a new lease of life

The UK's 2006 finance bill includes changes that are likely to make finance leases a thing of the past for many companies. The new rules might also create renewed interest in operating leases, although strict rules now apply. Toby Guise a director at the Moorgate group provides an overview.

A substantial part of UK company balance sheets is made up of things you can drop on your foot – physical assets, in other words. These represent a considerable source of risk in terms of depreciation in their market value due to 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. Transfer of ownership is therefore the only complete form of risk transfer – and one that is often exploited by treasurers in the form of operating leases on new equipment.

The use of operating leases is being encouraged by the closure of one of the main avenues for big-ticket asset procurement – the finance lease. This will be enacted by a reform to be introduced with the 2006 Finance Bill, final details of which were only released in May this year. Given that leases commence not when equipment is ordered but when it enters use, next year's reform is likely to affect orders that have already been placed.

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 a company until the eventual transfer of ownership – making use of its capital allowance on the purchase cost to offer cheaper overall finance.

However, since the 1980s, the amount of the capital cost eligible for a tax break has been whittled down from 100% in the first year to 25%, and then 25% per annum on a reducing balance basis thereafter. Now the 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. This is to make sure the party that takes on the residual risk of an asset is the one that benefits from the tax break. Capital allowances for operating leases, where the bank retains ownership of the asset at the close of the lease, will therefore still 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.

Short leases to remain

However, given that finance leasing has proved to be a godsend to smaller companies, the legislation will 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 which cannot qualify for operating leases.

This carve-out currently covers leases of under 51 months, just over four years, with leases of between four-and-a-half and six-and-a-half years, potentially qualifying for the same treatment, providing they have smooth repayment curves rather than 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.

For longer leases, the Inland Revenue is introducing a wholly new category, the 'funding lease'. In order to capture 'synthetic' finance leases, the Revenue has developed four conditions that, if met, mean the capital allowances will only be available to the company itself (giving advantage only to those companies with large enough taxable profits to benefit). These conditions are:

- Where the lease is a finance lease under GAAP (Generally Agreed Accounting Principles),
- 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 that 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 expected economic life of the asset.
- 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).

Summary

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, companies that need to procure large assets with minimal outlay and minimal risk going forward 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 equipment 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.

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.