

THE CAPITAL ALLOWANCE ON LEASING: THE CASE FOR THE NIGERIAN MERCHANT BANKING SYSTEM *

Christian S. Nwinia
University of Birmingham

1. Introduction

The Nigerian merchant banking system undertakes a legislatively defined function of equipment leasing. In accordance with the Central Bank of Nigeria credit guidelines effective from April 1, 1976, the banks are expected to write leases to a maximum of 15% of their total assets¹. As indicated in Table 1, the system's performance between 1976 and 1981 was on average below the target by 84.3%.

Noted from the result of a survey of merchant bankers that the system is desirous of developing the leasing business but has been discouraged by the inadequate or poor rates of capital allowance. The banks have made representation to the Tax Authorities on the question of capital allowance for leasing but have not obtained satisfactory response. Notably the Financial Review Committee² recommended that tax incentives in the form of special scale of capital allowance should be considered for equipment leasing in order to make it a more regular feature of merchant banking activity.

Indeed the 9% of total customers' demand for credits attributed to leasing facilities is considered by the banks as more than sufficient to satisfy the prescribed maximum leasing finance³.

Given the adverse comments on the performance of the merchant banking system, this paper is intended to highlight why the system has not developed or actively engaged in leasing business, and thus emphasize the need for operationally feasible legislative and regulatory framework for the merchant bankers, and suggest a compromise solution to the controversy on capital allowance for leasing.

2. The capital allowance controversy

Presently the rates of capital allowance for leased equipment are 32.5% initial allowance (FYA) and annual allowance (WDA) of 12.5% on the written down value.

* This paper has benefited from the guidance of Professor J.M. Samuels, whose assistance is gratefully acknowledged.

1 Nwinia, C.S., « The Nigerian Merchant Banking System: An Empirical Study of its Role in the National Financial and Economic Development », Unpublished Ph.D. Thesis, University of Birmingham, 1983.

2 Federal Military Government's Views on the Report of the Committee on the Nigerian Financial System, Federal Ministry of Information, 1977, p. 10.

3 Nwinia, C.S., op. cit., p. 322.

Comparatively the normal rates of capital allowance for Plant and Machinery are 20% FYA and 12.5% WDA. It would appear that the 32.5% FYA is considered by the Tax Authorities as an adequate extra incentive for leasing.

Table 1

EQUIPMENT LEASING ACTIVITIES (PERCENTAGES)

	1976	1977	1978	1979	1980	1981
1 Actual % of Leases to Total Assets	1.9	3.9	3.2	2.5	1.8	0.8
2 Prescribed Maximum %	15.0	15.0	15.0	15.0	15.0	15.0
3 Deviation from Target (1-2)	-13.1	-11.1	-11.8	-12.5	-13.2	-14.2
4 3 as % of 2	-87.3	-74.0	-78.7	-83.3	-88.0	-94.7

Source: Nwinia C S, « The Nigerian Merchant Banking System: An Empirical Study of its Role in the National Financial and Economic Development », Unpublished Ph. D. Thesis, University of Birmingham, 1983.

According to the banks, the present rates of allowance make leasing still very unattractive for the following reasons:

- (i) The negative cash flow effect of the scale of allowances.
- (ii) To avoid providing substantial deferred taxation, the lessor must continuously write new leases, which require extra attention to ensure activity is within the maximum permissible amount of investment.
- (iii) The Tax Authorities are reluctant to allow the sale of equipment at normal price to cover the unrecouped capital allowance at the end of the lease period.

Acceptably, the attractiveness of leasing lies in the additional benefit from capital allowance. Logically, it is rather hypocritical for the Merchant Banks to want improved capital allowance on leasing when they do not even obtain a FYA on their investments in plants similar to the presently granted for leasing.

Ola⁴ and Olorunleke⁵ clearly provide the reasons why the Tax Authorities are

4 Ola, C.S., *Nigerian Taxation*. Graham Burn, 1981.

5 Olorunleke, D.A., Paper presented at the Symposium on Equipment Leasing, Lagos 20 May 1982. Olorunleke is Director, Federal Inland Revenue Department.

reluctant to review the rates of allowance leasing. These reasons are related to what may be called the philosophy of social change and development. First, Ola stresses that development « investments geared to and guided by taxation incentives have served to create small oases of prosperity amongst deserts of people living well below the poverty line ». Thus for taxation to serve as an effective instrument of development it must reduce income inequalities. Second, he further asserts that granting of allowances for capital wastage tends to encourage the development of capital intensive activities which, arguably, are unsuited to the real needs of developing countries usually with over-abundant supply of labour. Third, he suggests that the granting of widespread tax concessions to entrepreneurs and businessmen results in the appearance of innumerable tax loopholes, the existence of which encourage the sport of tax evasion as well as tax avoidance.

Olorunleke notes that the more equipments, the more the capital allowance and the less the tax revenue. He emphasizes the necessity for leasing productive equipments, and to industries in need of help. Specifically, he accuses the merchant banks of selfishness: paying more attention to their own interest and little or no concern for the benefit of customers.

Clearly, the pressure to improve the rates of capital allowance on plant and machinery has come as a result of the equipment leasing business in particular. Evidently, leasing is not officially classified by the regulatory authorities as loans and advances and therefore not covered by the guidelines on credit sectorisation and quite uncharacteristically, there is no stipulation of charges or rates on leasing.

In sum, the position of the Tax Authorities, as deduced from the statements by Ola and Olorunleke are:

- (i) Leasing must be restricted to equipments that will actually facilitate economic development.
- (ii) It should be geared towards the priority sector of the economy and industries and companies to which leasing facilities would be more advantageous.
- (iii) Leasing must be made attractive to the lessee, by passing to them some of the tax benefits accrued to the lessor; and
- (iv) Any change in the present rates of capital allowance would reduce Treasury revenue, particularly in terms of cash flow timing.

It would appear that it is on these suppositions that any acceptable compromise solution to the capital allowance controversy can be found.

3. Suggested Compromise Solution to Capital Allowance on Leasing

That attractive capital allowance would necessarily encourage capital investment of a typical Nigerian indigenous enterprise is debateable. It would be the elite entrepreneurs who will take advantage of the tax incentive. It is without doubt as all the merchant banks and the Financial Review Committee believe that attractive rates of capital allowance would stimulate and increase activity in the Nigerian leasing market.

In the developed economies, such as the United States of America and United Kingdom, the profitability of leasing is generally dependent upon the lessor or the bank being in high marginal tax bracket to gain immediate advantage of tax credit resulting from capital allowance on the leased equipment. Notably, the initial impetus for the growth of the U.K. leasing market in the 1970s is associated with the switch from investment grants to FYA which by October 1970 was raised to 100% on plant and machinery (applicable, especially for leasing to resident business enterprises).

Presently, the Nigerian merchant bank's leasing activities are for terms ranging from 3 to 5 years, and based on result of the interviews it could be said that the maximum lease period is still 5 years. As computed in Appendix 1, with the present rates of capital allowance only 60.4 of tax credit would be obtained at the end of 5 years. Assuming that the equipment has no residual value at the end of the lease period only 94.7% of capital allowance would have been claimed in 20 years. Clearly, all the clerical work involved in such a transaction, say ten years after it had been completed is unnecessary and not entirely satisfactory.

Also, as demonstrated in Appendix 1, with the present rates of capital allowance for leasing it is more convenient administratively to grant a direct-term loan than to lease. Generally, because of the benefit of capital allowance to the lessor, leasing is considered to provide a form of financial for industry that is cheaper than borrowing. The computations in Appendix 1 show that with a similar transaction (same amount, interest charge and repayment period) a bank would earn an after-tax internal rate of return (IRR) of 6% on a direct loan. This rate could be obtained only in 19 years with a leasing transaction and at the end of 19 years only 93.9% of tax credit from capital allowance would have been received. Thus, with lower leasing rates (than normal lending rates) and similar risk situation, it could be said that term lending is both convenient and profitable than leasing under the present Nigeria tax system.

As computed in Appendix 2 and summarised in Table 2, supposing with the hypothetical leasing transaction (2 in Appendix 1), a bank obtained 100% FYA,

charged lessee only its cost of funds (assumed 7% p.a.), it is able to recover its funds under 3 years and obtain a post-tax IRR of 10.5%. With the present rates of capital allowance (case E), the bank would obtain an after-tax IRR of 2% in 12 years with only 84.5% of capital allowance claimed. Should the bank wish to earn a post-tax IRR of 5% as in CASE D it would have to charge the lessee 6% over its cost of funds that is 13% p.a. (see computation in Appendix 2, Case E/1).

Table 2

THE EFFECT OF RATES OF CAPITAL ALLOWANCE ON LESSOR AND THE TREASURY

	CASE A 100% FYA	CASE B AA 20% on Cost	CASE C FYA 32.5% AA 12.5% all on Cost	CASE D AA 15% on Cost	CASE E Present Rates of C. Alice.
1. % of C. Alice Claimed in 5 years	100.0	100.0	82.5	75.0	60.4
2. Period 100% C. Alice obtained (year)	1	5	7	7	over 50
3. IRR (Post-Tax) (%)	10.5	6	6	5	2 in 12 years
4. Pay-Back Period (year)	3 (2 1/3)	4 (3 1/3)	4 (3 1/2)	4 (3 3/4)	9. (8 1/4)
5. Revenue to Treasury from Lessor in the first 5 years					
5.1 Nominal N	9,450	9,450	17,325	20,700	27,256
5.2 P.V. (7% Cost of Treasury Borrowing) N	2,594	7,749	13,176	16,975	20,923
5.3 Nominal of A-D as % of E	35	35	64	76	—
5.4 P.V. of A-D as % of E	12	37	63	81	—

Computed in App. 2.

On the question of tax revenue, a 100% FYA makes the Treasury worse off by 88% (discounted value) but under Case D (i.e. Annual Allowance of 15% of cost) the Treasury would lose only 19% of the revenue receivable in the first 5 years under present system. Under Case D, the bank would recover the entire 100% capital allowance in 7 years and get a pay-back period of 4 years, as would be expected on a five-year lease.

Considering all the five cases (A to E) in Table 2 in respect of IRR, Pay-Back Period, recovery of capital allowance and revenue to the Treasury, Case D would appear a

reasonable compromise position upon which the review of rates of capital allowance on leasing may be attempted.

However, to ensure that leasing is restricted to the priority sector of the economy, and that some of the benefit of capital allowance is passed on to the lessee, the Central Bank must sectorise leasing activities and set a maximum leasing rate which should not exceed 2 to 3% above the minimum rediscount rate. Thus, leasing should be properly treated as loans and advances and not investment as now statistically classified. Leasing is a specialised form of lending and the credit principles applied in leasing is similar to those adopted for term loans.

The volume of imported capital goods by Nigeria in Appendix 3 demonstrates the potential leasing business existing in the Nigerian economy. The fact that the banks have not taken full advantage of this opportunity is a testimony of their displeasure with the rates of capital allowance on leasing.

To develop the leasing market under the present tax allowance would involve lessee paying rentals or leasing rates of interest higher than rates on conventional loans and advances.

APPENDIX 1

TERM LOANS Vs LEASING: THE COMPUTATIONS

Hypothetical Transactions

1. Term Loan of N100000 repayable N20000 per year for 5 years with interest at $10\frac{1}{2}\%$ (on reducing balance). Instalment plus interest payable at end of each year beginning from the end of year in which loan granted.
2. Lease equipment costing N100000. Term 5 years. Interest $10\frac{1}{2}\%$ (on reducing balance) = N31500.
Annual Rental $131500/5 = N26300$, repayments being due on the first day of each of the years.
 $10\frac{1}{2}\%$ is the 1982 maximum lending rate for the Preferred Sector. Estimated economic life of equipment is 5 years.

TERM LOAN - Cash inflows and outflows

End of Year	(1) Interest Income	(2) Tax on Income [(1) \times 0.45]	(3) Outlay & Repayments	(4) Net Cash Flow (1) + (2) + (3)	Discount Factor at 6%	Present Value
0			-100000	-100000	1.0000	-100000
1	10500		20000	30500	.9434	28774
2	8400	- 4725	20000	23675	.8900	21071
3	6300	- 3780	20000	22520	.8396	18908
4	4200	- 2835	20000	21365	.7921	16923
5	2100	- 1890	20000	20210	.7473	15103
6		- 945		- 945	.7050	- 666
	31500	-14175			NPV =	113

IRR = 6%

Case B: Annual Allowance of 20% on Cost.

End of Year	(1) Lease Income	(2) Capital Allow.	(3) Tax Saving 2×0.45	(4) Company Income Tax	(5) Capital outlay	Net (1 + 3 + 4 + 5)	Discount Factor at 6%	Present Value
0	24200	20000			-100000	-75800	1.0000	-75800
1	24200	20000	9000	-10890		22310		
2	24200	20000	9000	-10890		22310		
3	24200	20000	9000	-10890		22310		
4	24200	20000	9000	-10890		22310	3.4651	77306
5			9000	-10890		-1890	0.7473	-1412
					IRR 6.1%			
	121000	100000	45000					94

Case C: FYA 32.5% and A.A. 12.5% on cost.

							Discount F. at 6%	
0	24200	32500			-100000	-75800	1.0000	-75800
1	24200	12500	14625	-10890		27935	.9434	26354
2	24200	12500	5625	-10890		18935		
3	24200	12500	5625	-10890		18935		
4	24200	12500	5625	-10890		18935	2.5217	47748
5		12500	5625	-10890		-5265	.7473	-3935
6		5000	5625			5625	.7050	3966
			2250			2250	.6651	1496
					IRR 5.9%			
	121000	100000	45000					-171

Case D: Annual Allowance of 15% on Cost

							Discount F. at 5%	
0	24200	15000			-100000	-75800	1.0000	-75800
1	24200	15000	6750	-10890		20060		
2	24200	15000	6750	-10890		20060		
3	24200	15000	6750	-10890		20060		
4	24200	15000	6750	-10890		20060	3.5460	71133
5		15000	6750	-10890		-4140	.7835	-3244
6		10000	6750			6750	.7462	5037
7			4500			4500	.7107	3198
					IRR 5.2%			
	121000	100000	45000					324

Case E: Present Capital Allowance rates - FYA 32.5%, WDA 12.5%

End of Year	(1) Lease Income	(2) Capital Allow.	(3) Tax Saving 2×0.45	(4) Company Income Tax	(5) Capital outlay	Net (1 + 3 + 4 + 5)	Discount Factor at 2%	Present Value
0	24200	32500			-100000	-75800	1.0000	-75800
1	24200	8438	14625	-10890		27935	.9804	27387
2	24200	7383	3797	-10890		17107	.9612	16443
3	24200	6460	3322	-10890		16632	.9423	15672
4	24200	5652	2907	-10890		16217	.9238	14981
5		4946	2543	-10890		- 8347	.9057	- 7560
6		4328	2226			2226	.8880	1977
7		3787	1948			1948	.8706	1969
8		3313	1704			1704	.8535	1454
9		2900	1491			1491	.8368	1248
10		2537	1305			1305	.8203	1070
11		2220	1142			1142	.8043	919
12		84464	999			999	.7885	788
								275

Case E/1: Lessor earning IRR of 5% in 7 years as in Case D.
Requiring Charge of 13% N39000 + 100000 Rental 27800

							Discount F. at 5%	
0	27800	32500			-100000	-72200	1.0000	-72200
1	27800	8438	14625	-12510		29915	.9524	28491
2	27800	7383	3797	-12510		19087	.9070	17312
3	27800	6460	3322	-12510		18612	.8638	16077
4	27800	5652	2907	-12510		18197	.8227	14971
5		4946	2543	-12510		- 9967	.7835	- 7809
6		4328	2226			2226	.7462	1661
7		69707	1948			1948	.7107	1384
								- 113
139000			31368					
		Bal.	13632		IRR approx. 5%			
			45000					

TAX REVENUE TO TREASURY FROM LESSOR

End of Year	Case A		Case B		Case C		Case D		Case E	
	Revenue	Present Value ¹	Revenue	Present Value ¹	Revenue	Present Value ¹	Revenue	Present Value ¹	Revenue	Present Value ¹
1	-34110	-31879	1890		- 3735	- 3491	4140		- 3735	- 3491
2	10890		1890		5265		4140		7093	6195
3	10890		1890		5265		4140		7568	6178
4	10890		1890		5265		4140		7983	6090
5	10890	34473	1890	7749	5265	16667	4140	16975	8347	5951
	9450	2594	9450	7749	17325	13176	20700	16975	27256	20923

¹ Discount Factor at 7% (Assumed Cost of Borrowing to Treasury)

Year 1	0.9346
2	0.8734
3	0.8163
4	0.7629
5	0.7130

APPENDIX 3

IMPORT OF CAPITAL GOODS

Year	1 Total Imports (Nm)	2 Imports of Cap. Goods	3 2 as a percentage of 1
1970 ³	756.4	282.6	37.4
1971 ¹	1078.9	428.9	39.8
1972 ³	990.1	398.5	40.2
1973 ¹	1224.8	491.4	40.1
1974	1737.3	646.5	37.2
1975	3721.5	1573.1	42.3
1976	5148.5	2249.9	43.7
1977	7093.7	3409.5	48.1
1978	8211.7	3908.6	47.6
1979 ¹	7472.5	3631.6	48.6
1980 ²	9658.1	3235.4	33.5
1981 ²	12013.2	3736.1	31.1

¹ Provisional² Estimated³ Commodity under 2 classified as Machinery & Transport Equipment

Sources: Annual Report & Statement of Accounts — CBN 1976 — 1981.
Annual Abstract of Statistics, F.O.S. Lagos 1981.

L'AMORTISSEMENT DU CAPITAL DANS LES OPERATIONS DE LEASING: UN EXEMPLE TIRE DU SYSTEME DES BANQUES D'AFFAIRES AU NIGERIA

SOMMAIRE

Les autorités monétaires ont établi que les banques d'affaires au Nigéria pourraient accorder des financements sous forme de leasing jusqu'au montant maximal de 15% de leur actif. Une analyse des comportements des banques d'affaires montre qu'entre 1976 et 1981 les financements sous forme de leasing ne dépassaient pas 2,4% de

leur actif. Les banquiers attribuent la dynamique peu satisfaisante du marché du leasing au faible taux d'amortissement fiscal admis sur les biens d'équipement concernant les opérations de leasing: taux d'amortissement que l'administration fiscale est assez maldisposée à modifier. En se basant sur une évaluation des effets de différents taux d'amortissement fiscal sur les transactions en forme de leasing, on suggère une solution de compromis pour développer le marché du leasing au Nigéria. Ce compromis prévoit un amortissement annuel de 15% sur le coût tandis que dans le système actuel le taux est de 32,5% pour la première année et de 12,5%.