



MINISTRY OF AGRICULTURE, FOOD AND RURAL AFFAIRS

Lease Agreements, Farm Equipment

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Introduction

Leasing is now a common method for acquiring new farm equipment. This is partly due to the increasing cost of farm equipment, which if purchasing requires large outlays of capital. Farmers are also now more comfortable with the concept of controlling, instead of owning, the asset. This Factsheet will help farmers understand and evaluate equipment leasing and ownership arrangements.

Section 1. Lease Agreements

Human Components of a Successful Lease

Any form of business agreement requires a good deal of mutual respect and trust. Leasing land is no different. To be successful, the lease arrangement must satisfy both the landlord and the tenant. Before entering into a lease, the landlord and the tenant should consider more than just price. The compatibility of the landlord and the tenant and the fairness of the lease are important aspects to consider.

Checklist of a Successful Lease

Compatibility - Can you get along and discuss differences? ___ yes ___ no

Honesty - Do you trust the person you are dealing with? Have you had business dealings together before? ___ yes ___ no

Clarity - Are the obligations of each party clearly defined in the written lease? ___ yes ___ no

Equitable Terms - Do both parties agree to the terms of the lease? ___ yes ___ no

Suitability - Does the lease fit the crop and encourage good agricultural practices? ___ yes ___ no

Advantages and Disadvantages of Leasing Land for Agricultural Use

There are advantages and disadvantages to all leasing arrangements.

Advantages

Lower Capital Investment

- Capital investment is shared between landlord and tenant.
- Landlord supplies land, buildings and perhaps some of the operating expenses.
- Tenant supplies labour, machinery and usually the major portion of the operating expenses.
- Operators can increase the size of their business with limited capital investment.
- Since leasing is an alternative to ownership, it is really a means of "financing" a land base.

Increasing Financial Efficiency

- When funds are limited, it is often more profitable to spend this money on seed, fertilizer, chemicals and machinery than on buying land.
- Investing scarce funds in land may severely restrict the money available for operating capital, thus lowering the efficiency of the farm business.

Obtaining Farm Experience

- Renting enables the beginning farmer to gain needed experience in the financial operation of a farm business before committing to a long-term investment in land.
- Renting enables an operator to learn more about land in an area and allows the flexibility to change farms or leave farming.
- Renting may enable an inexperienced farmer to obtain the managerial assistance or mentorship of a more experienced landlord.

Sharing Risk

- By renting, both the landlord and the tenant can share in the risks and profits of farming. This is particularly important to a farmer with limited capital. The extent of the risk-sharing depends upon the nature of the lease agreement.

Family Arrangements

- A family business arrangement might include a lease agreement whereby someone rents land from a parent or rents land from a third party and shares the machinery investment with the parent.

Providing Retirement Income

- A retiring farmer might consider leasing all or a portion of his or her land base rather than selling.
- Ownership of land provides a hedge against inflation.
- The income from the rent provides a form of "pension" income to live on during retirement.
- A farmer approaching retirement could gradually phase out of farming by renting a portion of his or her land and farming the rest of it.

Disadvantages

Lack of Security of Tenure

- Short-term leases create uncertainty for the tenant.
- Since machinery investment is matched to the land base, the cancellation of a lease could result in having machinery over capacity and a higher cost per acre.
- Short-term leases provide more flexibility for landlords since it is possible to change tenants quickly or to sell the land. However, short-term leases can work to the detriment of the landlord since they may not encourage sustainable farming practices by the tenant.

Lack of Efficiency, Conservation and Incentive to Make Improvements

- Short-term leases may discourage production efficiency. For example, some tenants may not use the optimum amount of fertilizer under a crop share lease unless the landlord shares in the expense of fertilizer.
- Most soil conservation practices are a long-term investment. Most tenants with a short-term lease are interested only in practices that will show results during the term of the lease.

People Problems

- As with any business venture involving two or more persons, disputes and disagreements can arise.

Availability of Credit

- The tenant farmer usually has a more difficult time obtaining intermediate and long-term credit than does the owner-operator because:
 - the lender may require land as security for the loan
 - leased land does not build equity
 - the lease is short term

Lack of Bargaining Power and Managerial Control

- There may be situations where the landlord has greater bargaining power even though the tenant is a capable manager.

- The landlord may insist on making most of the management decisions even though his or her contributions to the lease may be substantially less than the tenant's. For example, the landlord may insist on certain crops being grown that the tenant feels are not the most profitable.

Lost Opportunity for Capital Gain

- Land prices have generally increased over time, although they do decline occasionally.
- Land appreciation is an added benefit to the landowner, even though the capital gain is not realized until the property is sold.

Potential Loss of Tax Deferral or Exemption

- Leasing land can in some cases prevent the use of both the tax-deferred transfer to children and the \$800,000 capital gains exemption (the exemption increased to \$800,000 in 2014, and will be indexed for inflation starting in 2015).
- Consult an accountant.
- See Section 2. [Tax Implications of Land Leases](#).

A Written Lease Agreement

The most important thing you can do as a tenant or landlord is to put your agreement in writing. This one action would eliminate the vast majority of disagreements that occur. Even though the handshake has been a long-standing method of doing business in the rural community and a verbal lease agreement is a valid contract, it has serious disadvantages. However, many farmers and landowners are reluctant to use a written lease for several reasons:

- Tenants and landowners alike do not want to give the impression that they distrust their neighbours by requiring a written lease.
- The added time and cost to prepare a written lease may not seem justified when dealing with other farmers or community members.
- The disadvantage of a verbal lease becomes apparent when a disagreement about the terms of the lease occurs, because it is exceedingly difficult to prove what the original understanding between the parties was.
- Without a written agreement:
 - settling a misunderstanding between the parties once the land is in use (through mediation by a third party, arbitration or litigation) can be extremely costly
 - it is more difficult to protect the interests of both parties against any claims of a third or outside party to a right to the land or the crop - it is much easier to protect your interests from third-party claims by documenting the details of the agreement at the time you enter into it
 - the risk of losing significant time and business goodwill is high for both landowner and the lessee
- A written agreement is not a sign of distrust - it shows that both parties want to protect and clearly document the agreement they are making.

Advantages of a Written Lease Agreement

Under the Ontario Statute of Frauds, all documents that create an interest in land must be in writing. A written lease is advantageous to both the landlord and the tenant since it provides both with a record of what they have agreed to. In the case of crop share leases, where the landlord and tenant are sharing costs, this is especially important. A written lease:

- clarifies the expectations, obligations and responsibilities of both parties. If a dispute occurs, a written lease can prevent costly legal action by providing for alternatives to a court proceeding
- gives the landlord some protection in the event of an environmental liability
- provides a valuable guide to heirs if the landlord or tenant should die
- provides documentation for tax purposes

What to Consider Before Entering Into a Lease Agreement

Insurance - Landowners may consider requesting proof of crop insurance, especially if the rent has not been prepaid. The tenant and landlord should also discuss insurance for protection from any potential environmental damage. If the tenant plans on storing any harvested crop on the landowner's property, there should also be insurance provisions for protection from theft or damage.

Securing the lease payment - Registering any unpaid portion of the lease payment with ServiceOntario under the Personal Property Security Registration will help protect a landowner's interest as a creditor in the event of non-payment by a tenant. Landowners may register online or by calling ServiceOntario.

A tenant may also want to have the lease registered against the title to be protected in the event that the land changes ownership. There may be very good reasons to consider the registration of the lease: for instance, any payments relating to the real estate can, in some instances, be considered "personal property" and fall within the registration provisions of the *Personal Property Security Act*; any interest in those payments would be subordinate to any other interest by way of a lease, so long as the lease is registered first.

Most properties in Ontario are registered under the Land Titles system, which dictates that leases for a period not exceeding 3 years do not require registration where the tenant is in actual possession of the property described in the lease. For properties under the less popular Land Registry system, the period is increased to 7 years. In the absence of registration, a subsequent purchaser of the land could take ownership without having to honour the terms of the lease.

Title search - Tenants may also perform a search on the title of the land to be leased to make sure they are entering into an agreement with the person who is the owner of the land. A title search may be done through the Ontario Land Registry Office.

A Lease Agreement as a Succession Planning Tool

A long-term lease agreement (not to be confused with a sale and leaseback arrangement) may be used as a succession planning tool. Landowners and potential farm successors thinking about alternatives to traditional financing options might want to consider a long-term leasing arrangement. Lease arrangements may include land, buildings and/or equipment. Owners and successors may choose to have multiple lease arrangements or a single inclusive lease. Leases in Ontario can be of any length of maturity, however, leases longer than 21 years must have the approval of the municipality to be valid.

Like any lease, the terms must be negotiated to the satisfaction of both parties. One of the biggest difficulties after setting the initial lease payment amount is determining what the annual increase should be. For longer-term leases, an impartial setting, such as the annualized core Consumer Price Index, which is published by Statistics Canada, may be used. It is advisable to talk to a succession planning professional to help set out some of these terms.

Section 2. Tax Implications of Land Leases

The following is for general illustrative and information purposes only and is not comprehensive, nor is it intended to be legal advice. It does not replace professional advice from a tax specialist. Remember, tax laws and qualifications for programs may be time limited or may change. It is strongly recommended that you consult with a tax specialist for up-to-date advice that is specific to your agreement.

The tax implications of entering into a lease agreement should be carefully considered.

Landlords can inadvertently disqualify themselves from being able to use two major tax provisions. The Canada Revenue Agency (CRA) does not consider many types of leasing to be farming. For example, a share crop lease, where a portion of the crop is given to the landowner as payment for the land, may not meet the

CRA's definition of farming. As a result, some leasing arrangements can disqualify landowners from using the following tax provisions:

- the ability to use a tax-deferred rollover on the transfer of land to children (called a rollover)
- the \$800,000 capital gains exemption on their land

Tax Deferred Rollover to Children

The Income Tax Act allows for the transfer of farmland to a child on a tax-deferred basis. This is accomplished by using what is called a "rollover." It allows the transfer price to be set at any value between zero (a gift) and the fair market value (FMV) of the land. In the case of a gift, the transfer value would be the adjusted cost base (ACB). Without the use of the rollover, the land would have to transfer at its FMV and all the gain would have to be reported.

To qualify for the rollover, the property must have been used principally in the business of farming prior to the transfer by the taxpayer, the taxpayer's spouse or their children who were actively and continuously involved. This means that the land's use was farming for greater than 50% of the time (as defined by the CRA). The property does not, however, have to be used in farming immediately before a transfer takes place in order to qualify for the rollover.

Landowners who want to use the rollover should monitor the percentage of time that they have leased their land and what type of leasing arrangement they are using. For example, a landowner who farmed a property for 20 years, then leased the land for 4 years could still qualify for the rollover. If, however, the leasing period was longer than the farming period, it could disqualify the use of the rollover. An exception to this is if the person leasing the property is the landowner's spouse or child actively engaged in farming.

The \$800,000 Capital Gains Exemption

Selling Farmland

The \$800,000 capital gains exemption is available to individuals on the sale of qualified farm property. Individuals who had used their entire \$100,000 personal exemption, which was eliminated in 1994, have \$700,000 remaining. The exemption is also available for partners in a partnership, since taxes are paid at the individual level. However, corporations do not have any capital gains exemption.

Qualified farm property includes:

- farm land and buildings
- shares in a family farm corporation
- an interest in a family farm partnership
- quota (referred to as eligible capital property)

Qualified farm property must meet the following definitions:

- property purchased before June 18, 1987, must be used in farming at the time of sale, or have been used in farming for any 5 years during its ownership
- property purchased after June 17, 1987, must be owned for 24 months prior to the sale, and in at least 2 years, the gross farm income must exceed net income from other sources or the property was used by a family farm partnership or corporation in a 2-year period during which time the individual, spouse, child or parent was actively involved in the farming business

In either of the above cases, property must be used in farming by:

- the individual
- the spouse, child or parent of the individual, or
- a family farm partnership or corporation of the individual, spouse, child or parent

In all cases, the qualifying individuals, whether farming as a sole proprietorship, a partnership or as a shareholder in a farming corporation, must be actively engaged in management and/or the day-to-day activities of the business.

Leasing Farmland

Leasing farmland is most likely to affect the use of the exemption on land purchased before June 18, 1987.

Land purchased before June 18, 1987, must be farmed for any 5 years or farmed in the year of sale to be considered qualified farm property and therefore eligible for the capital gains exemption. If the 5-year rule has not been met, the property must be farmed immediately before the sale.

Since leasing is not considered to be farming, according to the Canada Revenue Agency (CRA), a lease in the year of sale could disqualify the landowner from using the capital gains exemption because it was not farmed immediately before the sale. Even a share crop lease, where a portion of the crop is given to the landowner as payment for the land, does not meet the definition.

Hiring custom operators to do the cropping work may solve this problem. Alternately, a share crop lease where the landowner is sharing the cost of inputs may also meet the CRA requirements of farming. Discuss such agreements with your accountant.

Canada Pension Plan and Registered Retirement Savings Plan

Rental income from a cash lease cannot be used as a basis for contributions to the Canada Pension Plan (CPP). Farmers who lease their land and have no other CPP-eligible income source will be unable to make contributions to the plan. This may have the effect of reducing the amount of CPP pension benefits. Although rental income is not eligible for contributions to the CPP, it is considered earned income for the purpose of contributions to a Registered Retirement Savings Plan (RRSP).

Rather than operating under a cash lease, a landowner could farm the property by hiring custom operators or lease the land on a crop share basis where the inputs are shared. Currently, the net income from these sources is eligible for contributions for both the CPP and RRSPs.

Non-Resident Withholding Tax

If the landlord is a non-resident of Canada, the tenant is required to withhold 25% of the rent (cash rental or crop share) and submit it to the Canada Revenue Agency (CRA). If the tenant does not remit the 25% withholding tax, the CRA will attempt to collect the tax from the landlord. If the landlord does not pay this tax, the tenant will be liable for the payment.

Capital Cost Allowance

When a landowner changes the use of the farm land, buildings or machinery, such as in renting, the Income Tax Act requires that the depreciable assets purchased before 1972 (Part XVII) be switched from the Straight Line Method of capital cost allowance to the Declining Balance Method, which is used for depreciable assets purchased after 1971 (Part XI).

In most cases, this is undesirable, since it would mean that all recaptured capital cost allowance that occurs when the class is closed out (e.g., sale of all machinery in that class) would be taxable income. The landlord could choose to not use the property and still maintain the Part XVII status, however, no deduction could be claimed in the years when it was not used. Any other use, either personal or rental, would require a change to Part XI. The landlord could choose to use his machinery or buildings as part of a custom farming arrangement and thereby maintain the farming status.

Harmonized Sales Tax (HST)

Generally speaking, a lease is taxable unless specifically exempted under Part I of Schedule V of the Excise Tax Act, which might apply in limited situations such as land destined as long-term residence. Rent that is paid by way of share of the crop is not subject to the HST. The treatment of cash rents for HST purposes may also depend on the landlord's total income. A business (including a landlord who rents property) does not have to register to collect and remit HST if its gross taxable and zero-rated sales are under \$30,000. Landlords whose only source of business income is rent, where the rental income is less than \$30,000, need not register, although they may choose to do so.

Farm Property Class Tax Rate Program

The Farm Property Class Tax Rate program enables eligible farm properties to be taxed at 25% of the municipal residential/farm tax rate. The farm residence and 1 acre of land surrounding it are taxed as part of the residential class.

To be eligible for the reduced rate, an application to the program must be filed showing that the property is used by a farming business with a valid Farm Business Registration number that has gross farm income of \$7,000 or more. Exceptions to this threshold can be made for new farming operations. For more information, contact the ministry, toll-free, at 1-877-424-1300 or visit the website at www.ontario.ca/farntax <<http://www.ontario.ca/farntax>>.

Section 3. Elements of a Lease Agreement

The Components of a Lease Agreement

A written lease can be as simple or detailed as the landlord and the tenant wish. The following summary presents the items that a lease can contain, categorized under three headings.

Items in Written Lease Agreements

Required Items

- names and addresses of tenant and landlord
- description of property to be rented
- term and renewal of the lease
- rent payable payment and use of utilities

Recommended Items

- right of inspection and removal of crops
- transfer of property
- termination of the lease
- use of the land
- environmental matters
- insurance
- rights to assign or sublet the lease
- resolution of differences
- restrictions of land use

Optional Items

- production practices and management decisions
- income support payments, subsidies and reimbursements
- repairs to buildings, fences and improvements
- duty to notify AGRICORP
- compensation for property damages
- rights of first refusal
- option to purchase
- municipal zoning restrictions

Required Items

All leases must contain this information:

Names and addresses of the tenant and landlord - Including spouses if required.

Description of property to be rented - Includes the legal description and specifies buildings or areas to be excluded.

Term of the lease - Indicates when it starts and how long it lasts. Although not a basic requirement of a lease, this section should also address the renewal of the lease if the parties wish to maintain the lease agreement for a period of years, including when and how such a renewal will take place.

Rent payable - The amount of rent, how it is calculated and when it is to be paid. In the case of a building lease or where the renter has access to facilities, the payment and use of utilities should also be stipulated.

Recommended Items

Items that every landlord and tenant should consider including in the lease agreement:

Right of inspection and removal of crops - Includes the following:

- The landlord should have the right at all times to inspect the rented property.
- The tenant should be able to complete harvesting of the crop after a reasonable time period after the termination of the lease agreement or the sale of the property. If this is not possible, the landlord will compensate the tenant for the anticipated agreed value of the crop.
- The incoming tenant, purchaser or landlord should have the right to enter on the land after harvest in the last year of the agreement to prepare the land for next year's crop.

Transfer of property - It is important that the landlord and tenant discuss their expectations in the event that the landlord sells the farm property to a new owner during the term of the lease. A fair agreement will attempt to strike a balance between the landlord's desire to not unduly restrict his or her ability to sell the farm and the tenant's desire to continue the lease arrangement.

Termination of the lease - The lease should clearly spell out how it can be terminated. This could be due to a breach of the terms of the lease or merely because the termination date of the lease has arrived.

Use of the land - The lease should state how the tenant is going to use the land. The lease should also describe any certification, regulatory or contractual constraints that the renter should be aware of, such as the land being certified as organic. The tenant should be required to adhere to normal farming practices in regard to disposal of manure. It should also be clearly stated how the land is to be left after termination of the lease. If buildings are included in the leased property, the lease should state how the buildings will be used and the rules for accessing the buildings.

If the farm will be used for selling products such as pick your own fruit, the lease should indicate this, and the tenant should be made aware of all the regulations governing the sale of food products, in addition to food safety requirements.

Environmental matters - This clause addresses the issue of environmental policies and responsibilities. In the event of an environmental problem, landlords, as owners of the lands, are ultimately responsible for activities occurring on their land. The tenant, as "user" of the land, should agree to adhere to appropriate and accepted farm practices and legislation relating to the environment (manure disposal, pesticide and herbicide applications, etc.). The tenant should also provide a "warranty" - a legal term meaning that this assurance can be legally relied upon - that they possess the necessary provincial licences for the application of pesticides or other chemicals to be used on the property.

Normally the tenant bears the cost, including the costs associated with an environmental clean-up, and reimburses the landlord for any costs that the landlord incurs as a result of the breach by the tenant of any environmental regulation.

Insurance - A clause regarding insurance would allow the landlord and tenant to identify who will be responsible for insurance coverage. The parties should ensure that adequate policies of insurance coverage, including occupier's liability insurance (insurance against personal injuries sustained by people coming onto the farm property) and fire insurance (especially if buildings are included), are in place.

Rights to assign or sublet the lease - The written agreement should contain a clause that prevents the tenant from subletting or assigning the lease to another individual without the written consent of the landlord.

In a production lease, the consent of the landlord can be withheld at the landlord's sole discretion, without explanation or reasonable cause (i.e., unreasonably withholding consent). In the case of a residence, the landlord cannot unreasonably withhold consent.

Resolution of differences - An arbitration or mediation clause in the written agreement describes how to deal with disagreements the tenant and landlord cannot resolve. The most common practice is to appoint a mutually agreed upon third party to act as a mediator or arbitrator.

Restrictions of land use - The lease should clearly define any areas that may have restricted use (e.g., the area directly underneath a wind turbine).

Optional Items

These items add clarity to the lease agreement and provide discussion points for the landlord and tenant as they formulate the lease agreement:

Production practices and management decisions - This clause deals with production and management decisions the landlord wants carried out by the tenant. Some of those factors could include:

- cropping decisions
- proper use of fertilizer and chemicals
- crop insurance and revenue insurance
- delivery and sale of crop

Income support payments, subsidies, reimbursements - The written agreement should clearly specify how government or marketing agency payments will be divided. This is most relevant in a crop share lease.

Repairs to buildings, fences and improvements - A clause stating who is responsible for repairing buildings, fences and other improvements, and how the expenses will be shared. A common practice is to have the tenant responsible for all minor repairs and for the landlord to reimburse the tenant for improvement costs that have a lasting benefit longer than the rental term.

Examples of major improvements that extend beyond the length or termination of the lease are:

- building and fence construction
- erosion control
- tile drainage
- clearing land

It is usually required that tenants obtain written permission from the landlord before making major improvements. It is also important to outline how the value of improvements will be determined and when compensation will be made. An example of one form of compensation to the tenant for improvements is for the landlord to let the tenant farm the improved land rent-free for a specific period of time to be agreed upon between the parties (in writing) at the time the improvement is consented to by the landowner. An annual review and agreement of the repairs and improvements needed could also be included here.

Duty to notify AGRICORP - Both the landlord and tenant must notify AGRICORP of any crop-sharing arrangement.

Compensation for property damages - This clause is especially necessary for determining responsibility for third-party and environmental damages.

Rights of first refusal - In some cases, the tenant is interested in purchasing the leased land but is either unwilling or unable to do so at the time. In these cases, the landlord may be willing to include an option whereby the landowner will notify the tenant that there is an offer to purchase from another party, allowing the tenant to bid on the purchase of the land before the landowner accepts the offer to purchase the land from the other party.

Option to purchase - The parties may include an option similar to the right of first refusal that allows the tenant to purchase the leased lands. This could be for a limited or unlimited time and for either a fixed price or

a price to be determined by some objective method such as a real estate appraisal by a certified agricultural appraiser.

Miscellaneous - The lease agreement may contain a clause that would terminate the lease if certain natural disasters occurred. For example, if the land were flooded and the tenant were unable to use the property, it would be unfair to insist the tenant continue to pay the cash rental unless the original rent charged had considered the risk of flooding. Other unforeseen circumstances include the installation of a highway, gas line, oil well sites, etc., on the rented land, creating inconvenience and additional operating costs for the tenant. In some instances, instead of terminating the lease, it may be considered desirable to renegotiate the terms of the lease or compensate the tenant for the added costs or reduced income they may incur.

Municipal zoning restrictions - The tenant enters into a farm lease with the express intention of conducting agricultural operations; it is important that the landlord provide an assurance to the tenant that the lands are properly zoned for such use. If the landlord is unwilling to provide such a warranty, the tenant should get advice from the local municipal authorities to ensure that the purpose to which the tenant wishes to put the property is permitted.

Section 4. Farm Equipment Lease Basics

What are You Paying for in a Lease?

An equipment lease payment is made up of two components. One is interest that is calculated on the entire value of the machine; the other is the principal amount, which is the sale price minus the residual value. The residual value is the value of the machine at the end of the lease period as stipulated in the lease agreement. Generally, lease payments are lower than similar purchase payments because only a portion of the total cost of the machine is covered in the principal portion of the payment.

Leases often include an option to purchase the machine at the residual value, which represents the remaining principal payment, at the end of the term.

How a Lease is calculated

Despite industry efforts to improve their transparency, leases are generally confusing for most people. Lease payments are calculated based on five variables:

- the cost of the machine (also called initial value or purchase price)
- the interest rate (often called an interest or lease factor)
- the residual or termination value - the value of the leased asset at the end of a lease
- the term
- the monthly or yearly payment

Once the first four variables are known, it is possible to calculate the fifth. This is especially useful for calculating the interest rate of a lease payment, allowing comparison to other leases or financing options.

Types of Leases

There are two types of leases: an operating lease and a financing or capital lease. It is important to know the type of lease, as the tax treatment of each is different. The Canada Revenue Agency (CRA) evaluates a lease based on the "legal relationship created by the terms of the agreement." Consult a lawyer or tax advisor if there are any concerns about the type of lease being negotiated.

Operating Lease

Sometimes called a true lease or an off-balance-sheet lease (see definition below), this is the lease most people are familiar with. In an operating lease, ownership of the equipment stays with the lessor, the company or lender leasing the equipment to the user (called the lessee). For income tax purposes, the user of the equipment can deduct the entire amount of the lease payments as an expense.

Generally, the term of an operating lease is for less than the useful life of the equipment and allows the user to return the equipment at the end without further obligation.

The Off-Balance-Sheet Lease

An operating lease is sometime called an "off-balance-sheet lease," because when an asset is purchased using a finance lease, it is recorded on your balance sheet as a leased asset and the payments as a liability. With a true operating lease, the balance sheet is not affected, and the payments are recorded as an expense on your income-and-expenses statement.

Financing Lease

With a financing lease (also called a capital lease), ownership of an asset does not generally transfer to the user until the end of the lease. In a financing lease, equipment is purchased at some point in the lease, with a bargain price usually available at the end of the lease period.

The payments on a financing lease cannot be fully deducted. A calculation determines what part of the payment represents the interest charge and what part can be deducted as capital cost allowance (CCA) or depreciation. This is the same deduction as if the equipment was purchased with a loan.

Table 1 highlights the main differences between an operating lease, financing lease and a purchase.

Table 1. Lease-purchase comparison

Components	Operating Lease (True Tax Lease)	Finance Lease	Purchase ²
Definition	Ownership stays with the leasing company. User can return equipment ¹	User becomes the owner of the equipment at some point in the lease, usually at the end, and at a bargain price. The length of the lease is generally greater than 75% of the useful life of the asset. The lease payments represent substantially all of the value of the asset.	User owns the asset.
Tax treatment of payments	All payments can be claimed as a tax-deductible expense.	Full payments are not claimed as an expense. Capital Cost Allowance (CCA) and a calculated interest expense can be claimed as a tax deduction.	Interest cost on loan and depreciation (CCA) can be deducted.
Affect on cash flow	Typically the cash flow requirements for leasing are less than for purchasing. Increasing the residual value or lengthening the term can reduce cash flow requirements.	Same as the operating lease. No down payments mean that more cash can be used in other areas of the business.	Cash requirements of servicing the loan are usually higher. There is flexibility on the term of the loan.
Affect on financial statements and ratios.	This is called an "off-balance-sheet lease" because the asset does not appear on the balance sheet. If your lender is concerned about your working capital, this type of lease would be preferable. This advantage may be overstated since most lenders require full disclosure of all liabilities.	The equipment appears on the balance sheet as a leased asset and payments as a liabilities.	The equipment appears on the balance sheet as an asset and the loan to finance it as a liability.

¹ This is usually an option only if you're dealing with an original manufacturer of equipment. Leases through banks usually have a clause that allows for the purchase, sale to a third party or a re-lease of the equipment.

² A conditional sales contract (CSC) is used to finance the purchase of the equipment from the manufacturer.

Lease or Purchase?

Whether it's better to lease or purchase depends on a number of factors.

After-Tax Cost - The after-tax cost of leasing vs. buying is very important. If a business is in a high tax bracket and the asset has a high capital cost allowance (CAA) for tax purposes, e.g., 30%, purchasing often yields a better after-tax result. This is because the CCA allowed in the first few years of ownership results in a large tax deduction.

Cash Flow Requirements - Lease payments are usually lower than loan payments, reducing cash flow requirements. If cash flow is tight, leasing may be more attractive. This is especially true if investment elsewhere in the business can return a higher rate than the cost of the lease.

Impact on Balance Sheet Financials - As mentioned above, leased assets are not owned and therefore do not impact the financial ratios of the balance sheet. Owned assets do appear on the balance sheet and can affect ratios such as the current ratio (current assets to current liabilities), which lenders may use as part of their evaluation of lending limits. However, lenders want to be aware of all financial obligations, so this advantage may be overstated.

How Do You Compare? - Net Present Value Cash Flow

Compare a lease vs. a purchase on an after-tax cost basis that takes into account the timing of the payments and deductions. To do this, the future payments and deductions (or cash flows) are converted to a present value using a discount factor. This method is called the net present value cash flow method (see below).

Net Present Value Cash Flow Method: The Time-Value Concept of Money

The net present value cash flow method is based on the time-value concept of money. This concept recognizes that money spent or received in the future is less valuable than money received or spent today.

The value of a future expenditure or income in today's dollars is said to be its present value. For example, if you could receive a dollar today or a dollar in a year from now, which would you choose? If received today, the dollar could be invested or used. It is therefore more valuable than a dollar received a year from now. If, however, you were offered \$1.05 in a year from now and the interest rates were 5%, these two offers would be equal. The present value of the future payment would be equal to \$1.00. The term "discount rate" is used to describe the percentage used to convert future values to present values.

Present value calculations allow you to determine the least expensive alternative. Using the dollar example, if you had to pay \$1.10 a year from now, or \$1.00 today, which would be cheaper? Using a discount rate of 5%, the present value of the \$1.10 would be \$1.048. That means it would be less expensive to pay the \$1.00 today as opposed to the \$1.10 in a year from now. This same principle is used in calculating the present value of the series of payments that must be made on a loan or a lease. These are added together and discounted, and the result allows a comparison to be made between the two options. This is called the net present value cash flow method.

Tax Deductions - Capital Cost Allowance, Interest and Lease Payments

An after-tax comparison measures total cash outflow after considering the reduced tax payable because of the deductions that are allowed under the purchase or lease options. Farmers can deduct capital cost allowance (CAA: the tax deduction representing depreciation) and interest on borrowed money on purchased assets. If equipment is acquired through an operating lease, the entire payment can be deducted.

For tax purposes, machinery and other depreciable assets are placed in classes, each with specific depreciation rates. For example, tractors, combines and other self-propelled machinery are in Class 10, which has a capital cost allowance rate of 30% per year. Equipment such as balers, cultivators, seeders and ploughs are Class 8, which has a CCA of 20% per year. Assets such as grain bins are in Class 6 and have a CCA rate of 10% per year.

In the year of purchase, however, only half the prescribed rate can be used. These rates are applied on a declining balance as shown in Table 2.

Generally, farmers in a higher tax bracket who acquire an asset with a higher CCA rate find that purchasing produces a better after-tax result than leasing. This is because the CCA provides large tax deductions. Table 2 shows that an asset depreciated at the 30% rate is 80% depreciated after 5 years. These deductions are of more benefit to farmers in the higher tax brackets.

Table 2. Capital cost allowance deductions on a \$100,000 asset

Year	Value	CCA Deduction at 30%
Year 1	\$100,000	\$15,000
Year 2	\$85,000	\$25,500
Year 3	\$59,500	\$17,850
Year 4	\$41,650	\$12,495
Year 5	\$29,155	\$8,747
Year 6	\$20,409	\$6,123
Year 7	\$14,286	\$4,286
Year 8	\$10,000	\$3,000
Year 9	\$7,000	\$2,100
Year 10	\$4,900	\$1,470

Lease or Purchase Comparison

The following example compares leasing vs. purchase of a \$120,000 piece of equipment, including the CCA and tax rates.

Tables 3 and 4 below, show the net present value cash flow analysis of leasing vs. buying. Column A shows that the total payments for leasing were \$92,500, while the purchase option total was \$138,280. Looking solely at cash flow, it seems better to lease.

However, once tax deductions are considered and the net present value calculated, purchasing appears more economical. Leasing has a net present value of \$60,552, and buying, a net present value of \$55,836. This means that, from a total cost perspective, in this example purchasing is the better option.

Lease vs. Purchase Example

Cost of equipment: \$120,000

Sale price at end of loan period: \$50,000

CCA rate: 30%

Tax rate: 28%

Discount rate: 5%

Lease details:

Residual value: \$50,000

Number of payments per year: 1

Term of lease: 5 yr

Interest factor or rate: 6.0%

Lease payment: \$18,507

Loan details:

Down payment: \$25,000

Amount of loan: \$95,000

Annual interest rate: 6.0%

Length of loan: 5 yr

Number of payments per year: 1

Compounding periods per year: 12

Payment per year: \$22,656

Table 3. Net present value cash flow analysis - Lease

Year	A. Payments	B. Tax Deduction (A x 28%)	C. After-Tax Cash Outflow (A - B)	D. Discount Factor (5%)	E. Net Present Value
Year 0 ¹	\$18,500	\$5,180	\$13,320	1.000%	\$13,320
Year 1	\$18,500	\$5,180	\$13,320	0.9524%	\$12,686
Year 2	\$18,500	\$5,180	\$13,320	0.9070%	\$12,082
Year 3	\$18,500	\$5,180	\$13,320	0.8638%	\$11,506
Year 4	\$18,500	\$5,180	\$13,320	0.8227%	\$10,958
Year 5	\$0	--	--	0.7835%	--
Totals	\$92,500	\$25,900	\$66,600	--	\$60,552

-- = not applicable

¹ Year 0 represents the beginning of the year. Lease payments are required in advance so a payment shows in year 0 but not in year 5, since the years 1 to 5 represent the year end.

Table 4. Net present value cash flow analysis - Purchase

-- = not applicable

Year 0

A. Payments	B. Interest	C. Un-depreciated Capital Cost (UCC)	D. CCA (Cx30%)	E. Tax Deduction [(B+D)x28%]	F. After Tax Cash Outflow (A-E)	G. Discount Factor (5%)	H. Net Present Value
\$25,000	--	--	--	--	\$25,000	1.0000%	\$25,000

Year 1

A. Payments	B. Interest	C. Un-depreciated Capital Cost (UCC)	D. CCA (Cx30%)	E. Tax Deduction [(B+D)x28%]	F. After Tax Cash Outflow (A-E)	G. Discount Factor (5%)	H. Net Present Value
\$22,656	\$5,859	\$120,000	\$18,000	\$6,681	\$15,975	0.9524%	\$15,214

Year 2

A. Payments	B. Interest	C. Un-depreciated Capital Cost (UCC)	D. CCA (Cx30%)	E. Tax Deduction [(B+D)x28%]	F. After Tax Cash Outflow (A-E)	G. Discount Factor (5%)	H. Net Present Value
\$22,656	\$4,823	\$102,000	\$30,600	\$9,919	\$12,737	0.9070%	\$11,553

Year 3

A. Payments	B. Interest	C. Un-depreciated Capital Cost (UCC)	D. CCA (Cx30%)	E. Tax Deduction [(B+D)x28%]	F. After Tax Cash Outflow (A-E)	G. Discount Factor (5%)	H. Net Present Value

		Cost (UCC)					
\$22,656	\$3,724	\$71,400	\$21,420	\$7,040	\$15,615	0.8638%	\$13,489

Year 4

A. Payments	B. Interest	C. Un-depreciated Capital Cost (UCC)	D. CCA (Cx30%)	E. Tax Deduction [(B+D)x28%]	F. After Tax Cash Outflow (A-E)	G. Discount Factor (5%)	H. Net Present Value
\$22,656	\$2,556	\$49,980	\$14,994	\$4,914	\$17,742	0.8227%	\$14,596

Year 5

A. Payments	B. Interest	C. Un-depreciated Capital Cost (UCC)	D. CCA (Cx30%)	E. Tax Deduction [(B+D)x28%]	F. After Tax Cash Outflow (A-E)	G. Discount Factor (5%)	H. Net Present Value
\$22,656	\$1,316	\$34,986	\$10,496	\$3,307	\$19,348	0.7835%	\$15,160

Sale

A. Payments	B. Interest	C. Un-depreciated Capital Cost (UCC)	D. CCA (Cx30%)	E. Tax Deduction [(B+D)x28%]	F. After Tax Cash Outflow (A-E)	G. Discount Factor (5%)	H. Net Present Value
--	--	\$50,000	--	--	(\$50,000)	0.7835%	(\$39,176)

Totals

A. Payments	B. Interest	C. Un-depreciated Capital Cost (UCC)	D. CCA (Cx30%)	E. Tax Deduction [(B+D)x28%]	F. After Tax Cash Outflow (A-E)	G. Discount Factor (5%)	H. Net Present Value
\$138,280	\$18,278	--	\$95,510	\$31,861	\$56,418	--	\$55,836

There are many variables that affect the analysis. The most important are the CCA rate and the tax rate. But assumptions must be made about the discount rate and the value of the purchased machine at the end of the period. To compare a purchase with a lease, the purchased machine is deemed to be sold at the end of the time period that corresponds to the lease. The lease residual value is used as the sale price.

Comparing lease and purchase options in this way is a decision-making tool. Differences of a few thousand dollars on a large machinery purchase may be small enough to suggest that the options are comparable. Larger differences may suggest a preferred option. In either case, the purpose of the analysis is to provide the business owner with information to make a reasoned decision beyond just a subjective evaluation.

Decision-Making Aids

While the net present value cash flow can be calculated using present value tables, it is easier to use the Equipment Lease Analyser spreadsheet available from the OMAFRA website at www.ontario.ca/agbusiness <<http://www.ontario.ca/agbusiness>>.

It is a decision-making aid to help evaluate the economic differences between leasing and purchasing equipment. The spreadsheet analyzes the alternatives on the basis of the net present value cash flow as described in this Factsheet.

Negotiation Points

There are several potential items open for negotiation when considering an equipment lease.

Sale Price - Negotiating a lower sales price reduces the annual lease payment and the end-of-lease purchase option price.

Lease Term - The term of a lease is probably the easiest area to negotiate. Select the lease duration that fits your farming plans for the next several years. If there is no known need to change equipment in 3 or 4 years, and if controlling an asset outside of its warranty period is no problem, consider a longer lease.

Number of Hours of Use per Year (hr/yr) - Select the number of hours that minimizes the total equipment cost over the life of the lease. Because leases have limited hourly choices (e.g., 400, 600 and 800 hr/yr), it is important to evaluate which option is least expensive. For example, if a tractor is needed for 475 hr/yr, it might be cheaper to pay for a 600-hr lease than to choose the 400-hr lease and pay the extra charge for the additional 75 hr. See Calculating Optimum Lease Hours, below.

Calculating Optimum Lease Hours

Terms	Lease 1	Lease 2
Contract hours per year	400 hr	\$15,000
Annual payment	\$15,000	\$16,500

Equipment power: 225 hp

Charge for extra hours: $\$0.15/\text{hp} \times 225 \text{ hp} = \$33.75/\text{hr}$

Break-even additional hours: $(\$16,500 - \$15,000) \div \$33.75/\text{hr} = 44 \text{ hr}$

Conclusion

If you anticipate using the equipment for less than 444 hr/yr, the 400-hr lease is less expensive than the 600-hr lease.

The Equipment Lease Analyser spreadsheet calculates the optimum hours to choose. It can be downloaded from the OMAFRA website at www.ontario.ca/agbusiness <<http://www.ontario.ca/agbusiness>> .

A Negotiation Plan

A plan for negotiation might include the following steps:

- Make your best deal on the purchase of the equipment you are interested in controlling.
- Ask dealers about equipment leases they offer. Compare their lease contracts for various lease lengths and annual use. Note that the best purchase deal might include trade-in of used equipment, whereas a lease may not allow trade-ins.
- Ask dealers about options for financing purchases.
- Ask your lender how the purchase would affect your financial status and what interest rate would be charged for a loan, if needed.
- Ask if your lender is interested in purchasing the equipment and leasing it to you.
- Before signing any lease, discuss the terms of the arrangement with your tax advisor.

Conclusion

Leasing allows farmers to control productive assets without owning them. Comparing a lease vs. a purchase using net present cash flows can ensure you choose the best option for your business.

This Factsheet was written by Business Management Unit Staff, OMAFRA, Guelph. Portions of this Factsheet were used by permission from the University of Missouri publication G00429 "Leasing Farm Equipment" written by Raymond E. Massey, Crop Economist, University of Missouri.

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For more information:

Toll Free: 1-877-424-1300

E-mail: ag.info.omafra@ontario.ca