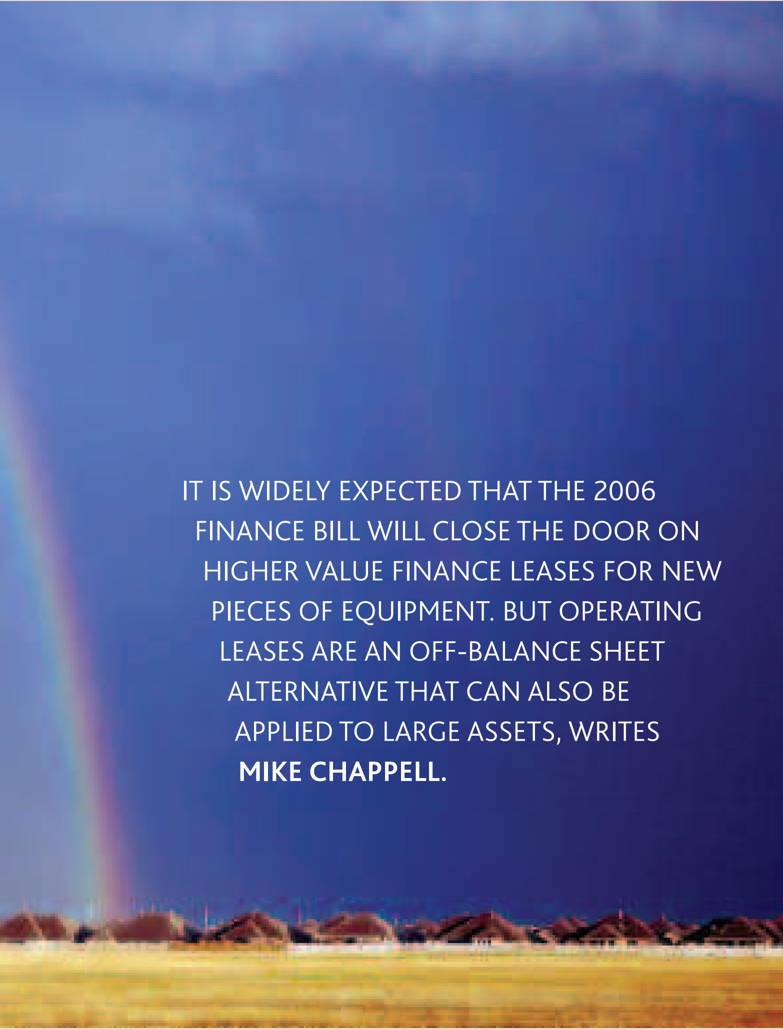
Operating leases therefore combine the cost reduction resulting from the capital allowance with the highest level of risk-transfer, as the asset never represents a balance sheet exposure – or debt burden – for the company. And companies can also transfer existing assets off-balance sheet by completing sale and leasebacks, providing the asset's remaining economic life is long enough for the bank to take some degree of residual risk.

SHORT LEASES TO REMAIN However, given that finance leasing has proved to be a godsend to smaller companies, the legislation is expected to include a carve-out clause that enables the allowances on shorter finance leases to remain with the bank – which will still be able to pass on its tax benefit via cheaper finance. This will have the effect of keeping asset procurement costs down for companies that need smaller assets that cannot qualify for operating leases, for instance on account of their specialised or fixed nature.

This carve-out currently is anticipated to cover leases of under 51 months – just over four years – with leases of between four-and-a-half years and six-and-a-half years potentially qualifying for the same treatment, providing they have smooth repayment curves rather than simply a lump sum at the end. The time element is essential to the tax efficiency of finance leases as the capital allowances are apportioned across the repayment schedule. This is why the carve-out clause is framed in terms of the length of the lease rather than

Executive summary

- Treasurers often seek to avoid taking on title of physical assets and this is being encouraged by the incoming tax regime.
- Operating leases combine cost reduction resulting from capital allowances and the highest level of risk-transfer.
- Short leases are to remain while a new category, the funding lease is being introduced.
- Treasurers and banks will have to get to grips quickly with the new regime.



ALTHOUGH THE ATTENDANT REFOCUS ON OPERATING LEASES SHOULD PAY SUBSTANTIAL DIVIDENDS IN TERMS OF FINANCIAL PLANNING, ORGANIC GROWTH AND BALANCE-SHEET MANAGEMENT, GEARING UP FOR A FUTURE IN WHICH BANKS OWN SUBSTANTIAL PORTFOLIOS OF ASSETS AND COMPANIES LEASE THEM ON RENEWABLE CONTRACTS WILL REQUIRE A RANGE OF RESPONSES.

the value of the asset. It would be impossible to shoehorn an airplane lease, for example, into a four year finance lease and expect to gain any tax advantage – as the time apportionment for four years is too short.

For longer leases, the Inland Revenue is introducing a wholly new category – the funding lease. In order to capture only those synthetic finance leases that it intends, the Revenue has developed four conditions that, if met, mean the capital allowances will only be available to the lessee itself (giving advantage to those corporates with large enough taxable profits to benefit). As stated above, these are intended to identify where the bank is not, in fact, left with sufficient residual value to continue benefiting from owning the asset, therefore ruling out an operating lease. These conditions are anticipated to be:

- where the lease is a finance lease under Generally Accepted Accounting Principles (GAAP).
- where the Net Present Value of the lease rentals is more than 75% of the market value of the asset (it being judged that less than a quarter of the value does not qualify as true residual value).
- where the minimum term of the lease is more than 50% of the remaining expected economic value of the asset (less than half the lifespan being similarly judged).
- where the asset could not, in fact, be re-used on account of its specialised nature (the Eurotunnel drill bits, for example, which have little residual value buried under the English Channel).

IMPACT ON ASSETS BUYING What, then, will be the impact of these changes on companies buying new assets in the UK, as well as the banks that fund such assets?

First, those corporates that need to procure large assets with minimal outlay and minimal risk going forwards are likely to look closely at the operating lease option. This means banks need to improve their equipment management capability – i.e. ongoing asset valuation and portfolio management – in order to be confident about taking on ownership of a large number of assets. And to price the leases on these competitively, banks will require extensive equipment management teams, including sector specialists, to ensure that lease pricing takes into account present and future market conditions for an asset.

Second, those companies in need of smaller assets – often smaller companies themselves – should benefit from increased liquidity among asset finance divisions looking to offer finance leases that fall within the carve-out clause. This is good news for the mid-market, especially as some banks are specifically targeting this market with offerings that combine standardised application processes with bespoke, centrally provided deal structuring. Given that even orders for relatively small assets – from fleets to warehouse fittings – can be bundled together to qualify for this treatment, there are substantial financial advantages to be had even quite far down the market.

Third, although leases signed before the Bill comes in will be grandfathered – i.e. exempted from the incoming regime – the order process leading to some leases that will qualify may already have begun. And with details only recently confirmed, this timeframe could see both banks and companies confronted by the reality of the new regime sooner – and with less room for manoeuvre – than they think.

The comments above are the personal view of the author and what he anticipates the new legislation will say. Companies in need of more detailed guidance should seek legal advice.

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