Lease vs. Buy: What are the tax effects?

Comparing your options for equipment acquisitions

Obtaining the equipment necessary to grow and stay competitive continues to challenge mid-sized businesses. This white paper outlines important factors to consider when investing in new equipment for your business – factors that can impact your overall financial health.

In the midst of fast-changing markets and ever-greater capital concerns, business growth poses a dilemma. Leading-edge technology, timeliness and scalability all play an important role in an organization's assets. However, there is no single, best answer to the question of how to pay for required equipment.

Equipment financing varies, though a customized structure can help you reach your financial objectives. For example, there are options to optimize cash flow, help you out of AMT and maximize temporary tax incentives. There are even options that facilitate equipment replacement and upgrades. Here are some factors to consider while assessing your options.

Credit preservation

Foremost, financing equipment allows your organization to be nimble without depleting its capital reserves or bank lines of credit. By acquiring the equipment you need immediately, your assets can generate revenue while you pay for them over time.

Cash flow

Flexible payment options can optimize your business cash flow, address seasonal requirements – and help keep your business competitive. In addition, equipment financing options often involve little or no down payment. Typical out-of-pocket costs such as software, maintenance, delivery costs and training can be bundled into a single financing arrangement.

There are options that facilitate equipment replacement and upgrades.

Equipment management

If using the latest technology is important to your business, an equipment lease may offer mid-term upgrade and end-of-lease options, which both help you avoid the risk of owning obsolete equipment. You may also have the opportunity to renew the lease, purchase the equipment, or return your assets at the end of the term.

Tax savings

For many businesses, asset depreciation plays an important role in fiscal management. All equipment offers depreciation benefits. Determining whether your company can effectively use all of that depreciation requires some consideration. This is especially true for equipment-intensive businesses. Full taxpayers in need of the sheltering effect of equipment depreciation will typically benefit from tax ownership of equipment. This can be accomplished with a loan, installment payment agreement and some leases. All of these options allow the user to deduct depreciation and interest charges from taxable income.

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Companies with a more complex tax situation may want to consider a tax lease. Tax leases effectively trade tax depreciation for lower payments. Plus, tax leases allow the entire lease payment to be deducted as an operating expense. Here is a high-level overview of factors to consider when you evaluate your options for equipment acquisition.

Lease vs. Buy What are the tax effects?

Alternative Minimum Tax (AMT)

Corporations near to or already paying Alternative Minimum Taxes should beware of the implications of purchasing their assets. Such organizations cannot effectively use all the tax benefits associated with accelerated equipment depreciation. Consequently, they can experience an increase in the after-tax cost of acquiring an asset.

Consider a tax lease: It can minimize the creation of additional tax depreciation.

In contrast, a tax lease can minimize the creation of additional tax depreciation: The lessor records the equipment ownership and resulting depreciation. And because equipment leasing companies are able to more efficiently utilize the tax benefits associated with depreciation, the lessee can enjoy the savings in the form of lower monthly payments made to the lessor.

Net Operating Losses / tax credits

A lease agreement is also advantageous for corporations with expiring Net Operating Loss (NOL) carryforwards or other similar tax credits. Depreciation deductions on purchased equipment reduce taxable income, sometimes preventing a business from fully using its tax credits. Leasing allows you to maximize the use of the credits to lower your tax liability. In this manner, tax benefits are passed on to the customer in the form of lower payments.

Mid-quarter convention

The mid-quarter convention states that if a company acquires more than 40% of its assets during the fourth quarter, it must recalculate its depreciation expense using the mid-quarter convention tables. Most companies attempt to avoid the mid-quarter convention by closely managing the amount of assets they purchase (and place in service) during the fourth quarter.

Leasing, however, allows your company the freedom to purchase the equipment it needs, when it's needed. By assigning the ownership role to the lessor, you avoid the fourth-quarter asset acquisition restrictions, yet still receive the full MACRS tax advantage in the form of lower payments – because the lessor records the ownership of the asset(s). Leasing can be a helpful option when project delays or unexpected equipment replacement needs arise in the fourth quarter.

Summary: Weighing the benefits

Remember that equipment financing can be used as a strategic tool: It lets you acquire and employ assets immediately and develop a plan to achieve long-term goals.

Whether your company's objective is to enhance cash flow or optimize tax savings—or both—an in-depth analysis of your equipment is necessary. Assessing your current and future asset needs in the form of a Lease vs. Buy Analysis will help determine whether a lease or loan is the best alternative. To develop the most profitable acquisition strategy, consult with an equipment financing expert. In particular, seek someone with a background in lease structuring and industry expertise – as well as an understanding of your unique business goals.

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