**Looking to reduce interest expense? Compare the costs and benefits of a capital lease.**

The interest rate hikes are the Fed’s reaction in response to higher levels of inflation. Typically, the Fed’s goal is to have inflation between 1% and 2%. The current level of inflation is slightly higher than the Feds wants to see but is lower than the recent highs in June of 2022 of around 9%. Increased interest rates put a damper on inflation by reducing the amount of loanable funds demanded by consumers and businesses.

In the last year, the Federal Reserve implemented a series of interest rate hikes to their target for the federal funds rate. The federal funds rate is the interest rate that commercial banks borrow and lend excess reserves to each other overnight to ensure reserve requirements are met. While it doesn’t directly impact consumers or businesses, it does make banks reluctant to grant loans and ultimately reduces the funds available and puts upward pressure on interest rates for consumer and business loans.

Farmers, ranchers, and small businesses are all considering ways to reduce interest expenses in the wake of higher rates. One tactic is to reduce the size of operating loans by financing with one’s own working capital. Another would be to reduce the length of time your operating line of credit sits above a zero balance. A third option, which is usually given less consideration, is leasing capital equipment instead of purchasing. One of the major benefits of leasing is the reduction in interest expenses. It’s important to weigh the full costs and benefits before determining if this is the best option for your farm or ranch.

Long-term leases on capital equipment generally fall into two categories: an operating lease or a capital lease. Operating leases tend to be more common for real-estate in agriculture; however, manufacturers sometimes offer these on machinery and equipment because they have a comparative advantage in equipment maintenance. Operating leases can also be done over a shorter period; whereas, capital leases are more common for agricultural machinery and equipment. Capital leases are almost always long-term, and the lessee is responsible for all the risks and costs associated with the machine, but still gains the benefits of ownership.

When capital lease interest is not paid, because no loan is taken, there is still an obligation to make lease payments. This also means the full value of the yearly lease expense is tax-deductible; however, some of the tax savings are offset because depreciation cannot be taken due to the asset technically not being owned. Another benefit of a capital lease is that because a loan is not required, more of a farm’s financial capital can remain free for other uses.

While there is no downpayment required for a capital lease, a prepayment is usually stipulated in the agreement so that the first lease payment is made prior to the start of ownership (and probably prior to the start of harvest). Unlike an operating lease, a capital lease should still be accounted for on the balance sheet so it can impact your financial ratios.

When is it more beneficial to purchase a capital asset as opposed to leasing it? The answer depends on a few factors. First, as forementioned, higher interest rates will make capital purchases more expensive compared to a lease. Higher tax rates also make leasing more attractive than purchasing. Another thing to consider would be the amount of the lease payment or the length of the loan if purchasing.

The decision to lease or buy a capital asset is multi-faceted. Understanding the factors that influence stream of total payments in the years to come is important and a full analysis should be done including evaluating the balance sheet, examining the impact on financial ratios, and determining the net present value of lease payments versus a credit purchase.

For more guidance on capital leases or determining whether a capital purchase or a lease is right for your farm, reach out to your local ND Farm Management Instructor.

The North Dakota Farm Management Education Program provides lifelong learning opportunities in economic and financial management for persons involved in the farming and ranching business. Visit ndfarmmanagement.com, Facebook @NDFarmManagementEducation, or contact Nikki Fideldy-Doll, State Supervisor for Agricultural Education, at nfideldy-doll@nd.gov or 701-328-3179 for more information. The ND Farm Management Education Program is sponsored by the North Dakota Department of Career and Technical Education.