The Economics of Leasing Vehicles

Has Tax Reform Made Leasing The Better Deal?

by Joseph Arkin, C.P.A., MBA

Today’s economic environment and atmosphere necessitate a close examination of automobile leasing vis-a-vis owning an automobile. More and more people in the business world are addressing the question: Does it make sense, economically, for me to lease an automobile?

Automobile leasing has become a billion dollar industry. This plateau was exceeded by leasing companies as increasing numbers of individuals and businesses learned the advantages of leasing. This boom is rapidly attracting prospective lessees. Never before have the deals been better, the conveniences more tempting, nor the variety of plans more plentiful.

Competition is keen in the leasing field and leasing companies often run “teaser ads,” for their 18-month and 24-month contracts. You must be an astute shopper and compare prices to obtain the maximum services at minimal cost.

The crux of the question is a comparison of ownership factors vs leasing costs. By and large the leasing industry emphasizes service and convenience. Actually, leasing costs are not materially cheaper or costlier than individual ownership, but there is the positive reduction of worries, frustrations and record-keeping.

A primary consideration is depreciation. Starting from the time the automobile is driven off the showroom floor depreciation becomes the single greatest factor consuming the value of asset. At a rate of 25% the first year, 15% the second year and 10% the third, it is easy to see that an automobile could depreciate to half the purchase price in just 3 years. The cost of a 36-month lease may not be much more than the cost of buying a new car and trading it in after 3 years. Therefore, the lease may be a feasible option for those who purchase a car every two or three years and whose disposable income position is not overtaxed by perpetual lease payments—which actually equate to car notes.

At this point a logical question might be: How can a leasing company, with payroll costs, overhead expenses and large advertising budgets lease an automobile at less cost to the lessee than if the lessee had bought his own car?

The industry’s answer, as given to the author by the leasing firm, Cars For Commerce, is that leasing firms buy cars for much lower prices than are available to the general public, they research to find the makes and models that give best performance and value; because of specialized know-how, they get top-dollar when reselling cars; they maintain their own repair shops and pay a fraction of the repair costs charged to the unknowing layman; they reduce insurance costs by carrying a “fleet” basis coverage; and they take advantage of factory guarantees that are available to the public, but unused because of lack of knowledge as to their availability.

Another important aspect to the businessman is the question of reimbursing employees for the operation of their privately owned automobiles.

Mileage payments to employees for car use is probably the most expensive form of business transportation. That’s because mileage payments amount to leasing the car from the employee . . . and leasing from the employee means high cost, because the employee buys, repairs, insures and finances his car at retail.

Because most mileage allowances cannot cover these retail costs (unless excessive rates are paid), the employer and the employee are frequently at odds. Both feel, with some justification, that they are being cheated.

Leasing a car for an employee reduces this friction. It gives him a car during lay up periods for repairs and removes the temptation to increase income by padding expenses. This arrangement does not tie-up an employee’s capital and makes for more harmonious relationships and relieves the employer’s office staff of the onerous bookkeeping chore.

Basically a monetary advantage is gained if (a) your company owned (or employee owned) vehicles are driven at least 12,000 miles per year, and especially if they are driven in excess of 15,000 miles annually, (b) if their annual repairs and maintenance bills are above normal because of the manner in which the vehicles are handled, or because of local climate or driving conditions, (c) if the vehicles driven are used more for business than for pleasure.

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The advocates of leasing cite a list of primary advantages which can be summarized as follows: 1) Leasing instead of purchasing leaves capital free for other purposes. 2) Cash is not tied up in fixed assets and is free for investment. 3) Such investments are a hedge against inflation and puts money to its best use. 4) Automobiles purchased on time cause a mortgage to be filed in the County Clerk’s Office, which, in some instances can impair a credit rating. 5) Persons and firms using automobiles for business purposes can get a tax deduction for the lease payments. 6) Bookkeeping chores are eliminated for the maintenance of depreciation schedules, upkeep costs, adjusted trade-in values, etc. 7) A cash saving is effected by the elimination of the need for paying license or inspection fees. 8) Time is saved in the procurement of license plates.

Probably the most salient feature in addition to those named above is that the lessor will pay (on full-maintenance contracts) all repair costs, even those where you are at fault. When the automobile is laid up for repairs, another automobile is furnished.

How much does leasing cost? In the classified and automotive sections of your local newspapers you can find a variety of prices quoted. You’ll pay more for a prestige car than for an economy model, you’ll pay more for a full-maintenance contract than for a mere rental.

There are basically two types of lease, a closed-end lease and an open-end lease. A closed-end lease is like an apartment lease. You agree to pay a certain amount for a number of months. This is also known as a “net lease,” a “fixed lease,” or a “walk-away lease.” The open-end (finance lease or equity lease) is riskier. At the end of the lease, you may either buy the car or let the company sell it. If the car sells for more than the lessor originally estimated, you get the surplus. If it sells for less, you pay the difference (not more than three times the monthly payment). However, an open-end lease is usually a little less expensive per month.

At the time of this writing, the author found that a fully loaded automatic transmission economy car leased for $257*, a mid-size for $359* and a luxury class for $465* per month. (All contracts are without insurance and are not full maintenance.)

It is of interest that in 1979, 20 percent of all new cars in the U.S. were leased. That figure is projected to rise to 40 percent by 1989. Although most of the leased cars are for business and government use, most of the industry’s growth is expected to come from the public sector.

If the owner can get more than $7587.00 for a two year old economy model, or more than $11329.00 for a luxury model, it would be cheaper to own rather than lease.

Leased automobiles can be obtained with full maintenance (the lessor will pay for all repairs, insurance, oil changes, license plates, winterizing, tire replacements, etc.) or without main-
tenance. In the situation without maintenance you pay all of your own expenses and only lease the car itself. In either case you pay for your own gasoline, tolls and parking fees. Most leases will allow for 15,000-20,000 miles for annual usage, after which you must pay for additional miles driven as a surcharge.

Leasing is also the answer to the accident prone individual who cannot secure coverage because of a poor experience rating. This, coupled with the economic and service features previously mentioned should give you the impetus to take a good look at auto leasing.

If all of the foregoing has “sold” you on leasing, the next question is from whom? The big factor is one that is often hidden from the casual inquirer—the quality of the service offered by the leasing company. Some companies have garages that give an around-the-clock service, others close their service departments on holidays and weekends.

Before entering into any leasing arrangements, first check the company’s reputation with your local Chamber of Commerce, the Better Business Bureau, or a local automobile club. As with many growth industries, the leasing field has been invaded by many marginal operators. Thus, it is also important to know some of the main points covered in the lease agreement.

**Security deposit:** You may be required to leave a refundable deposit equal to one or two monthly lease payments.

**Advance payment:** Most companies also require two months payment in advance. Be wary of companies that require a down payment because they are non-refundable and increase the cost of the lease by the amount of the down payment.

**Fees and taxes:** Your monthly payment will be subject to sales tax, and you will probably have to pay registration fees.

**Insurance:** You can probably get insurance through the company, sometimes at a lower rate than you could get on your own.

**Damage and excessive wear:** At the end of the lease, you will have to pay for any unusual wear, missing equipment, and unrepaid damage. Insist the lessor provide you with a specific description of the kinds of damage you’ll have to pay for.

**Terms of the lease:** Know how long your lease is—most leases to individual customers run 24 to 36 months.

**Option to purchase:** (Open-end lease only). The lessor should specify the predicted wholesale value of the car at the end of the lease. You have the right to purchase the car at that price.

**Early termination:** The lease should state under what conditions the lease is terminated, such as default or if the car is totaled. Most lessors will allow early termination when someone is found to continue the lease.

**Mileage surcharge:** The normal range or base is 16,000-20,000. Make

### COMPARISON OF BUYING vs LEASING COSTS

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<th>Buying</th>
<th>Economy</th>
<th>Luxury</th>
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<tbody>
<tr>
<td>Cost of automobile</td>
<td>$10000.00</td>
<td>$16000.00</td>
<td></td>
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<tr>
<td>Local sales tax (5%)</td>
<td>500.00</td>
<td>800.00</td>
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<tr>
<td>Interest on financing (7.125%)</td>
<td>908.00</td>
<td>1448.00</td>
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<tr>
<td>Maintenance cost (AAA estimates)</td>
<td>1087.00</td>
<td>1669.00</td>
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<tr>
<td>Complete insurance—2 years</td>
<td>1800.00</td>
<td>2200.00</td>
<td></td>
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<tr>
<td>License plates and inspection—2 years**</td>
<td>108.00</td>
<td>108.00</td>
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<tr>
<td>Total for 2 years</td>
<td>14403.00</td>
<td>22225.00</td>
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<tr>
<td>Amortization—2 years</td>
<td>(6816.00)</td>
<td>(6816.00)</td>
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<tr>
<td>Price needed when car is retired</td>
<td>$7587.00</td>
<td>$11329.00</td>
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*Insurance cost around $40 per month
**Applicable for State of Texas, effective August 1, 1984 (sales taxes vary by state)

*Rates are average monthly payments—prices will vary, depending on company

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sure the mileage base is realistic and avoid leases with a surcharge of more than eight cents per mile.

**Maintenance:** Services and repairs are your responsibility unless you have a full-maintenance contract.

**Basic monthly payment:** This is based on the lessor’s estimates of depreciation, interest cost, overhead, and profit. Don’t be fooled by low monthly payments—it’s the total cost you’re concerned with. Recently a newspaper ran an ad listing a new 1984 Cadillac Coupe de Ville for $299 a month; but how much does that car really cost? Well, there’s a $1500 non-refundable down payment, a $500 security deposit, an annual $55 fee for registration and inspection, and a $40 monthly insurance charge. Also, there is a surcharge of 25 cents for every mile beyond the 1000 allotted miles and a possible charge for excessive wear and tear. Considering all factors, including tax and if you drove 1200 miles a month, your monthly payment would be over $479—a difference of over $180 a month or $4320 over a 24-month lease.

It is also advisable to have your attorney carefully read over the lease (which incidentally is a complicated document) so that you don’t unwittingly get into a bind or sign something other than that which was orally represented to you.

Contrary to what automobile leasing companies advertise, not all leasing fees are tax deductible. To correct an erroneous impression given in some newspaper advertisements, the Internal Revenue Service issued a Technical Information Release which stated in part:

“Federal income tax rules on this point are quite clear. Auto or truck lease payments are deductible only if they represent ordinary and necessary expense of, and are directly attributable to, the operation of a trade or business. Under no circumstances are such lease payments deductible to the extent they represent personal use by a taxpayer, such as for vacation trips or driving to and from his place of business or employment. And, no deduction will be allowed for so-called lease expenses which, in fact, constitute payments toward the purchase price of autos or trucks.”

While all of the foregoing has related to automobiles, the logic and economic results will apply equally as well to the rental of light and heavy duty trucks.

In the final analysis, the deciding factors are governed by the variables of your particular economic situation. Hopefully, this information will facilitate your prudent judgement.

About the author: Joseph Arkin holds a Bachelor of Business Administration Degree in Accounting and a Master of Business Administration Degree in Taxation. He is licensed by the States of New York and Florida as a Certified Public Accountant and has written extensively for trade and professional publications.