Developments in leasing

In the 1984 Budget, the Government announced changes to the corporate tax system that had major implications for the leasing industry. This article outlines the nature of leasing and its relation with the tax system; sets out the implications of the 1984 tax changes for leasing; examines the current position; and considers future prospects.

The nature of leasing and its relation with the tax system

Leasing is a financing arrangement, similar in effect to hire purchase, that enables a firm to obtain the use of plant, equipment or vehicles while laying out few or no funds at the outset. It can take various forms, but this article, like earlier *Bulletin* articles,[1] is concerned only with finance leasing, where capital goods are purchased by a leasing company (the lessor) and leased to a firm (the lessee) for an agreed period and at a rental calculated to cover both the capital and the interest cost to the lessor of purchasing the equipment. The lessor remains the legal owner of the equipment. It is principally this characteristic that separates leasing from other forms of financing capital goods.

Although leasing finance has been available in the United Kingdom for many years, it became an important means of financing capital expenditure only after the 1970–72 changes in investment incentives from a system of government grants to one of tax allowances. Under the system then introduced, companies were able to deduct 100% of most capital expenditure from taxable profits in the year in which the expenditure was incurred. These tax allowances were of direct value only to companies with profits sufficient for them to take advantage of the allowances, but leasing enabled companies without sufficient profits to obtain these benefits indirectly. Lessors, as the owners of leased equipment, were able to claim tax allowances for their own account (provided, of course, that they themselves had adequate taxable profits), and to share the benefits with lessees by charging them a lower rental.

Leasing has not only enabled companies with insufficient profits to take advantage of capital allowances but has also enabled companies generally to accelerate the benefit of allowances. A company can claim capital allowances only after the end of its accounting year, so that if it undertakes capital expenditure early in that year it will have to wait some time before receiving any direct benefit of allowances. But if it leases capital goods from a lessor with an earlier year-end, the indirect benefits (in rentals which reflect the lessor's capital allowances) will be received more rapidly. Because of this, many lessors have established leasing subsidiaries with different year-ends.

For the reasons outlined above, leasing came to play a major role in enabling companies to take advantage of investment incentives. From a small base in the late 1960s, the leasing industry grew to a point where in 1983, for example, it financed roughly a tenth of total investment.

The 1984 tax changes and their implications

In the 1984 Budget, the Government announced that the rate of corporation tax was to be reduced from 52% to 35% by April 1986, and that the 100% first year tax allowances were to be replaced over the same period by a 25% writing-down allowance.[2] The changes are set out in Table A.

Table A
Corporate tax rates and allowances

Percentages

	Corporation tax rate(a)	First year capital allowances(b)(c)
Financial Year		
Pre-1983/84	52	100
1983/84	50	100
1984/85	45	75(d)
1985/86	40	50(d)
1986/87 onwards	35	25(d)

(a) Full rate. A lower rate applies to small firms.
(b) On plant and machinery.
(c) Since the 1985 Budget, different arrangements have applied to short-life assets.
(d) Reducing balance allowances. In subsequent years 25% of the balance can be claimed.

These changes reduce significantly the value of tax allowances to those undertaking capital expenditure, however financed. The value of allowances depends, first, on the rate at which they can be claimed. In the absence of a system of accelerated capital allowances companies would, when calculating their taxable profits, deduct the cost of capital equipment from their income gradually over its expected life. A system of accelerated tax allowances reduces companies' taxable profits early on and increases them later, thus postponing tax payments. Before April 1984, companies could claim up to 100% of the cost of capital expenditure in the year the expenditure was incurred: there was thus a significant postponement of tax from the first to later years of the asset's life. With the new system of reducing balance allowances, much less tax will be postponed.

(1) See the September 1980 and September 1982 Bulletins.
(2) An allowance on capital expenditure of 25% in the year the expenditure is incurred, 25% on the remaining balance in the next year, and so on. Thus after the second year, for example, allowances of 43.75% (25%, plus 25% of 75%) will have been given.

Second, the value of allowances depends on the rate of corporation tax. It is obviously of greater benefit to postpone tax when the rate is 52% than when it is 35%. For both these reasons, therefore, the tax changes increase the cost of purchasing capital equipment.

Under the new system of investment incentives, a company can still obtain the benefits of tax allowances either indirectly through leasing or, if it has sufficient profits, directly by buying capital goods. But because of the fall in the value of allowances the incentive to choose leasing is now generally less. For firms with insufficient profits, the difference in cost between purchasing equipment (and not obtaining the full benefit of allowances because of lack of profits) and leasing it (and obtaining allowances indirectly) will now be substantially reduced. For firms with the necessary tax capacity, which could previously obtain some advantage from leasing because of differences in year-ends, the advantage will also be reduced. Thus demand for leasing is likely to fall. But by how much is difficult to assess. Because there will still be some incentive, leasing will remain a rational financing alternative for some companies.

Demand for leasing can be expected to fall for another reason. Demand is determined primarily by companies' profitability and the level of investment that they wish to undertake. As a result of the change in allowances the amount of investment that companies can make before tax allowances exceed profits has risen, albeit temporarily. When allowances were 100%, a company with profits of £1 million could purchase capital equipment of £1 million before exhausting its taxable capacity. But when allowances are reduced to 25% the same company will be able, initially, to spend £4 million on capital equipment and still obtain the full benefits of available allowances.[1] This increased capacity will gradually disappear: in future years companies will continue to claim the 25% reducing balance allowances on assets acquired in earlier years, thus reducing their capacity to claim allowances on further capital assets. But until this extra capacity disappears fewer companies will, for a given level of profits and investment, be tax-exhausted, and hence fewer will need leasing finance to take advantage of the allowances.

The fall in allowances will have a similar expansionary effect on the capacity of lessors: for a given level of profits, lessors will be able to undertake more business before becoming tax-exhausted. Thus while the demand for leasing is likely to fall, the industry's capacity will increase and, as a result, lessors' margins are likely to fall. Lease rentals depend on the cost and life of capital assets, the cost of finance to lessors, the availability of capital allowances, and a margin to cover administrative costs and provide lessors with a profit. While the 1984 tax changes will lead to a rise in the cost of leasing because of the lower value of capital allowances, lower demand and increased supply are likely to limit this rise by driving lessors' margins down to a low level.

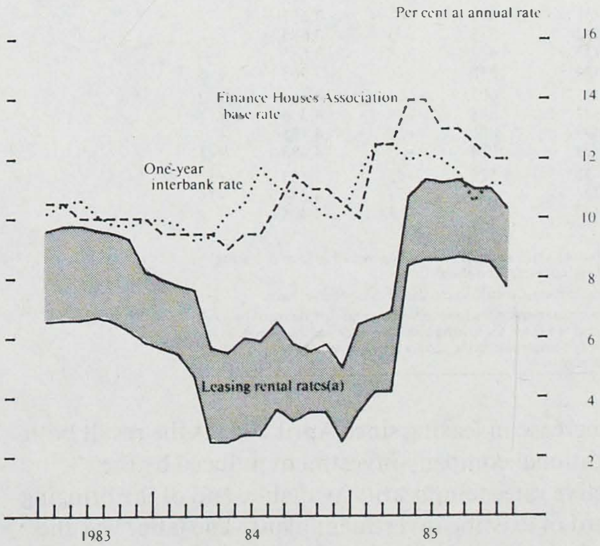
The current position

After March 1986, the net effect on the volume of leasing business of the tax changes announced in the 1984 Budget is likely to be one of contraction, albeit contraction of uncertain size. It might therefore seem surprising that leasing is currently enjoying a boom. Over £4 billion of leases were written in 1984, when corporation tax and tax allowances were first reduced. This was some 40% more than in the previous year. The leasing figure for 1985 is expected to be higher still (the total in the first three quarters alone was over £4 billion, compared with about £2.7 billion in the same period of 1984).[2] But there is a very good reason for this.

The corporation tax rate is being reduced in stages and only after March 1986 will it settle at 35% (Table A). It has, therefore, been advantageous for companies to delay tax payments until after March 1986 and pay tax at a rate of 35% rather than 40% or 45%. Capital allowances therefore currently not only enable tax to be postponed but also result in an absolute saving of tax.

This cost-saving effect was greatest in 1984/85, immediately following the announcement of the tax changes, when tax payments could be postponed to a time when the corporation tax rate was 35% rather than 45%; in that year it more than offset the rise in costs resulting from the reduction in allowances, and thus there was a net fall in the cost of investment (whether financed by leasing or otherwise). This year the effect is weaker: taxable income can now be postponed so as to face a rate of 35% rather than 40%, a smaller advantage. At the same time

Interest rates and leasing rental rates



Source for leasing rental rates: Saturn Lease Underwriting Limited.

(a) These leasing rates are estimates of the rates implicit in rental agreements. The upper limit of the range is the monthly average, and the lower limit the minimum, on five-year leases with quarterly rental payments. These rates are given as a general indication only; they are not necessarily fully representative.

(1) In practice a company needs to consider future as well as current profitability.

(2) These figures are Bank estimates of new leases written and are in current prices.

the allowances have been reduced further, and thus the cost of investment has risen again. But there is still a substantial advantage in undertaking investment before April 1986, when allowances will again be reduced and when it will no longer be possible to save tax by postponing it.

These changes in the cost of investment have been reflected in the rentals charged by lessors as they share with lessees the changing benefit of tax allowances. The chart shows the drop in leasing rentals in April 1984 and the rise a year later. A further rise can be expected in April 1986.

Changes in the cost of leasing have had an appreciable effect on the volume of leasing business. Table B shows both total industrial investment undertaken in recent years and the amount financed by leasing. The table has a number of noteworthy features. The first is that, following the fall in leasing rates in April 1984, the increase in leasing was significant but not dramatic (the volume rose rather less than in the previous two quarters). It seems to have taken potential lessees time to realise the full implications of the Budget. However, a substantial increase did occur in the third quarter, and a dramatic increase in the first quarter of 1985—just before leasing rates rose again. Since then the volume of leasing has fallen back, but is still above the levels achieved before April 1984.

Table B
Investment and leasing
£ billions, 1980 prices; seasonally adjusted.
Percentage changes in italics.

		Leasing(a)		Industrial investment(b)(c)	
1982	Q1	559		3,704	
	Q2	569	*+ 2*	3,682	*- 1*
	Q3	627	*+10*	3,774	*+ 3*
	Q4	590	*- 6*	3,804	*+ 1*
1983	Q1	589	—	3,697	*- 3*
	Q2	515	*-13*	3,685	—
	Q3	472	*- 8*	3,685	—
	Q4	548	*+16*	3,968	*+ 8*
1984	Q1	607	*+11*	4,106	*+ 3*
	Q2	648	*+ 7*	4,306	*+ 5*
	Q3	800	*+23*	4,435	*+ 3*
	Q4	824	*+ 3*	4,488	*+ 1*
1985	Q1	1,528	*+35*	5,163	*+15*
	Q2	721	*-53*	4,334	*-16*
	Q3	760	*+ 5*	4,405	*+ 2*

(a) Includes a small amount of operating as well as finance leasing, and excludes leases on ships.
(b) Manufacturing, construction, distribution and services.
(c) Data on investment include capital expenditure financed by leasing. However, the leasing and investment series are not directly comparable as they cover different sectors of the economy.

The increase in leasing since April 1984 is the result both of additional company investment induced by the attractive rates temporarily available, and of the bringing forward of existing investment plans. The latter was the main factor behind the large increase in leasing in the first quarter of 1985: it was realised that capital expenditure undertaken before April 1985 would be significantly cheaper than that undertaken afterwards. Another factor in the first quarter of 1985 may have been an increase in the number of users of capital equipment who chose to lease rather than purchase. Publicity about the effect of the tax changes on leasing rates may have brought the advantages of leasing to the attention of a number of tax-exhausted companies for the first time.

Whilst the volume of investment financed by leasing has reacted to changes in its cost, investment overall has not been affected in the same way. There was no significant increase in total investment until the first quarter of 1985, and that seems to have been more than accounted for by the increase in leasing. It is not obvious why this should have been. The incentive for those purchasing their capital goods to increase their purchases or to bring them forward is as great as for those who lease them. One possible explanation is that the lower cost of investment may have been particularly obvious to potential lessees because they were faced with an explicit rental rate (and, perhaps, because lessors made a particular effort to market their services). To those considering financing their investment by other means, the change in costs may have been obvious only if they had themselves calculated the effects of the changes in tax allowances.

The future of leasing

The current boom in leasing is probably only a temporary phenomenon. Leasing activity may increase sharply again in the first quarter of 1986, but it is likely to decline thereafter. The extent of the slowdown is hard to predict. Inasmuch as the current boom has been caused by the bringing forward of planned investment, the immediate slowdown may be substantial, and may last until companies have had time to put into effect new investment plans. Once this adjustment period is over, the size of the leasing industry will depend principally on how sensitive investment as a whole is to the increase in the cost of investment, on how many companies are tax-exhausted, and on how many of these companies decide to continue using leasing to finance their investment.

The evidence of recent developments is ambiguous. It suggests that while investment as a whole may be relatively little affected by changes in its cost, the volume of leasing may be more sensitive to such changes. On the other hand, if this apparent sensitivity was simply the result of publicity on the part of lessors and/or the bringing forward of investment plans, it may not be a helpful guide to future developments. The balance of opinion in the leasing industry appears to be that the narrowing of the advantages of leasing will have an appreciable dampening effect, and cause fewer companies to use this form of financing. Perhaps about £2–£3 million of leasing will be written in 1986/87—a low point from which slow but steady growth will be resumed.

Although its future is uncertain, leasing will continue to have a number of advantages to lessees—above all, perhaps, its convenience. Many leases are written on the basis of a fixed interest rate, thus providing an element of certainty for lessees. Of course, fixed-rate finance is available from sources other than lessors, but in a lease (and in related forms of finance such as hire purchase) total payments of both capital and interest can either be spread evenly over an asset's life or be varied to suit a lessee's needs—to fit in with his seasonal cashflow, for example. Leasing is convenient in other ways, too. An example is so-called 'sales-aid leasing', where the lessor constructs a package enabling a manufacturer to provide his customers with both goods and the finance to pay for them.

In the past, a less desirable reason for a company to choose to lease assets has been that, in contrast with a loan, a lease did not have to appear in the company's balance sheet: visible debt was reduced. However, this attraction of leasing has now disappeared, as analysts have come to include rental commitments in debt calculations, and with the Accounting Standards Committee's decision in 1984 that finance leases should be capitalised and shown in lessees' balance sheets. Some companies may still prefer leasing to other forms of finance because it may be treated as revenue rather than capital expenditure within the company and, perhaps, be subject to less close scrutiny as a result (it may be easier for a departmental manager to authorise leasing expenditure of a regular monthly amount rather than a large lump sum on a purchase). But in general leasing will be viewed as a straightforward alternative to other ways of financing investment—not radically different, but a convenient option in certain circumstances.

If there is a substantial fall in the volume of leasing, and if lessors' margins remain low, some lessors may decide to leave the industry. Perhaps the most likely to leave are those that are not financial specialists—lessors that are primarily manufacturers or retailers, and that have established leasing subsidiaries principally as a way of making use of their taxable profits. Some financial groups that have leasing subsidiaries may perhaps combine their leasing with other lending operations. Overall, however, it seems probable that financial specialists that have successfully exploited leasing's attractions in the past will not only continue to do so but will also seek to develop their leasing activities in various new ways, thus continuing to demonstrate the innovative skill that they have shown in the past.