Lease or Buy?

big money *It might be one and the same—with unintended consequences.*

By Steve Mulligan

When the Canada Revenue Agency (CRA) institutes a new tax, it gets all the fanfare of the circus coming to town. They advertise, produce glossy pamphlets, and otherwise shout it from the mountaintop.

But when a change to the Income Tax Act might reduce your tax burden, it often goes unheralded. A big part of our job at TFS Group is to sniff out these changes and help clients change their tax strategy accordingly.

This brings us to *Shell Canada Ltd. v. The Queen, 99 DTC 5669*, a case heard by the Supreme Court of Canada in 1999. It brought about a monumental difference in the way CRA assesses what is a lease agreement and what is a purchase agreement. Further, it resulted in the cancellation of Interpretation Bulletin IT-233R in June 2001. You may not know it, but if you ever signed a lease to acquire a tractor, you used rules set out in this now-canceled IT bulletin.

IT-233R determined whether a contract was a lease or sale based on the "underlying economic reality" of the deal. Say you lease a new $120,000 truck for 60 months with a $15,000 security deposit; 8 percent lease rate; $2,129.02 monthly payment; and a $1 buyout at the end. This type of financing was, and remains, common; we call it a "bargain purchase option." The deal is, for all intents, a purchase.

IT-233R interpreted a bargain purchase option lease as a loan with the truck added to the capital cost allowance (CCA) schedule.

No more. The Supreme Court said, "the economic realities of a situation cannot be used to re-characterize a taxpayer's bona fide legal relationships." Simply put, your lease payments are expensed and your truck is not capitalized. Your tax deduction is now equal to the real cash outbound and your accounting and tax planning are simplified. CRA no longer has the authority to review your lease agreement and force you to treat the deal as a virtual purchase agreement. The CRA provides background at its website: www.cra-arc.gc.ca/E/pub/tp/itnews-21/itnews-21-e.html.

So chalk up one for the little guy—and a tax advantage if applied intelligently. There's the rub: How does this rule change affect you when you decide to trade your current truck? Here are four scenarios.

1 Your present truck is on your books as a purchase and your new truck arrives, again, as a conditional sales contract finance agreement—in short, a purchase. Since you're moving from a purchase to a purchase, the change should not affect your tax planning.

2 Your present truck sits as a purchase, but your trade is being financed through a lease. Now pay attention: the disposal of your present truck may close out that CCA class altogether. Any recapture of depreciation at the point of trading trucks is income. This could be sizeable. If your truck is on the books for $25,000, and you trade it on a lease for $60,000, then $35,000 of recapture will be included in your current year's income without any significant offsetting expenses from the new lease agreement. Ouch!

3 Moving from an existing lease to a new lease is not an issue, but again, only if the existing lease was treated as a true lease. Watch for any business income derived from the difference between your current truck's trade-in value and your lease agreement's bargain purchase option (e.g. $1). This gain must be declared as income. It's something many owner-operators miss, only to be terribly surprised once audited.

4 You're trading a true current lease for a new purchase. Again, watch for business income derived from the difference between the trade-in value and your lease's bargain purchase option. Any gain on the sale of your old leased truck is income that year and your new truck will be added normally to your CCA schedule and interest expensed from your loan's amortization schedule.

The disappearance of IT-223R may result in a surprise tax hit if you're not well advised when you trade in your truck. Before you structure your next truck acquisition, talk to your accountant about the tax implications. And don't accept a blank look as an answer. ▲

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