How can you borrow funds at 8 percent, lend them out at 4½ percent and still get a 13 to 16 percent pretax yield on your investment? Sound improbable? To some, maybe, but more and more banks are doing it, and accounting for the transaction is driving their auditors wild.

It is called leveraged leasing. Although the practice was virtually unheard of ten years ago, today banks are investing in the neighborhood of $1.3 billion annually in leveraged leases. Substantially all of the jumbo jets flown by U.S. airlines are financed by leveraged leases; Anaconda’s new $40 million aluminum plant is financed by a leveraged lease; there is hardly a major railroad in the United States that is not operating railroad cars financed by leveraged leases.

Central to all leveraged leases are the tax benefits associated with the ownership of property, such as the investment tax credit and the right to use accelerated depreciation. Leveraged leasing allows a company (such as an airline) that has more tax shelter than it can use to trade investment tax credit and accelerated depreciation to a company that needs tax shelter (such as a bank) for a lower interest rate.

STRUCTURE OF A LEVERAGED LEASE

To understand just how this tradeoff is accomplished, let us look at a typical leveraged lease transaction.

An airline wishes to acquire $1 million of new equipment which it intends to use for fifteen years. Given the airline’s credit rating and the value of the collateral, an insurance company agrees to lend approximately 80 percent of the funds required at an 8 percent interest rate repayable in equal instalments over fifteen years. The remaining funds would be supplied by the airline with equity funds—the cost of which undoubtedly would exceed 8 percent. Thus, were the airline to purchase the equipment itself, its total average cost of money would exceed 8 percent.