Analysis of leaseback transactions

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Abstract. Leaseback transaction is often seen as a possible way to minimize tax payments. However, one should understand that is unlikely to considerably save on taxes with it. Article is devoted to the resolution of disputes arising in the implementation of the leaseback agreement, the example discussed different possibilities venture acquisition of fixed assets. Justified legitimacy recognition as expenses lease payments under lease when the lessee also acts as a seller. Assessed the risks arising in the implementation of this type of transaction.
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Introduction

Leaseback is a kind of leasing. It is characterized by the fact that the seller at the same time acts as the lessor and the lessee within a leasing agreement. Leaseback transaction does not contravene existing legislation and is a permitted leasing scheme. Tax authorities may regard the coincidence of the seller of the leased asset and the lessee as bad faith of the parties with a view to obtain tax advantages. There is some practice when tax inspections credit additional taxes in leaseback transactions, recognizing them as schematics. Claims of the regulatory bodies to participants of leaseback transactions are often based on the argument that such an agreement does not meet the criteria of the leasing contract, which means that it can not be applied to the rules and principles of accounting and taxation, set for leasing transactions. However, the arbitration courts in such situations take the position of the lessor and lessee. Leaseback is not considered as a serious risk.

Legal basis of leasing activity is enshrined in paragraph 6 of Chapter 34 of the Civil Code [1] and in the Federal Law 164-FZ “On the financial rent (leasing)” (further as the “Law”) [2]. In addition, the existing rules do not contain a ban on combining the functions of the seller and the lessee in one person. Moreover, the Law is a direct reference to the fact that “the seller can simultaneously act as the lessee within a leasing relationship” (Section 1, Art. 4 of the Law). This norm shows that the leaseback agreement fully complies with applicable laws and even to a certain extent is provided by them.

A special attraction leaseback acquired in 2013 after the abolition of the property tax on the majority of movable property. In this case, the implementation of lease transaction allows to exclude from taxation the lessee's assets acquired and put to balance until 2013, providing additional financial savings.

Subject to leaseback can be movable and immovable property, including buildings, equipment, vehicles, machinery and other, which is:

- already purchased and in use by the client;
- being acquired by the company (signed supply agreements to the property, made an advance payment to the supplier);
- planned to acquire companies in the near future.

Scheme of implementation of leaseback transactions:

1. The client sells and the leasing company acquires property that is owned by the client;
2. The leasing company receives a bank loan and pays the cost of the property to the customer, ownership passes to the leasing company;
3. The leasing company transfers property to lease back to the client.

Features: supply agreement is conditional and requires no detailed agreement as the property remains in the use of the lessee. Advance lease may be missing – the price of property may be reduced to the advance amount. In case if less than one year has passed since the date of delivery of imported assets, resources from foreign banks may be attracted.

Applications: for operational refinancing of costs incurred to purchase expensive assets, using tax incentives. As a more efficient alternative to lending secured company-owned assets or real estate.

Variants of application schemes:

Situation 1

When the lessee requires urgent advance payment to the seller for the property and there is a complexity with financing the entire amount under the concluded delivery agreement.

1. The customer enters into a contract to purchase the property. Parallel or after some time he enters into a contract with the leasing company for the supply of the same property, but now he acts as a seller.

2. The leasing company pays the customer for property on schedule according to the schedule of payments between the customer and the seller, so the client does not distract his own funds.

3. Acceptance and transfer is made from two supply contracts with simultaneous acceptance and transfer on lease.

Features: lessee alone, sometimes in advance, agrees on contractual basis and payment schedule with the seller, which accelerates the process to enter into a supply agreement. Depending on the risks of the project the leasing company may change the fees or offer to change and renew the supply contract directly (the format of classical financial leasing).

Situation 2.

When the lessee buys a large amount of property from many sellers or the estate purchased by him requires additional processing or acquisition.

1. The client shall supply contracts with different suppliers in different conditions. The client out of a large number of small supply contracts forms large items of property (creates a new object of a large number of elements) and sells them to a leasing company acting as an integrator or an engineering company.

2. The leasing company pays the client for property to an agreed schedule, which is usually not connected with payments to terminal sellers refinancing part of the abstract client funds. Sends back to leasing.

Lessee on itself concentrates all documents with suppliers. At the same time from its own resources and / or resources of the leasing company he provides prepaid and payment terms. There is an opportunity to use the tax advantages of leasing for small amounts of property for various accessories and even for construction works.

Procedure for leaseback is very popular on the market today because it gives the company an opportunity to use technical equipment, while freeing the capital.

The main purposes of using leaseback:

The company may use the procedure of leaseback for the following purposes:

• Optimization of taxation. The actual operation of the equipment, which is not listed on the balance sheet, will allow several times to reduce tax payments if the tenant will include lease payments in the cost of ongoing operations.

• Stabilization and adjustment of balance. If the assets of the enterprise have unnecessary capacity, it is adversely affecting its financial returns. Leaseback allows making the company structure more liquid and attractive due to the sale of property in service at market value.

• Re-equipment of the enterprise. After the purchase of new equipment, the company can get the money spent from the leasing company, retaining property rights for the purchase of machinery.

• Improving the efficiency of investment. Leaseback allows the company to release a significant portion of capital that can be invested in long-term projects and business expansion.

Study of effectiveness of leaseback procedures reveals both advantages and disadvantages of its use. The advantages include:

1. Obtaining additional working capital.
2. Favourable cost of financing involving the leaseback.
3. Creating liquid balance involving mobile assets.

Disadvantages of leaseback:

1. Firstly, leaseback is risky because it can be considered illegal in terms of fiscal services.
2. Moreover, transfer of assets to second parties leads to the loss of the right of property used.
3. Finally, for the recognition of the legitimate leaseback transaction, the company must carry out calculations using real money, not promissory notes and other formal methods of payment [3].

Leaseback has long time and widely been considered as one of the most effective tools for replenishment of working capital of enterprises. However, its development is hampered by prejudice of tax authorities considering such transactions as unfair.

Leaseback is successfully used to improve the balance sheet ratios through the sale of the property not at the net book value, but at the market, which usually exceeds it. That is, the company brings its balance sheet in accordance with the market situation, thus increasing its capacity and attractiveness in the eyes of creditors [4].

Leaseback is a profitable option of refinancing capital investments of the company, requiring less cost than, for example, the involvement of bank lending and acquisition of assets at their own expense. Leaseback is especially useful if the solvency of the company is put into question due to creditors because of the unfavourable ratio between its own capital and borrowed funds. Profitability of a transaction will be measured by the difference between income from new investment and the amount of the lease payments. In turn, the leasing company at the same time takes to the deduction all “input” VAT on purchased hardware, earns income – the difference between the lease payments received and the loan amount, returned to the bank with interest [5].

Overall leaseback transaction can be compared with the issuance of a secured loan. But costs for the lessee under lease agreements are generally lower than the interest on bank loans. In addition, by optimizing taxation leaseback transaction can be more profitable for the customer than credit [6]. The advantage over traditional leaseback (direct) is that the organization enters into a contract not to purchase specific equipment, but to obtain money that it can use at its discretion for any purchase. For a leaseback contract one does not need to present balance sheets and other documents that would normally require banks to determine the creditworthiness of the customers. With the conclusion of an ordinary contract the lessee often has to pay up to 30 % of the value of the leased property. Sometimes organizations can not find such means. Tax representatives have always been suspicious regarding leaseback transactions, considering savings on taxes as the sole purpose of such contracts. Inspectors believe that the business purpose of the operation can not be traced: sales company disposes the property to rent it; besides these transactions involve interdependent persons [7]. And profitability of the operation to the lessor is not always obvious, especially if he purchased the property with borrowed funds (interest on loans further reduce the profitability of the transaction). Tax authorities believe that the lessor receives income only by the VAT refund, which leads to an unjustified tax benefit (paragraph 9 of the resolution of the Plenum of the Russian Federation of October 12, 2006 № 53). Claims of fiscal authorities are not so groundless – often lessees do not really need the means, but only reduce payments to the budget. Arbitration practice shows that in some cases, inspectors (and the courts often support them) tend to characterize the actions of taxpayers under the tax optimization schemes as “abuse of tax law”, which leads to the invalidation of the transaction and, as a consequence, to additional taxes [8].

Nevertheless, the decision of the Presidium of the Supreme Court of Arbitration of the Russian Federation of January 16, 2007 № 9010 /06 “On the application of VAT deductions under leaseback” confirmed that leaseback are legitimate dealings with reasonable economic motives for both sides, which do not lead to unjustified tax benefit. Therefore, the lessor on leaseback can accept input VAT on the acquisition transaction for deduction, even if it is unprofitable [9].

Major corporations and industrial holdings that have implemented or are preparing to carry out IPO, have great interest in the leaseback directly related to the optimization of the company's assets. International investors who are parties of the purchase of shares in IPO, pay attention to the fact that the company placed the securities was clearly focused on its core business. But historically many large Russian producers have either their own transport division in their composition or subsidiary transport companies. From an investor's perspective, the presence of non-core assets on the balance sheet is a serious drawback. Given that the majority of large domestic companies need substantial investment to upgrade the main production, leaseback in the next five years could be one of the most popular services [10].

What are the real advantages and disadvantages of leaseback compared to direct lease? Here is an example. The first two cases represent finance leases due to the credit of the bank or company's own funds, the last two – leaseback with instalments or without them [11].

Financial leasing + bank loan

This scheme is offered to enterprises that are interested in purchasing equipment, but do not have sufficient funds at the time of purchase, as well as when the working capital of the enterprise generate revenue on average more than the sum of the rate of interest on the proposed loan from income and leasing company.

Upon request, the lessor (in this case – the leasing centre) of the enterprise through a bank loan buys the necessary equipment from the supplier, in this case paying the full cost of the equipment to the seller. In the next stage equipment owned by a lessor is leased to the enterprise which pays the cost of equipment and interest to the lessor in a certain period. After the payment ownership of the leased equipment is transferred to the company. At the same time the leased property by agreement of the parties may be considered both as being on the balance sheet of the enterprise or on the balance sheet of the lessor. Thus, the company receives the necessary equipment and additional savings on taxes, and after completion of the leasing agreement almost fully depreciated fixed assets.

The following example compares the possibility of the enterprise to independently obtain a bank loan for the purchase of fixed assets and the opportunity to purchase these same assets through leasing under the same conditions of bank credit, but for the leasing company. Period of calculation is adopted as 3 years, and the amortization period is 10 years (the useful life of fixed assets, most commonly used in leasing schemes).

Initial data for comparative analysis:

The base cost of the equipment – the loan amount – 5 000 000 rubles.

The interest rate on the loan – 16% per annum.

Term of financing and leasing period – 3 years.

Amortization period at the credit – 10 years.

Repayment of the loan – monthly equal instalments with interest on the remainder.

Tax rates: income tax – 24%; Property tax – 2.2%; VAT – 18%

Additional options of leasing:

Commission rate of the leasing centre (for a specified amount of the project) – 7% per annum.

The interest rate on the loan, invoiced as compensation – 16% per annum. Lease payments include compensation of property tax of the leasing company in the project based on accelerated depreciation over the life of the leasing agreement. Advance payment of the lease agreement is 0 rubles.

Calculations show the following costs of the company:

CREDIT:

Repayment of the loan: 5 000 000 rubles.

Accrued interest: 1 235 555.54 rubles.

Property tax for businesses loan period: 239 214.15 rubles.

At the time of full repayment of the loan amount of the accumulated depreciation will be: 1 260 681.36 rubles.

The accrued interest on the loan, accrued property tax for businesses and accumulated depreciation on the equipment reduces taxable base on the income tax and is: 2 735 451.05 rubles. Thus, the savings on income tax will be: 656 508.25 rubles, and in the amount of VAT equal 762 711.87 rubles, formed when purchasing equipment, gives savings for companies in the amount of taxes: 1 419 220.12 rubles [12].

Conclusion

According to the information presented the conclusion is: In the first place deal with leaseback is profitable for the organization that needs to get into circulation additional funds. The use of this mechanism allows, having obtained the funds from the sale of the item, to continue its operation without stopping the production process.

Leaseback can be likened to bank credit, attracted for the replenishment of working capital.

It should be noted: leaseback transaction attract special attention of the tax authorities. If the transaction is pure, then it is limited to the attention only because leaseback is a full, provided by the Federal Law 164-FZ type of lease.

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