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Time to review your financing?

New tax allowances which came into operation in the UK this April could cause many rental companies and end users to reconsider how they fund the equipment they use. Nigel Greenaway of JCB finance, which is active in the aerial lift, crane and telehandler sectors, provides some insight into the matter.

As usual the UK budget was not a particularly exciting affair with many of this year's changes such as the Annual Investment Allowance (AIA) and the annual Writing Down Allowances (WDA) - announced almost two years ago. Even so many were hoping that the government would rescind these changes in order to encourage on-going investment. The bad news is that the chancellor didn't change his mind and from April this year the AIA has lost much of its appeal because of the reduction from £100,000 tax write-off in the first year to just £25,000.

To make matters worse the reduction of the WDA from 20 to 18 percent will stretch the period it takes to write off 90 percent of an asset's cost against tax from 10 years to 12 years. Either way, users of modern construction equipment are likely to regard the new £25,000 limit to the investment allowance as a serious disincentive and will prefer alternative and faster methods of writing off capital expenditure against tax. Now is probably a good time to reconsider the most tax efficient and cost effective method of funding equipment because of two reasons - speed of tax write-off and impact on the balance sheet.

Operating leases

Faced with the dramatic changes to the tax rules operating leases are a more tax efficient alternative funding method that will allow faster write-off against taxable profits. It certainly warrants further investigation because it does not have to be an all or nothing, black or white scenario. A blend of hire-purchase and operating lease is possible and this may give the flexibility to suit many individual business' circumstances.

Ownership and Balance Sheet impact

Depending on the nature of a business, the ultimate ownership of the equipment and its position as an asset on the balance sheet may not be very important. Traditionally this is the case if the equipment is part of a production process where it is often more important to know how much each piece of machinery contributes to the overall cost of the process. In the waste/recycling, mining and quarrying sectors for example operating leases and contract-hire are very popular forms of equipment funding.

In the construction industry - where hire-purchase remains the most popular form of funding - a number of companies have realised that they have a core group of machines that are operated for a set period and are unlikely to be changed or disposed of before that period has expired. This core fleet could be written-off against tax far quicker because, with an operating lease, 100 percent of the monthly instalments can be offset against taxable profits. Run the machine for three years and 100 percent could effectively be written off.

£100,000 expenditure	cash/hire-purchase	operating lease
1st year tax write-off	£18,000	£28,320
2nd year tax write-off	£14,760	£28,320
3rd year tax write-off	£12,103	£28,320
Total tax write off over three years	£44,863	£84,960

The example below shows the tax treatment of an additional £100,000 expenditure on plant, financed over three years, which will only be eligible for the 18 percent WDA tax write-off. It compares cash/hire-purchase against an operating lease.

The operating lease offers almost 90 percent better tax write-off in as little as three years. The figures will vary depending on the make and model of machine and its respective residual value but multiply these figures for a fleet of machines and the numbers can become eye watering!

Ironically, the higher the depreciation, the greater the tax write-off and the higher the rate of corporation tax or income tax the higher the actual amount saved. Having said that I doubt if anyone objects to the reduction in the main rate of corporation tax down from 26 to 24 percent in April with two further one percent falls over the next two years.

However, there is another reason to consider an operating lease, which for many companies may be just as important as the speed of tax write-off. Increasingly a number of rental companies are turning to operating leases in order to reduce the level of debt carried on their balance sheet. This focus on the balance sheet has been exacerbated by the continuing caution being exercised by the major banks. With an operating lease or contract-hire agreement the plant will not appear as an asset on the customer's balance sheet (the asset is owned by the leasing company). This in turn can dramatically improve such key accounting ratios as Return On Capital Employed because the same revenues and profit are effectively measured against a smaller asset base.

Operating Lease features and benefits

Off-balance sheet funding with fixed low cost lease payments reflects a predicted future residual value which remains unconnected to the customer (lessee). This residual risk is taken by the leasing company which recovers the machine at the end of the period and sells it in order to realise this unpaid amount.

Benefits include:

- Low capital outlay.
- Spreads the impact of VAT which is collected on each rental as it falls due.
- Low fixed repayments.
- Tax efficient
- Preserves working capital reserves.
- Removes residual value risk.
- Off balance sheet funding.
- Easily combined with repair and maintenance contracts to offer total peace of mind.

Ultimately your accountant or finance director will need to run the calculations to see what is best for your business coupled to a sound reason for investing in additional plant and machinery in the first place.

Nigel Greenaway is general manager - marketing at JCB Finance and has over 26 years' experience in the equipment finance industry. JCB Finance is not a financial advisor.