Motor Vehicle Leases -
Are They A Useful Tool Or Another Wealth Creation Trap?

By David Bradley, Chartered Accountant

One of the most common tax related questions I'm asked is "Is it better to buy or lease my motor vehicle?"

In this month's Hot Topic I'll try to outline the common pitfalls associated with leasing and indicate when it might be appropriate to choose to lease your motor vehicle as opposed to paying cash.

What Is Leasing?

There are two types of leases:

The first type is an *Operating Lease*, where the user pays the owner for hire of the asset but does not assume the risks of ownership. An example of an operating lease is when you hire a car on holidays. You don't own it and if it breaks down it's generally not your responsibility to pay for repairs.

A *Finance Lease* is where the majority of the risks and rewards of owning the asset transfers to the user and actual ownership transfers at the end of the lease term. For example, if you opted for a finance lease then you would have to pay for any repairs and maintenance to the motor vehicle, but at the end of the lease you would own it.

Finance leases are usually broken down into a series of periodic payments and sometimes conclude with a lump sum 'residual' or 'balloon' payment.

For example, at Holden's web site there is the following lease deal available:

"Astra City 3 Door man. with air & metallic paint. Max sale price incl. GST $20,185 excl. Dealer Delivery and on-road costs. Based on 60 month Loan contract with a 30% balloon payment, deposit of 15% and an Annual Percentage Rate of 9%. Available through Holden Financial Services to approved applicants. Fees & charges apply."

Translating this to English (assuming a purchase price of $20,185), you would pay a deposit of $3,027.75 and have a finance lease that translates to 60 monthly payments of $275.87 and a once off final payment of $6,055.50.

At the end of the lease the amount you have paid for your Astra would be $25,635.45, broken down as:

- Deposit: $3,027.75, plus
- Lease Payment $16,552.20, plus
- Balloon Payment $6,055.50

The Buying / Leasing Decision

Let me make it absolutely clear that in 99% of cases, buying a new car is a lifestyle and **not** an investment choice. Sadly, most people buy a new car to access depreciation allowances to keep taxes down, which is a strategy that keeps people working hard in a job for life.

Avoid asking your accountant whether or not you should buy a new car, because your decision is yours to make based on what lifestyle you can comfortably afford to maintain.

The 1% of cases where a new car would not be a lifestyle choice would be vehicles such as utes and courier vans that are necessary as a tool to generate income.

The point I'm trying to make is that the choice whether to buy or lease your car should only be made *after* you've decided that you would need to upgrade your vehicle in the first place.

If you are only seeking to access tax benefits, then consider the earlier example of the Astra. Provided you used the vehicle solely for work then you would be making lease payments of $275.87 per month but the maximum deduction you could claim would be $133.80 (48.5%). The remaining $142.07 is money lost out of your pocket forever.

The idea of spending money to save tax is a poor strategy that does not help in achieving the goal of financial independence.

The Financing Option

Let's imagine that you are considering upgrading your car. You locate a car you like which has a price tag of $40,000 on the road. What are your options and what are the pros and cons of each?

Option	Advantages	Disadvantages
Pay Cash	• There is no interest or repayments to make as there is no finance. • May be able to negotiate a cash discount on purchase price. • Insurance is generally cheaper when there is no finance involved.	• $40,000 is a lot of cash to allocate to a non-income producing asset. • The opportunity cost of the money that you could earn by investing the money instead of buying a car.
Use Redraw From His Home Loan	• Possibility to purchase 'no money down' as you are redrawing from existing equity. • Will probably pay a lower interest rate on a home loan than on a lease product.	• May end up paying a large amount in interest if it takes 25 years to repay the amount borrowed. • There is a finite amount of equity available to borrow against.
Personal Loan	• Generally, easy to source funds as most major lenders have a specific personal car loan product. • Term can be flexible to suit your needs.	• Personal loans generally attract a higher interest rate than home loans. • The application process can involve a lot of red tape.
Hire Purchase / Finance Lease	• 'No Money Down' possibility as some lease providers will allow a 100% lease in pre-approved circumstances. • Most dealerships have finance arms that ensure the finance application process is relatively trouble free. • Sometimes the finance option is discounted by offering low or honeymoon finance periods to improve sales.	• Sometimes tempting to forget that finance leases are a form of credit and that if you are not careful with your residual payments then you might never actually own the car. • Dearer insurance when car is financed

So with so many different choices, what should you do? Here's the order of preference that I would recommend for the 'average' person:

1. Cash

Where possible, make it a rule to pay cash for lifestyle expenses and since buying a car is a lifestyle choice, my advice is to pay cash whenever possible.

Now this is fine in theory but if you really must have a new car now and you don't have sufficient cash reserves, then the finance options below are probably your only other option.

Even if you do choose a finance option, be sure to contribute as much cash as you can to keep interest repayments on no-income producing debt to as low as possible.

2. Redraw From Home Loan

Redrawing from your existing mortgage (provided your home loan package is a flexible product) will probably be your cheapest source of finance given the security offered is 'bricks and mortar'.

However, the temptation might be to extend the term of your redraw for the remainder of your home loan that could be up to twenty-five years. So while you have a cheaper interest rate, unless you are vigilant in repaying the debt associated with your car as soon as possible, you may pay more interest over the longer term.

That is if you refinance and then only make the new minimum home mortgage repayments, you are in effect financing your car over 25 years. Obviously the amount of interest you will pay over this period of time will be substantial, but don't expect the bank to tell you this is a bad option!

3. Hire Purchase and Finance Lease

Both of these options are finance products suited to purchasing motor vehicles.

As mentioned, they are generally structured with terms of between three and five years, involve monthly payments and include a balloon (residual) payment at the end of the lease. The amount of the residual is usually the expected market value of the vehicle at the end of the lease.

In finance terms the difference between a lease and a hire purchase are quite minimal and while there are some minor differences in the accounting and tax treatment, for the purposes of this Hot Topic they are essentially the same.

Suffice to say that you will probably find a finance lease is more attractive for tax purposes and it will have a slightly higher interest rate compared with a hire purchase.

A feature of these products are the 'low monthly payments', which make the possibility of owing a new car attractive and affordable. But a dangerous reality that is most purchasers buy a car that has easy monthly payments that make it difficult to save enough money to pay out the residual when it falls due.

The reality that a lot of people face is that they can't afford to make the lump sum balloon payment and end up having to refinance using a personal loan. But a bigger and more sinister trap that unwary people fall for is when the dealer offers the option of avoiding the residual all together by upgrading to a new car with a new lease term.

Case Study

Consider the following example. You have just purchased a brand new car for $40,000. The dealer was kind enough to offer their 'red carpet' finance plan where you only needed a $500 deposit and your application was approved in less than 24 hours.

The terms of the lease are monthly repayments of $800 and a 50% residual ($20,000) due in three years time.

You can comfortably afford the $800 a month and you certainly enjoy the new car smell and the pleasure of driving around in your pride and joy... did I mention that your car came with cruise control?

Every month you faithfully pay the $800 by direct debit and before you know it, the three years are up and it is time to pay the balance of $20,000. The problem is that you haven’t saved enough money to pay out the $20,000. What are your options?

You can release your residual, which means you continue to pay $800 per month for a further three years. Or, you can upgrade your car to the latest model and it is only going to cost you an extra ten dollars per month - a seemingly generous offer!

Which do you choose? Well now your old car is out of warranty and a few expensive things have started to go wrong. The new $810 lease plan includes a vehicle fresh off the production line which is covered by a brand new warranty.

If you chose the new car lease alternative, then you are not alone because most people would make the same choice. And that's fine except you have an obligation to continue making a new $810 per month lease payment and have just deferred the residual problem for a further three years.

So is this a problem?

I believe it is because you have the responsibilities of owning a car (such as repairs and maintenance, insurance etc.) without ever actually owning it. If you chose this option then the reality is you might be better off simply hiring a car on a long-term contract under an operating lease where the Hire Company pays for all the ownership costs other than petrol.

If you haven’t got a spare $40,000 of cash laying around, have no equity in your house and I've turned you off the hire purchase or finance lease option, then what options are left if you really want to get that new car.

I think the solution is quite simple.

Take out the hire purchase but ask for the loan to be written with no residual. The car salesman won’t offer this option to you but just ask for it. It will cost you more per month in monthly payments but you won’t get the nasty $20,000 surprise at the end of three years.

Using this method, you will also only get into a finance situation that you can afford in the long-term rather than a deal that will earn the salesperson a higher commission.

4. Personal Loan

The final option is a personal loan. The problem with this option is that the interest rate you'll pay is likely to be much higher than any rate quoted to you under the above finance alternatives. On this basis, I recommend you secure a finance lease with a zero residual before obtaining a personal loan.

Who Is Your Adviser?

I'd like to warn you again to be wary from whom you seek finance advice in the form of a true story.

Steve and I met a respected accountant for lunch several months ago who ran a mortgage business as we were again chasing funds to buy properties. One of the many stories he told us was how he'd been to the casino in Melbourne and won a brand new BMW by playing the poker machines.

Before Steve and I could get a word in, he continued to tell us that he re-leased this car to pay out some other personal debt and that now his 'free' car only costs him $1,000 per month.

"$1,000" we said in disbelief, unable to comprehend that someone would pay $1,000 a month for something they had previously won for nothing.

“I know” the accountant said coyly, “It should have been $1,200 but I managed to negotiate a good deal”.

Steve and I were speechless, as we couldn't believe that someone who was trained as an accountant and a so-called financial expert would get into debt in such a circumstance.

Final Thoughts

Steve has tried hard to get the message across that the goal of financial independence is only sustainable if you have an income that funds your lifestyle, rather than a lifestyle underfunded by your income and needing debt to fill the shortfall.

There are temptations of 'easy finance' and 'cars from $40 a week' in most motor magazines, which entice the unwary purchaser into making buying today and paying later. This is an error in judgement that keeps people locked into working long hours.

Cars are not generally appreciating assets, which makes them poor investments. The minimum cost of car ownership is depreciation reflected by the loss in value as your drive out of the showroom.

While it's a personal decision, my advice would be to allocate your funds to income producing assets and then upgrade your car when you can afford the lease payments from the passive or investment income you derive.

Remember, if you only did things that made money then you'd have to make money.

Sincerely,

David Bradley