Equipment leasing

Leasing of capital equipment by industrial and commercial companies has become increasingly important during the last ten years. This article surveys the development of equipment leasing, explains some of the reasons for its growth, and discusses recent market trends. During the preparation of the article, officials of the Bank visited a number of lessors in order to discuss current developments. These discussions were particularly helpful in preparing the final section. The Bank would like to thank all those who helped.

Introduction

The most important distinguishing feature of leasing as a source of finance for capital investment is the separation of ownership and use. An equipment leasing company (the lessor) buys a piece of capital equipment and leases it to a customer (the lessee) for use in his business. Leases are normally with commercial customers and are not used for consumer transactions.

A distinction is usually made between finance leasing and operating leasing. Finance leasing—the main subject of this article—is generally regarded by the lessee as an alternative to outright purchase. The lessee selects, and the lessor buys, the equipment to be leased. The term of a finance lease usually approximates to the useful life of the equipment being leased. The equipment is depreciated by the lessor during this primary period, after which it may be sold and a share of the proceeds passed to the lessee as 'rebate of rental'. Alternatively, the lease continues at the option of the lessee into a secondary period at a lower rental.

Operating leasing, on the other hand, is akin to hiring. Operating lessors are usually able to offer technical advice to lessees on the choice of equipment. Their profits depend on their ability to re-sell the equipment or to re-lease it. For this reason the most suitable assets for operating leasing are those which are moveable, easily maintained, readily insured and have a fairly wide market with predictable values: they include computers, containers, commercial vehicles and cars. Some manufacturers also arrange for the leasing of their products as a means of encouraging sales.

Finance leasing enables the lessor, as owner of the equipment being leased, to obtain the benefit of the capital allowance available for it. The user of the equipment (the lessee) pays the lessor a rent which covers both the capital cost of the equipment and a finance charge. This charge reflects the benefit to the lessor of the cash flow advantage of deferring his tax liabilities until he receives (taxable) repayments of his initial outlay in the form of rentals. For the lessee, leasing effectively spreads the benefit of the capital allowance over the period of the lease. This would result in a cash flow disadvantage for lessees who are taxpayers, because they pass to the lessor the capital allowance and thus effectively defer receipt of the benefit of the allowance. On the other hand, if a lessee has no, or small, taxable profits, the deferral of the receipt of these allowances has little significance. Provided that the finance charge levied by the lessor is lower, as it usually is, than the cost to the lessee of borrowing a similar sum, then leasing will be the more advantageous form of finance for the non-tax-paying company, and can be so even when the absence of taxable profits is short-lived.

Leasing is attractive in conditions where:

- there are on the one hand a number of companies to act as lessors with taxable capacity substantially in excess of their own investment requirements, and, on the other, a number of companies to act as lessees with investment requirements substantially in excess of their taxable capacity;

- inflation and nominal interest rates are high, so enhancing the lower effective interest rate which the lessor is able to charge.

The appendix provides a more detailed explanation of why the lessor is able to charge a lower interest rate on a lease than for lending, and also describes the cash-flow effects of leasing.

Growth of leasing in the 1970s

Although the origins of equipment leasing in this country can be traced back to the nineteenth century, its modern development began in the 1960s. The main period of expansion, however, was in the 1970s. This is illustrated by estimates published by the Equipment Leasing Association (ELA) of the new business undertaken by their members since 1971, which are shown in Table A. This reveals rapid growth in leasing, especially since 1975 (although to some extent this also reflects an expansion in the membership of the ELA). The Department of Industry have, since 1975, published more comprehensive estimates of the amount of leasing, hiring and renting out, and these show growth of 30% per annum in real terms between 1975 and 1979.

Table A also illustrates the growth in leasing to manufacturing industry. In 1979, assets leased to manufacturing companies represented nearly 14% of their recorded investment in plant, machinery and vehicles, compared with around 6% in 1975.

Table A
Amount of leasing

£ millions
Estimates at 1975 prices in italics

	Gross assets acquired for leasing (including ships)				Per cent
	Equipment Leasing Association estimates		Department of Industry estimates		Proportion of investment by manufacturing industry in plant, machinery and vehicles financed by leasing
1971	159	*280*	..	..	..
1972	130	*210*	..	..	..
1973	280	*410*	..	..	..
1974	321	*390*	..	..	..
1975	340	*340*	537	*537*	6.5
1976	421	*360*	670	*574*	7.0
1977	675	*515*	1,004	*765*	8.9
1978	1,214	*820*	1,634	*1,100*	11.7
1979	1,802	*1,145*	2,394(a)	*1,520*	13.7

.. not available.
(a) Provisional.

The initial impetus for the growth of leasing in the 1970s was the switch from investment grants to first-year allowances which was announced in 1970. Instead of receiving a cash grant from the Government, a company was able to offset allowable capital expenditure against taxable income in the year that the investment was made, and so reduce its liability to corporation tax. The change to first-year allowances did not make a substantial difference to companies with taxable profits high enough to cover capital allowances: they obtained a similar benefit whether as a grant or as reduced liability to corporation tax. However, companies with insufficient taxable profits could not take full or immediate advantage of allowances and, although such companies could offset allowances against taxable incomes in future years, the real value of the allowances was reduced by inflation. Such companies included new and expanding ones with investment programmes which were large in relation to their current profits.

In the mid-1970s there was an increase in the number of industrial companies which were not able to take immediate advantage of capital allowances. The growing incidence of tax exhaustion partly reflected increases in the generosity of first-year allowances and the introduction of stock relief in 1974, and partly a general decline in profitability.[1] These factors meant that leasing became an increasingly attractive form of finance for a growing number of companies. Until the 1980 Finance Act, leasing also allowed local authorities and other tax-exempt bodies potentially to obtain the benefit of 100% first-year allowances, even though they themselves would not be entitled to these allowances.

The entitlement of leasing companies to capital allowances, as owners of the equipment being leased, enabled them to pass on part of the benefit to the lessee in the form of lower rental payments. For this transfer of taxable capacity to be possible, it was necessary for leasing companies with limited investment programmes of their own to have sufficient profits to furnish them, in effect, with unused allowances. The clearing banks were in this category and their leasing subsidiaries became the major force in leasing in the early 1970s—a period when the clearers were widening their range of financial services. Other institutions with leasing subsidiaries include independent finance houses, merchant banks, some insurance companies and overseas banks. More recently, some industrial and commercial companies have begun writing leases, commonly with the advice of an established leasing company.

The rapid growth in leasing between 1976 and 1978 also reflected a spectacular increase in car leasing. Table B, which provides a breakdown of the type of assets leased by members of the ELA, shows that cars represented only 1% of assets leased in 1976, but 8% in 1977 and 28% in 1978.

There were two reasons for the expansion of car leasing. The first was a judgment in 1975 that leasing companies were entitled to 100% first-year allowance on leased cars (in place of a 25% annual allowance on a reducing balance). The second, and more lasting, reason was the abolition of hiring controls on leased cars in June 1977, which removed the need for payment of ten months rental in advance. The entitlement to 100% first-year allowances was subsequently withdrawn by the 1979 Finance Act (except in relation to short-term hire); even so, car leasing has remained fairly buoyant, and accounted for 26% of ELA members' business in 1979.

Table B
Analysis of leasing business of ELA members

£ millions
Percentage share in italics

	1976		1977		1978		1979	
Assets acquired during year								
Plant and machinery	139	*33*	198	*29*	250	*21*	415	*23*
Computer and office equipment	78	*19*	164	*24*	240	*20*	315	*17*
Ships and aircraft	117	*28*	108	*16*	158	*13*	298	*17*
Commercial vehicles	58	*14*	114	*17*	154	*13*	225	*12*
Cars	6	*1*	57	*8*	343	*28*	468	*26*
Other	23	*5*	34	*6*	69	*5*	81	*5*
	421		675		1,214		1,802	
Assets owned at year-end (at cost)								
Plant and machinery			753	*32*	976	*29*	1,338	*27*
Computer and office equipment			467	*20*	660	*19*	933	*19*
Ships and aircraft			525	*22*	656	*19*	940	*19*
Commercial vehicles			363	*15*	490	*14*	670	*13*
Cars			99	*4*	434	*13*	884	*17*
Other			171	*7*	191	*6*	265	*5*
			2,378		3,407		5,030	

Although the introduction of capital allowances and stock relief together with the decline in the profitability of industrial companies were the main reasons for the growth of leasing in the 1970s, leasing has other attractions as a method of finance. It provides, for example, 100% medium-term finance usually at fixed rates, which facilitates management of cash flows. Also, the fact that leasing commitments do not have to be disclosed in companies' balance sheets was one factor in the initial growth of leasing in the 1960s. But its importance receded in the 1970s as financiers learned to look behind the published accounts. Nevertheless, leasing does allow companies to finance capital expenditure in a way which is

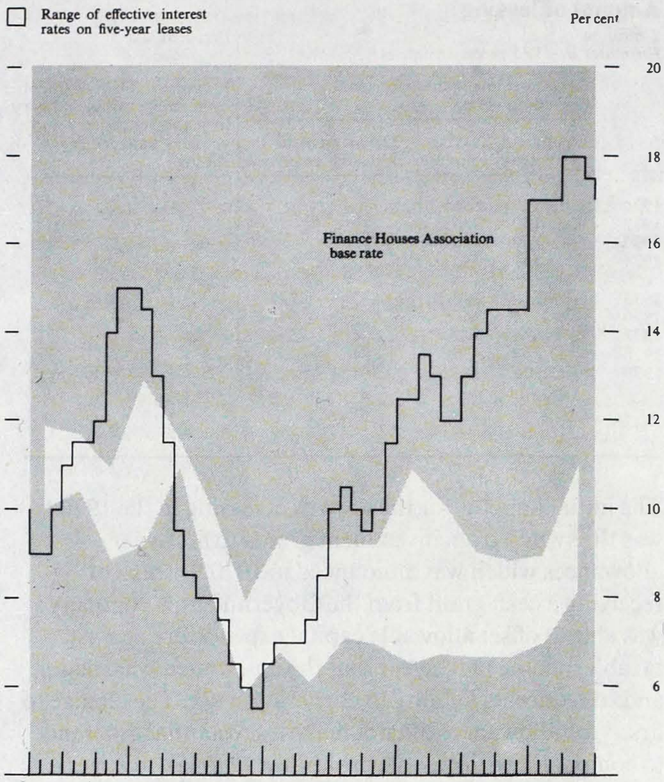
(1) See, for instance, 'Profitability and company finance' in the June *Bulletin*, page 191.

not taken into account in calculating restrictions on borrowing in, for example, debenture trust deeds.

The view has gained ground that greater disclosure of leasing commitments in company accounts is desirable for its own sake, though opinions differ on the most appropriate method by which this should be achieved. The main question of presentation is whether the leased assets and associated rental liabilities should be shown on the face of the balance sheet or in a note to the accounts. The Accounting Standards Committee has been examining this subject and is expected soon to issue a discussion paper or an exposure draft.

Finally, some leasing may have been prompted by the fact that, because leasing rentals are usually treated as revenue expenditure, they are sometimes subject to less close scrutiny than capital expenditure financed in other ways. Thus a departmental manager may be able to authorise additional revenue expenses of, say, £1,000 per month for a five-year lease, when he would find it difficult to persuade his seniors to spend £50,000 for the same item of equipment.

Effective lease interest rates



Source: Saturn Lease Underwriting Limited

Market trends 1976–80

Cost of leasing

When a lease is negotiated, the cost to the lessee is usually expressed in terms of a regular rental payment rather than as the underlying interest rate which can be derived from the stream of rental payments. This is one of several factors which make it difficult to monitor and interpret movements in the cost of leasing. Other factors include the segmentation of the market by size of transaction; variations in cost due to the timing of transactions; the frequency of rental payments; and differences in the methods used, and assumptions made, by lessors in calculating rentals.

The chart, which has been produced from information compiled by a firm of lease brokers, shows movements over the four years up to June 1980 in a range of rates paid by lessees on five-year leases with rentals paid quarterly in advance. Not all lessors would regard these rates as being fully representative, but they can be taken as broadly indicative of trends over the period.

The striking feature of the figures is that effective leasing rates have not increased in line with money-market rates (illustrated in the chart by the Finance Houses Association base rate), and indeed have not varied greatly for the last three years. They have been particularly competitive in the last year when interest rates generally have been high.

Competition has been fiercest in the middle segment of the market, covering equipment with an original cost in the £50,000 to £500,000 range. Most lessors find that leases of this size enable them to fill their portfolios with a convenient number of transactions with lessees of good credit standing without incurring either the proportionately high administrative costs attending smaller transactions or the concentration of risks involved in larger transactions.

Spreading risks over a number of transactions—albeit with higher limits than £500,000—appears to have been the preferred policy even of the leasing subsidiaries of the clearing banks up to about 1976. Since then, however, the increase in their taxable capacity has encouraged them to take on larger leases individually. Leases of £10 million or over, which might typically have been syndicated up to 1976 or 1977, are now customarily undertaken by one bank; indeed, a lease of over £60 million has recently been written by one clearing bank subsidiary. In consequence, syndicated leases have become less common. They tend in any case to be less competitive than leases written by single banks because of the additional documentation and administration involved and because of the need to quote terms to reflect the highest of the minimum rental requirements of the members of the syndicate. Nevertheless, syndicates can still perform a useful role where lessors wish to share the credit risk.

Rates charged on large or 'big ticket' transactions were, until the last year or so, generally higher (by about ½% to 1%) than those earned in the middle segment of the market, where a greater number of lessors were competing for business. But market pressures have recently reduced margins on big ticket leases and, according to one lessor, these margins are now no greater than those earned in the middle segment of the market.

Rates on leases on small transactions (up to £50,000 in value) have generally moved within the top end of the range shown in the chart. Indeed, a lessor specialising in small leases reported arranging many leases at rates 1% above the top of this range. Margins on this business need to be higher to take account of the greater administrative costs and the higher credit risks entailed in dealing with small firms. In order to cover overheads, this business is usually managed by a finance house alongside its instalment credit business, operating through a country-wide network of branches. Some finance houses which have a branch network and the expert staff necessary to handle such transactions, but happen to be short of sufficient taxable capacity to take on the leases themselves, sometimes arrange for third parties to buy the goods and lease them to the finance house. The third party then utilises the capital allowance and charges the finance house a rental based on its prime credit standing; the finance house, in turn, charges the user of the equipment (the sub-lessee) a slightly higher rental to take account of its credit standing and the administrative costs.

The timing of a transaction can affect the cost of a lease. Because there is less delay before obtaining capital allowances, a lessor can quote finer rates for leases written towards the end of his accounting year. On a five-year lease with money costing the lessor 15% this could make a difference of up to three percentage points to the effective finance cost to the lessee. Several large lessors have therefore set up subsidiaries with different year-ends to enable them to meet the requirements of lessees by quoting competitive rates throughout the year. This development helps to smooth out a previous seasonal pattern whereby in years when banks increased their estimates of their taxable capacity rates became sharply competitive in the final quarter of the calendar year. At the smaller end of the market such arrangements are less important because lessors tend to fix their rentals by reference to a mid-year point, accepting that leases written before that date will be somewhat less profitable than those written after it. A further influence on the cost of a lease is the frequency of rental payments; the less frequently the rent is paid, the lower the rent the lessor charges for the same profit margin if the rent is paid in advance.

Because lessors adopt varying policies in defining their own profit objectives and make different assumptions in calculating the returns from a lease, they will not necessarily quote the same rentals despite seeking the same profit margin. The most important source of difference in this respect is probably the perceived cost of funds. Whereas, for example, a lessor which is part of a banking group would typically use the current cost of funds on the inter-bank market, an industrial or commercial company writing leases might use the opportunity cost of investing surplus cash.

Wide variations (from 6% to 12% for those lessors visited by the Bank) are also found in the rates of return assumed on the reinvestment of the net surpluses which lessors often obtain in the latter period of a lease. While the practical difference which this makes is in most cases small, it becomes important when additional benefits such as regional development grants or the subsidised interest rates on shipbuilding bring the lessor's cash flow into surplus at an earlier point in the life of a lease.

All the lessors interviewed agreed that their profit margins had been reduced, especially over the last twelve to eighteen months. This is also the clear implication of the relative stability (depicted in the chart) of effective leasing rates compared with money-market rates. A number of lessors did claim to apply a minimum gross profit margin of around $2\frac{1}{2}$% to 3% above their pre-tax cost of funds for customers of high credit standing, and a further gross profit margin of 1% to 2% on top of that for customers whose credit standing was less good. It is worth noting here that the credit rating of the lessee is normally the decisive factor in the assessment of the appropriate rental, and not the type of equipment leased. Thus the security associated with easily moveable equipment which holds its value, such as a fork-lift truck, would not usually induce a financial lessor to reduce his margin.

The majority of leases are written with fixed rentals, thereby entailing a fixed interest rate. In the small and medium-sized range of transactions this appears to be considered mutually convenient by most lessors and lessees because of the certainty it provides for budgetary purposes. There was some difference of opinion among lessors as to the effect of choosing fixed rather than floating rates; some claimed that in present conditions a fixed rate would be lower in expectation of a fall in rates in future, others that it would be based simply on current rates and hence be the same, initially, as a floating rate. Lessees in the middle segment of the market sometimes elect to take the option of a floating rate, but big ticket leases are almost invariably arranged at floating rates.

Causes of the reduction in leasing rates

The main cause of the reduction in margins in recent years has been the increase in the supply of leasing, which has stemmed principally from very large increases in the taxable capacity of the clearing banks in a period of high interest rates. This growth in leasing has been a major channel through which industrial and commercial companies have benefited from the strengthened profits of the banks. It has been estimated that the big four clearing bank groups undertook about £1 billion of new leasing business in 1979, more than four times as much in nominal terms as in 1976.(1) The increase in supply has also been cumulative in the sense that, as they have grown, the leasing companies have had an incentive to write an increasing amount of business to offset the taxable income flowing from the rentals of leases written in previous years.

(1) Estimates of new leasing business constructed from published accounts, as these are, suffer from differences in the reporting periods covered.

Although several industrial and commercial companies have also entered the market as lessors, their presence has not been sufficiently substantial to make a major competitive impact. Because they do not normally have the capacity to assess credit risks, they have tended to concentrate on leasing to prime customers such as local authorities. Hence it is possible that they will lose some of their appetite for the business now that the 1980 Finance Act has withdrawn 100% first-year allowances from equipment leased to local authorities. The reduction in leasing rates has also meant that these lessors may find it difficult to write leases profitably if they have to borrow to finance the initial purchase of the equipment. It is also possible that some companies which previously had spare taxable capacity will move into a position where lack of profitability may make them potential lessees instead of lessors. (It can sometimes even be profitable for the same company to act as both lessee and lessor in the same financial year, by leasing from another company with an earlier entitlement to a capital allowance at the beginning of the year and then offering to another lessee at the end of the year the benefit of the short period before its own entitlement becomes available. In order to obtain this benefit the company acting as both a lessee and a lessor must not be connected with the other companies.)

Competition has also been intensified by increased understanding among potential lessees of the way in which leasing works. Lessees are reported to show little loyalty to their traditional sources of finance or even to lessors previously used; they now generally ask for a number of quotations and choose the cheapest from a reputable source. Leasing brokers have contributed to this state of affairs by making lessees aware of the options available to them. Indeed, lease brokers were particularly active in arranging leases to local authorities which, because of their virtually risk-free status, were able to command the finest rates. This may thereby have indirectly exerted some downward pressure on rates for other lessees of high credit standing.

Other market practices

In recent years lessors have attempted in several ways to confine their exposure to the credit risks of leasing. It is usual, for example, in drawing up a lease, to allow for the possibility of changes in the rate of corporation tax. This practice became widespread following the increase in the rate of corporation tax from 40% to 52% in 1973/74, which led to losses on some leases where the lessor had gained a 40% reduction in his tax bill in applying the capital allowance but subsequently found that the rental income was taxable at 52%. Some tax variation clauses also cover possible changes in the system of capital allowances. Such a change would probably have a more profound impact on the lessor's profit margin than a change in the rate of corporation tax. It is likely that any quotations which did not include such variation clauses, and which happened to be outstanding when a change was made, would be renegotiated.

In most leasing contracts the responsibility to insure the plant leased lies with the lessee, who is also responsible for maintenance and safe installation. The lessor, however, remains the legal owner and could be held liable for such contingencies as industrial injuries or for faulty products manufactured with a leased machine. While a leasing agreement normally provides the lessor with recourse to the lessee, some lessors also take out their own insurance in case the lessee becomes insolvent, though some risks, such as massive pollution from an oil rig, may be too costly to insure in this way.

As a result of increasing competition, lessees have succeeded in reducing the amount of any residual value retainable by a lessor when equipment is sold at the end of a lease. In the early 1970s, a lessor might have expected to retain from 10% to 20% of the value; but $2\frac{1}{2}\%$ to 5% is now more usual and in some cases the lessors retain less than 1%. Secondary period rentals, which have always been much lower than primary rentals, have also, it appears, been reduced in recent years and such rentals are now quoted as being typically about $\frac{1}{2}\%$ to $1\frac{1}{2}\%$ per annum of the original cost of the equipment.

Another trend has been towards longer lease periods, particularly for larger items of plant. This can help both the lessee, whose returns on the equipment are more likely to match rental payments, and also the lessor, who will usually be able to write a longer lease on more profitable terms. Because of the increased credit risk, however, lessors are unlikely to wish to extend the length of leases substantially.

The trends so far discussed have applied mainly to finance leasing. Operating leasing also has experienced a reduction in margins over recent years as lessees have come to understand the potential benefit from selling or re-leasing the equipment. One new practice is a form of leasing which involves three parties: the lessee; a financial lessor who provides the initial capital outlay; and an operating lessor who contracts—generally by means of a side-letter agreed with the lessee—to replace the equipment, at the discretion of the lessee, before the primary period of the lease is completed.

Recent market conditions

The leasing market became extremely competitive in the last quarter of 1979. Unexpectedly high interest rates caused some lessors to revise upwards their forecasts of profits and so of the taxable capacity available for leasing. A number of the lessors visited by the Bank considered that some leases written at this time were of doubtful profitability and were undertaken only in an effort to meet revised portfolio targets. All lessors visited, however, contended that, although their margins had narrowed, they themselves had not been forced, and would not choose, to write unprofitable leases. Moreover, in several cases, they were able to meet any increased portfolio target by deferring business into the first quarter of 1980 by using a subsidiary with a different accounting year.

Partly because of this carrying forward, leasing activity appears to have been buoyant in the first half of this year. According to Department of Industry figures, new business grew by £480 million (net) in the first quarter. Several lessors said that they had undertaken more transactions in the first half of this year than in the first half of previous years. This may be partly because lessors wanted to avoid falling into the same position as in 1979 and have thus filled a larger part of their portfolios earlier in the year. Such a policy could carry the reverse risk that, if taxable profits were overestimated, losses could be incurred on business undertaken in excess of actual taxable capacity. This is one reason why estimates of taxable capacity are usually conservative.

Under the 1980 Finance Act, the entitlement of lessors to 100% first-year allowances has been withdrawn where leases are granted to bodies such as local authorities and overseas customers which are not liable to corporation tax. Equipment leased to these bodies now qualifies only for a 25% writing-down allowance. The Finance Act also includes measures to discourage the use of leasing by individuals for tax avoidance. Although announced in the Budget in March, these changes did not take effect until 1 June. In the interim a good deal of business was done, especially with local authorities, which led to an increase in the effective interest rate which lessors were able to obtain.

Some scope still remains for leasing to local authorities, which may still see an advantage in reducing the initial expenditure on capital equipment by leasing, and thereby incurring a revenue cost spread over several years which comes within their cash limits rather than their capital budget. Lessors, for their part, may be willing to undertake such business, and also some export leases, provided that they can lease over a long enough period (in practice, at least seven or eight years) to keep the size of the rental received in the first few years below the value of the writing-down allowance.[1] Such business could also appeal to lessors with only a modest taxable capacity; with a lower allowance, this could be spread over a larger number of transactions, earning comparatively high returns.

The prospects for the market in the remainder of the year are uncertain. Factors likely to increase the demand for leasing are the reduced profits of industrial and commercial companies and, unless conditions change, the continuing high interest rates payable on conventional borrowing. On the other hand, the demand for leasing is likely to be reduced through the general reduction in capital expenditure during the recession, through destocking by companies, which increases their taxable profits, and through reduced demand from local authorities. On balance, however, its comparative advantages seem likely to increase the demand for leasing by more than the general weakening in capital expenditure will reduce it.

The crucial factor affecting supply is likely to be the size of the taxable profits of the clearing banks. If lessors' forecasts of this taxable capacity were to be lower now than originally expected, the sharp increase in the supply of leasing usually experienced in the final calendar quarter will be unlikely to occur this year. Indeed the reverse could conceivably happen, and lessees postponing transactions in order to obtain the most competitive terms might find rates moving against them. The present low activity in the leasing market (compared with that at the same time last year) may indicate a reduction in taxable capacity and hence a reduced supply of leasing.

When these various possibilities are assessed, perhaps the most likely outcome is that the supply and demand for leasing in the last part of this year will be balanced at rates less competitive than those at the end of last year but not much higher, if at all, than those prevailing at present.

Conclusions

Leasing provides a good example of a competitive financial market. Notably, the profit margins obtained by lessors have declined as more lessors have entered the market or have been willing to commit more funds.

The major benefit of leasing is that it provides a form of finance for industry that is cheaper than borrowing or instalment credit for a company that is not paying tax. With the reduction in lessors' margins that has occurred concurrently with the increase in interest rates accompanying inflation, the benefit to industry has increased. The development of leasing can indeed be seen in part as a response of the capital markets to the problems created by inflation in reconciling the requirements of lenders and borrowers.

(1) At the end of the primary lease period the residual tax allowance is reduced by the sale proceeds, and any remaining balance continues to be written down at 25% per annum in the pool of similar assets. Unless the sale proceeds exceed, or are equal to, the residual tax allowance, the lessor continues to receive a tax allowance on equipment from which there is no rental income.

Appendix

This appendix provides a simplified explanation of how a lessor can charge an effective interest rate which is much less than the cost of conventional borrowing, and an example of a lessor's cash flow over the life of a lease.

If the cost of borrowing to an industrial or commercial company is, say, 16%, the lessor with adequate taxable capacity can afford to quote an effective 8% interest rate on a lease and still make a profit, because he obtains the benefit of the capital allowance. To put the argument simply, by initially ignoring finance costs, in the first year of the lease the lessor has a capital outlay of £5 million and receives repayment of capital of, say, £1 million. The lessor therefore obtains a net allowance of £4 million against taxable profits, which reduces the tax immediately payable by £2 million. But the lessor continues to pay tax on the rental income and, continuing to ignore financing charges, has to pay tax of £½ million in respect of the rentals received in the second to fifth year of the lease. Thus after the fifth year's tax has been paid the lessor has received no overall reduction in the tax bill, but the payment of tax has been deferred over the period of the lease, as follows:

Year	Deferral of tax (£ millions)
1	2
2	1½
3	1
4	½
5	—

If the lease had not been undertaken, the lessor would have paid the full £2 million of tax (arising from profits on other business) in the first year. Thus the lessor spreads the payment of this tax over five years; in effect, he obtains an interest-free loan equivalent to the tax deferred. At current tax rates this represents approximately half the lessor's investment in a lease, so that the lessor has to finance only around half the cost of the plant. The benefit of this reduced financial burden can be passed to the lessee by charging a lower effective interest rate on the reducing balance—typically, at present, half the cost to the lessee of borrowing a similar sum.

The above example is a simplification of the actual position, which in practice depends on the detailed cash flow associated with the lease and on the extent and direction of changes in the rate of inflation. Thus the frequency of payments and, in particular, the timing of the effective receipt of the capital allowance on the asset leased are important. Other relevant factors include the length of the primary period, the inherent profit sought by the lessor, the receipt of any investment grants, and the cost of funds, especially for the period until the capital allowance is utilised. Also, the same rental quoted by different lessors may represent a different effective cost to each, as their individual tax positions may not be identical. But after taking these and other factors into account, leasing rates for customers of good credit standing are, at present, approximately half the market rate for borrowing a similar sum.

The following example describes the cash flow of a lessor who leases equipment costing £1,000 for five years. It is assumed that a rent of £60 is received quarterly in advance, that the lease starts on 1 December 1980, and that the year end of the lessor is 31 December with corporation tax at 52% being payable nine months later. It is also assumed that the interest rate on funds borrowed by the lessor is 15%, and that the interest rate on the deployment of surplus funds is 8%. Then the quarterly cash flow is as follows:

£

		Capital outlay	Rental (received)	Interest paid/ (received)	Tax paid/ (received)	Balance at end of quarter
1980	Q4	1,000	(60)	12	—	952
1981	Q1	—	(60)	35	—	927
	Q2	—	(60)	34	—	901
	Q3	—	(60)	33	—	874
	Q4	—	(60)	14	(495)	333
1982	Q1	—	(60)	12	—	285
	Q2	—	(60)	10	—	235
	Q3	—	(60)	8	—	183
	Q4	—	(60)	9	65	197
1983	Q1	—	(60)	7	—	144
	Q2	—	(60)	5	—	89
	Q3	—	(60)	3	—	32
	Q4	—	(60)	5	105	82
1984	Q1	—	(60)	2	—	24
	Q2	—	(60)	—	—	(36)
	Q3	—	(60)	(1)	—	(97)
	Q4	—	(60)	—	114	(43)
1985	Q1	—	(60)	(1)	—	(104)
	Q2	—	(60)	(2)	—	(166)
	Q3	—	(60)	(4)	—	(230)
	Q4	—	—	(3)	124	(109)
1986	Q1	—	—	(3)	—	(112)
	Q2	—	—	(3)	—	(115)
	Q3	—	—	(3)	—	(118)
	Q4	—	—	(1)	99	(20)
1987	Q1	—	—	—	—	(20)
	Q2	—	—	(1)	—	(21)
	Q3	—	—	—	—	(21)
	Q4	—	—	(1)	5	(17)

The profit to the lessor is £17, an effective margin of about 2% on the balance of funds invested. The cost to the lessee is equivalent to an interest rate of 8%, which should probably be compared with an interest rate of about 16% payable on borrowed funds by an industrial or commercial company (which would not usually be able to obtain so fine a rate as the lessor).