

Vehicles and Equipment: The Pros and Cons of Buying or Leasing



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When you're looking to add or replace vehicles and equipment, the decision to lease or buy is more than a financial one. It can affect your operations, taxes and future company decisions.

If you want to build your asset base, plan long-term ownership, and are not in an overly leveraged debt position, purchasing may be for you.

Purchasing is pretty straightforward. You provide a down payment, get a loan and make payments. The asset is capitalized – listed on your balance sheet – as is your debt.

The interest portion of your payments and depreciation are allowable deductions from revenue. You are responsible for maintenance and disposal of the asset when the useful life ends.

In contrast, leasing can be complex with many options regarding structure, terms and add-on services. Leasing is poised to become even more complicated because the Financial Accounting Standards Board (FASB) is reviewing a key provision of operating leases: off-balance sheet accounting.

At this time, leases can be divided into capital and operating leases. Capital leases are treated like purchases in financial reporting. You list the asset and the liability, take depreciation and, in effect, are the owner.

The following FASB rules determine whether a lease is capital:

- The lease automatically transfers ownership of the property by the end of the lease.
- It contains a bargain purchase option.
- Lease term equals 75 percent or more of the estimated economic life of the property.
- Present value of the minimum lease payments at the beginning of the lease term equals or exceeds 90 percent of the fair market value of the property.

An example would be a lease that transfers ownership to you for \$1 at the end of the lease. Since capital leases don't require down payments like purchases and are often offered by the equipment or vehicle manufacturer, these can be an easy way to add new assets.

However, when you look at your lease payments, you may find that your effective interest rate is much higher than if you purchased. That is something to weigh out if you are in a position to borrow.

Operating leases – essentially a long-term rental contract – offer business owners flexibility in fleet management. The full lease payments are deducted from revenue, which may be beneficial tax-wise.

Debt ratios are not affected, freeing up the business's ability to borrow for other needs. Some leases include a set fee for maintenance, which creates predictability in budgeting and cash flow.

A relationship with a leasing company can make vehicles available for short-term needs, too. Fill-in vehicles or equipment needed because of seasonality, special contracts, events or downtime due to repairs, can be added and returned as needed.

A fair market value lease offers an option to purchase at the end of the lease for a to-be-determined fair market value. The lessee can also turn in the asset or renew the contract. Because of the firm option purchase price, fair market value leases are often less expensive than other types.

Terminal rental adjustment clause (TRAC) leases allow lessees to purchase for an agreed-upon amount at the end of the lease. If the purchase is declined, then value is assessed or the asset sold, and the lessee either makes up the difference or receives a refund.

TRAC leases are limited to motor vehicles and trailers. The lessee can also trade in the vehicle or extend the lease. Split-TRAC leases limit lessee liability for shortfall to a set percentage of the actual residual value.

For tax purposes, if absent the TRAC provision the lease qualifies, it may be treated as an operating lease.

Many commercial leases are open-ended, which means your final financial responsibility is not determined until residual value is established at lease end. Open-ended leases can be beneficial if you want to be unrestricted by mileage, signage or body condition limitations.