

Auto Financing: Lease vs. Borrow-to-Buy

*When it comes to buying a vehicle, the dilemma is not only selecting the right vehicle, but also making the appropriate financing decision. If you consider the long-term carrying costs, the least expensive way to obtain a vehicle is to pay cash. If you cannot afford to pay for the vehicle in cash there are two methods of financing: **leasing**, or **borrowing** to finance the purchase of a vehicle. This article will discuss what you need to consider in each case to assist you in making your financing decision.*

What happens when you lease?

When you lease a vehicle, you do not own the vehicle and you pay for only the portion of the cost which is utilized during the time you are driving the vehicle. The initial cash outlay is usually lower although there can be extra administrative fees and a security deposit when you lease a vehicle.

The total costs of leasing a vehicle and hence your monthly payments are dependent on the following three elements:

1. The **capitalized cost** of a vehicle which may include excessive administrative costs and hidden fees such as pre delivery inspection (PDI), freight, and A/C that may increase your lease payments unexpectedly.
2. The **money factor** which is the real interest rate to calculate the carrying costs or finance charges.
3. The **residual value** of the vehicle which is the estimated value of the vehicle at the end of the lease term. The higher the residual value the lower the lease payment.

You will have to negotiate these terms with the car dealer who acts on behalf of the lease company. The monthly lease payment will include three components:

1. A depreciation charge which compensates the leasing company for the portion of the vehicle's value that is lost during your lease;
2. A finance charge that reflects the interest on the money the leasing company has tied up in the vehicle while you are driving it; and
3. Sales taxes that are based on the monthly payments.

Once you have signed the lease agreement with the lease company (the lessor), you (the lessee) are bound by the terms and conditions of the agreement. If you breach any of the conditions of the lease contract such as above-average wear and tear or "excess mileage" you may incur additional costs.

At the end of the lease, you are usually given the option to either purchase the vehicle or return it.



What happens when you buy?

When you buy a vehicle, you own the vehicle from the first day and you pay for the entire cost of the vehicle. The initial cash outlay and the monthly payments when you borrow to buy a vehicle are usually higher compared to leasing. Generally, you need to make a down payment and pay sales taxes on the full price upfront.

However, unlike leasing, you can either arrange financing through the car dealer's finance company or any financial institution of your choice for a more favourable rate to reduce your finance charges.

Example

Joe plans to buy a vehicle with a purchase price of \$25,000. He is not sure if he should lease or borrow to buy. He has worked out the following calculations to help him make the financing decision:

	Lease	Borrow
Capitalized Cost/Car Price	\$25,000	\$25,000
Down Payment	\$1,000	\$1,000
Money Factor/Interest Rate	7%	7%
Residual Value	\$11,000	-
Months	36	36
Payment	\$462.87	\$741.05

In this case, leasing is not necessarily a better option for Joe because monthly payments are not the only factor that should influence his decision. Joe should also consider any personal preferences that may affect his financing decision such as the length of time that he intends to keep his vehicle and the flexibility of trading-in the vehicle at any time.

If monthly payments are a critical factor to Joe in a borrow-to-buy situation, he could reduce his monthly payments by extending the term of his loan or simply by buying a used vehicle with a lower cost. For instance, going back to the above calculations, Joe can reduce the monthly payments to \$475.23 with a 60-month loan term. If he keeps his car for at least 5 years, he will be debt-free and still be able to enjoy the vehicle. Borrow-to-buy may potentially be a better option for him.

It may be advisable to opt for ...

Leasing, if you ...	Buying, if you ...
1. Like to drive a new vehicle every few years and do not want to worry about any major repairs or maintenance expenses	1. Travel extensively (i.e. more than the standard 24,000 kilometres per year) and do not wish to incur any excess kilometre charges
2. Prefer lower monthly payments although they become part of your on-going expenses if you continue to lease a vehicle	2. Do not want any hidden fees or potential charges (such as excess wear and tear) at the end of the lease
3. Prefer lower monthly payments and invest the difference in a diversified portfolio	3. Prefer to pay off your vehicle and enjoy it for a long period of time
4. Want to have flexibility with respect to returning or buying the vehicle at the end of the lease	4. Prefer to own the vehicle and be able to trade it in at anytime

Additional Tax Benefits on Auto Financing

If you are a business owner or are self-employed and you borrow to buy a vehicle, you may be able to deduct the interest you paid on the money borrowed as a business expense. However, you need to consider any tax restrictions relative to your employment, business-use or a percentage attributed for personal use.

On the other hand, if you are a business owner or self-employed and you lease a vehicle, Canada Revenue Agency (CRA) allows you deduct a certain amount as leasing costs. Interpretation Bulletin IT-521R "*Motor Vehicle Expenses Claimed by Self-Employed Individuals*" provides formulae to determine the eligible leasing costs that are deductible against income from self-employment.

You can also deduct expenses for your vehicle if you are an employee earning commission income as long as you meet certain conditions as described in the Interpretation Bulletin IT-522R "*Vehicle, Travel, Sales Expenses of Employees*".

It is important that you speak to your tax advisor to review your situation.

Conclusion

Making the lease or borrow-to-buy decision is not simple. You may want to compare the various vehicle ownership options with the help of some on-line calculators such as the *Car Lease or Buy Calculator* on Industry Canada's website. Besides monetary discrepancies, personal preferences and motivation will also influence the decision process. In summary, whether you lease or borrow-to-buy will depend on what is most important to you, how you are going to use the vehicle and what the vehicle means to you.

Last revised: February 11, 2010

The information contained herein has been provided by TD Waterhouse Canada Inc. and is for information purposes only. The information has been drawn from sources believed to be reliable. Where such statements are based in whole or in part on information provided by third parties, they are not guaranteed to be accurate or complete. Graphs and charts are used for illustrative purposes only and do not reflect future values or future performance of any investment. The information does not provide financial, legal, tax or investment advice. Particular investment, trading or tax strategies should be evaluated relative to each individual's objectives and risk tolerance.

TD Waterhouse Canada Inc., The Toronto-Dominion Bank and its affiliates and related entities are not liable for any errors or omissions in the information or for any loss or damage suffered.

TD Waterhouse represents the products and services offered by TD Waterhouse Canada Inc. (Member – Canadian Investor Protection Fund), TD Waterhouse Private Investment Counsel Inc., TD Waterhouse Private Banking (offered by The Toronto-Dominion Bank) and TD Waterhouse Private Trust (offered by The Canada Trust Company).

®/ The TD logo and other trade-marks are the property of The Toronto-Dominion Bank or a wholly-owned subsidiary, in Canada and/or in other countries.