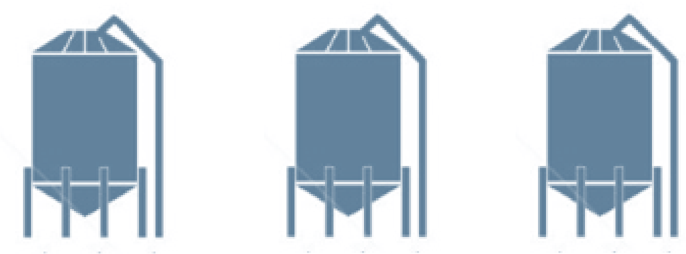
Be a pirate



One of our clients recently upgraded his on-farm storage facilities by leasing three hopper bins at a cost of $25,000. How did leasing bins compare with the more typical purchase using bank loan financing?

If our farmer had opted for a bank loan to finance buying the bins, the bank would have registered a security interest against the bins and in the loan agreement specified a rate of interest and repayment term.

Allyn Tastad, B.Comm, CPA, CGA - November 26, 2009

For tax purposes, our farmer would have deducted the interest payments as well as an annual depreciation charge called **capital cost allowance** (CCA).

When computing CCA, acquired assets are first segregated into the appropriate capital cost class. CCA is calculated by applying the applicable rate for the class involved to the **undepreciated capital cost** (UCC) of the class.

You can’t claim a full year’s CCA in the year a depreciable asset is acquired. The maximum CCA you may claim is limited to one-half of the normal CCA calculated. This is referred to as the **“half-year rule.”** Because claimed CCA reduces the UCC for subsequent calculations, the system operates on a declining balance basis.

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In our example, the bins are categorized for tax purposes as a Class 6 asset. The CCA rate for this class is 10 percent, with the half-year rule applying in the first year, limiting the CCA rate to five percent.

Twenty-three years later, the remaining tax value, or UCC, of the bins is $2,339, translating into $22,661 of claimed CCA.

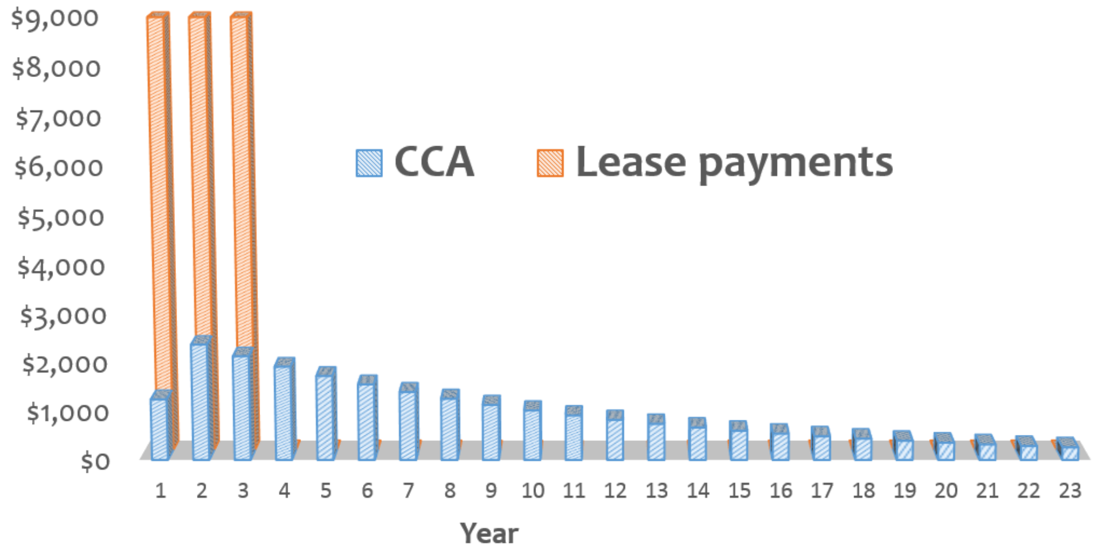
This hardly seems an efficient way to write off our farmer’s bins. I call it the Rip Van Winkle method.

Instead, our farmer decided to lease bins.

Under the lease agreement a finance company, known as the lessor, retains ownership. The farmer becomes the lessee and rents the bins in exchange for set payments over a defined period.

There is no stated interest rate but rather an implicit rate of interest that can be calculated by comparing the total of all of the lease payments to the fair market value of the bins. For tax purposes, the farmer deducts the lease payments. There is no deduction for interest or for CCA.

Our farmer will deduct $26,625 of lease payments over the next three years and at the end of the third year will buy them for $2,500. In three years, he has secured the same tax deductions from leasing that he would have secured over 23 years from interest and CCA. Does anyone feel like a pirate?



Does leasing beat owning in all cases?

No. Often CCA rates are accelerated, as a matter of government policy, to spur new investment. For example, your self-propelled combine is a Class 10 asset that carries a 30% CCA rate. Generally, we find that in leasing versus buying scenarios, the two typically generate the same writeoff over a six-year term.

If the writeoff is the same, your decision to lease or buy will become strictly a cost-of-borrowing decision. In these circumstances, you must determine the implicit rate of interest for the lease and compare it with the interest rate charged on your bank loan.

When the CCA rate is low, as it typically is for such things as grain storage, you should consider the leasing option. For our farmer, a bin writeoff over three years versus a bin writeoff over 23 years was an easy decision. We asked him if he felt like a pirate. He didn't respond but he did grin.

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