

Auto and Equipment Leasing

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What's a Good Auto Lease?

- You can use the car at least 12,000 miles a year *without* incurring added charges. In a soft market, many lessors will allow 15,000 miles.
- Any excess use above the 12,000 miles is charged at no more than 10 to 12 cents per mile. Some lessors charge 15 to 18 cents.
- You can buy the auto at a *fixed* price at the end of the lease. Try to avoid a to-be-determined price based on the auto's *projected* retail price. When the retail price is used, rather than the wholesale price, you may have zero equity at the end of the lease since you must buy the auto at the then retail (fair market) value.
- The manufacturer's warranty is for the full term of the lease. If not, ask to shorten the lease period to correspond to the warranty period. That should incentivize the lessor/dealer to provide a warranty for the full term of the lease.
- Be sure special lease provisions, such as GAP insurance, cancellation, maintenance, subrogation and indemnification, are clearly spelled out.

Good leases have a low interest rate and a built-in option to buy at the wholesale price at the lease's conclusion.

Auto and Equipment Leasing: **What to Know Before You Sign the Lease**

Today, practically everything can be leased — from automobiles to office furniture to giant construction cranes. *The best thing about leasing:* You get to "try out" the product before buying and without draining your cash flow. But leasing can be complex and there are many terms to know and clauses to negotiate. Do your homework and you can arrange a lease to be less costly or to provide you with more protection — or both.

This **Resource Report** will guide you through the many areas you will focus on in negotiating a lease for an automobile or any other equipment: type of lease, options to buy, cancellation penalties, warranties, maintenance and insurance, and special lease clauses. It will provide guidance on which lease terms to seek out and advice on avoiding common problems.

Part Two of this Report is an interview with a leasing expert who processes thousands of leases annually.

Although the information in this report applies to most equipment financings, we use the leasing of cars as our example because it is the most popular form of leasing. You have two basic questions to consider before you sign any lease. The first is whether you should even be leasing in the first place. Maybe you should purchase the car or equipment with available capital or through a conventional bank financing.

Overall, the purchase of a car or equipment can be less expensive than leasing. There is an intrinsic cost with leasing that can exceed the interest expense and opportunity cost of purchasing/financing the car or equipment. The *opportunity cost* is the use of your cash to buy the car, i.e., that cash will be tied up and is no longer available to generate a return for you from other investments. However, as we will explain later, factory-sponsored leases with very low interest and annual percentage rates (APRs) can make leasing more attractive than purchasing.

Your second question is the type of lease you want. Although there are a number of slight variations, basically there are two types of lease arrangements: the closed-end lease and the open-end lease.

Closed-end lease. In a closed-end lease, you lease the car or equipment for a fixed time and at a fixed monthly payment. When the lease period is over, you

usually have the option to buy the car. If you elect not to purchase the car, you return it to the lessor and the contract is terminated. This lease, commonly used for automobile leasing, is also referred to as *net lease*, *straight lease*, or *flat-rate lease*. Basically, they all mean the same thing.

Closed-end leases tend to be relatively simple contracts, but don't be caught off-guard by their simplicity. As you will see later, there might be "options" you will want to add and there are terms you want to avoid.

Open-end lease. In an open-end lease, you will end up owning the equipment at the termination of the lease period. The price you pay for the equipment at lease termination will principally depend on the amount and number of your monthly payments and the value of the equipment at the end of the lease. Higher monthly lease payments usually cover the full purchase price of the equipment. If they do, the amount you pay to purchase the equipment at the lease termination is usually a nominal amount, such as \$1.00. If the monthly payments fall short of the full value, your purchase price will be higher. An open-end lease is more like a conditional sales contract, which is why it is also known as a *finance lease*.

Ten Areas to Cover

No matter which lease you end up with, obtain a *written summary* of the provisions of the lease: the monthly payment, effective interest rate, charges, term, warranty, purchase option, etc. If the lease is covered by federal or state law, as most automobile leases are, the lessor will automatically give you that information. But with equipment leases, you usually need to ask for the written summary; the lessor probably won't volunteer the information.

Here are the basic provisions you should include in any lease agreement.

1. Cost of leasing: Payment due dates, amount of each payment, total to be paid over term of the lease, and late charges.

2. Security deposit: Most lessors ask for a security deposit; if so, be sure the sum is in the contract, and that it's clear the money will be returned at the end of the lease or used for your last payment. Try to limit the security deposit to one month's rental; sometimes two months' rental is required. If interest is going to be paid on the deposit, include it in the contract.

3. *Upfront costs:* Most leases require that the lessee pay some initial charges and fees, such as installation, taxes, transfer and license fees. Ask that those charges be itemized in the contract.

4. *Delivery:* The delivery and installation timetable should be spelled out, as well as your options if the lessor is late or if the equipment fails to function properly. Can you cancel the lease or withhold lease payments?

5. *Penalties:* What extra charges are there if you have to cancel the lease prematurely? What about late payments? It's wise to have all possible penalties spelled out beforehand and included in the contract. Keep in mind that if you cancel a lease prematurely, you are usually liable for the remaining lease payments. You can't just walk away from the lease.

6. *Use costs:* Some equipment, usually automobiles, is leased on maximum/minimum use terms. In other words, you may use a car a fixed number of miles per year — but any excess is charged accordingly. Get those details pinned down. *Alert:* In good auto leases, the mileage allowance is usually 12,000 to 15,000 a year with a 10-cents-per-mile excess usage charge.

7. *Equipment users:* Spell out who has the right to use the equipment or car. To allow for other users, you may have to modify the *Use Clause* in the lease contract. Read the small print carefully; this is an important clause.

8. *Maintenance:* If you're responsible for repairs, what's the guarantee on the equipment? Does the manufacturer provide one? Who does the periodic maintenance? If the lessor is responsible for the repairs, do you get a rebate on your monthly payments while the broken equipment or auto is out of commission? Do you get a temporary replacement? *Alert:* On most leases, there is a manufacturer's guarantee and the lessee takes care of routine maintenance.

9. *Insurance:* Often the lessor will stipulate the insurance coverage and the minimum amount, e.g., \$300,000 for bodily injury and \$50,000 for property damage. However, find out if you can use or buy your own coverage; it's almost always less expensive. If not, spell out the insurance coverage and cost for the full term of the lease. Also ask about "GAP" insurance to cover the difference between the balance

due on the lease and the fair market value of the auto if it is stolen or totally damaged.

Alert: In equipment lease financings, insurance is usually available from the lessor. In contrast, auto lessors generally do not offer insurance coverage; you have to add it to your existing auto insurance policy.

10. Assignability: Most lease contracts automatically *prohibit* assignability of the lease to another party. Try to *modify* this clause to include assignability to you, your spouse, and/or your business.

Advantages of Leasing

□ *Minimum cash outlay:* Most financings against assets require a 20% to 30% downpayment. With leasing, there is usually no downpayment except the security deposit and/or the last month's lease payment.

□ *Easier to arrange:* Compared to a business loan, the terms and covenants of leasing agreements are simpler, easier to arrange, and take less time to close since there is no initial equity in the underlying leased asset.

□ *Monthly payments:* Your fixed monthly lease payment is usually lower than monthly payments on a straight car loan. And, as a general rule, open-end leases are *more* expensive than closed-end leases. That's because in a closed-end lease you have a *residual value* at the end of the lease with the right — but no obligation — to purchase the auto/equipment. In an open-end lease, the full price of the equipment is usually covered by the higher monthly lease payments and you are usually obliged to assume ownership of the equipment at the lease's conclusion, but usually for a modest fee.

□ *More flexibility:* Since an auto lease is usually for two or three years, you can upgrade the auto at the lease's conclusion and many customers automatically do just that. On a good lease, you usually can lease a more expensive car than you could purchase since the monthly payments on a leased car are generally much less than the monthly payments on a conventional bank loan you take out to buy a car.

□ *Option to buy:* At the end of a closed-end lease, you simply return the car/equipment to the lessor or purchase it at a pre-determined price. Thus, your

liability is known and limited.

□ *Equipment obsolescence:* Not a big concern in closed-end leases since you are under no obligation to buy. In an open-end lease, you own the equipment at conclusion of the lease so obsolescence may be a concern.

□ *Maintenance costs:* If the warranty is for the full term of the lease, your maintenance cost may be lower. *Alert:* We used the words "may be"; be sure to negotiate the warranty and maintenance clauses. On good leases, the warranty period is *not less than* the term of the lease.

□ *Excess wear and tear:* Unless you exercise your purchase option, you must return the property in good shape and it must have been properly maintained. If not, the lessor can charge for abnormal wear and tear.

Some Disadvantages

□ *Ownership:* In many leases, you own nothing at the end of the lease. Without the right to purchase the asset built into the lease, you have no future equity in the auto/equipment. However, as discussed, good closed-end auto leases avoid this disadvantage since they contain a fixed option to buy. *Alert:* As a general rule, if you are going to keep a car or equipment for more than five years, owning should be more cost-effective than leasing.

□ *Higher total cost:* While the monthly payments can be lower on leasing, the overall cost of leasing can be higher than purchasing the auto/equipment outright with a downpayment and term loan. This is especially true if you *don't* eventually purchase the leased auto. *Strategy:* When leasing, look for factory-sponsored leases which contain low APRs compared to financed contracts; this can tilt the scale in favor of leasing.

□ *Penalty for early termination:* This is an additional charge for terminating the lease early. The earlier the termination, the higher the penalty. *Strategy:* Before terminating the lease, analyze the cost of purchasing the car versus the penalty. You may find it cheaper to buy the car and then resell it. Of course, this assumes the car's retail value is more than the combined total of the purchase price stated in the lease and the termination penalty.

□ *Extra usage cost:* Here you are charged for the difference between your contract (say, annual use of 15,000 miles) and your actual usage. *Example:* If your lease is for three years and you have accumulated 75,000 miles at the end of your lease, your *excess* usage is 30,000 miles (75,000 miles less 45,000 allowance). At a charge of 15 cents per mile, you owe the lessor \$4,500.

Strategy: If your annual usage is going to be high, like in the example above, and you're not going to exercise your option to purchase the auto at the conclusion of the lease, it is usually better to purchase the car at the outset. *Another approach:* Try to negotiate a higher excess mileage charge; some lessors go as high as 18,000 miles a year.

Terminology from an *Actual* Auto Lease

To help you better understand leasing contractual language, here is some terminology from an actual lease contract.

"When I return the Vehicle, it will have all parts and accessories in good running order. I will pay the costs of all repairs to the Vehicle that are not the result of normal wear and tear."

"I agree to indemnify you (the Lessor) and pay for any amount of loss, liability, or other expense arising from the operation, condition, use or ownership of the Vehicle, including claims made under the Strict Liability Document or other document."

"I have no right to assign any of my rights under this lease."

"If more than one Lessee signs (guarantees) the Lease, each Lessee will be *jointly* and *severally* liable for all obligations under this lease." *Note:* The word "severally" means the lessor can sue *either* guarantor for the full amount due.

"I will pay all expenses for Vehicle use and operation, including maintenance, repair, gasoline, oil, tires, and other expenses. At my expense, I will have the Vehicle serviced in accordance with the manufacturer's minimum recommendations, have the service validated, and be able to provide proof that such service has been performed."

BIG Money Considerations

■ **Purchase vs. leasing.** Owning the car usually results in more years of use

and equity build-up through the eventual sale or trade-in value of the car. On the other hand, the tax writeoffs for leasing generally exceed the writeoffs for purchasing/owning. The two major considerations are: (a) the residual value in the lease agreement, which provides you with potential equity in the car that can be comparable to that of owning the car, and (b) the interest rate, i.e., many manufacturers offer leases with interest rates well below the prime rate. That's not the case for autos purchased through conventional financing sources, such as banks and finance companies, where the interest rate can be the prime rate plus two to four points.

■ **Residual value.** If you have the right to purchase the car at a certain price (called the residual value), it is a big plus in the lease contract and, in effect, lowers your overall cost. *Example:* If the residual value is \$12,000 at the end of the lease and the fair market value of the car at that time is \$16,500, your equity (profit) is \$4,500. This profit reduces your *effective* financing costs on leasing the vehicle and it makes leasing comparable to or even more attractive than purchasing the car with a downpayment and bank loan. Without this purchase option, the cost of leasing can be much higher than the financing costs associated with the outright purchase of the auto. Thus, negotiating the residual value is a top priority.

■ **Business versus personal lease.** Whether you purchase or lease a car, consider owning it through the business rather than personally. When you work through the numbers with your accountant, you should find leasing through your business more tax advantageous and simpler than leasing the car personally. Also, when you *personally* lease or own the car, you have to itemize the deductions on your personal tax return to reflect your percentage of business use of the car. Furthermore, if the car will be used *solely* for personal purposes, you will *not* be able to deduct any of the lease payments or interest if the auto is financed through a bank or other lender.

What to do: Your accountant should prepare for you the projected tax writeoffs of leasing versus purchasing for the full leasing period, usually three years. At the end of the three years, he or she should project the market or replacement value of the car (or equipment) under both the lease and purchase scenarios. You then will be able to compare who should own the auto: you personally or the business.

■ **GAP insurance.** This insurance covers the difference between the balance

due on the lease and the fair market value of the car if it is stolen or totally destroyed. For example, if the balance due on the lease is \$20,000 and the auto stolen or totaled is valued at \$12,000, GAP insurance will pay the difference of \$8,000 less your deductible. Always consider buying GAP insurance or ask the lessor to provide it free; the cost is around \$300 to \$400 for the full term of the lease. The premium is paid at closing or added to your monthly payment.

■ **Subrogation claims.** You, as the lessee, are responsible for the cost of losses caused by your negligence. Subrogation means that the lessor's insurer can sue you for any damages you caused even though the lessor has insurance protection.

What to do: Include a *joint waiver of subrogation clause* in your lease. This protects both you and the lessor against subrogation. If the lessor does not agree to such a joint waiver, call your insurance broker; you should buy insurance to protect against this contingency.

■ **Indemnification.** Most leases require lessees to indemnify the lessor for third-party bodily injury and property damage lawsuits.

What to do: Be sure the indemnification clause you sign is within the scope of your *general liability policy*. If it isn't, you may need additional coverage; again, call your insurance broker to protect you against this contingency.

Tax Considerations

First, recognize that whoever owns the car (you or your business) and whether you lease or purchase the car, you will have to account for personal and business use and keep good records of that use.

Second, as a general rule and depending on the personal versus business use, you should find the following:

- Leasing is easier to effect and generally more tax-advantageous than purchasing the auto.
- It is also usually more tax-advantageous to lease the car through your business rather than personally.

Remember, when you *personally* lease or own the car, you have to itemize all deductions on your personal tax return to reflect your percentage of business use. Furthermore, if the car will be used *solely* for personal purposes, you will not be able to deduct the interest, so try to use the auto for business purposes and as much as possible. Substantial business use is the only way to qualify for the greater tax deductions.

Taxation: Here are the major tax items to review with your accountant in making the lease-purchase decision: deduction of the lease payments, sales tax, interest, and depreciation. You also want to review the methods of accounting for the car use, i.e., the standard mileage method of 55 cents per mile for 2009 or the actual cost method, and your projected percentage allocation of business versus personal use to determine your potential tax deductions. *More advisories:*

- When an auto is used for *both* business and personal purposes, you will find your recordkeeping easier and your tax deductions easier to compute if you lease the car.
- Personal ownership of the auto (not leasing it) usually provides no interest deductions, even if your business use is 100%. This fact alone can make business ownership preferable to personal ownership.
- If you frequently trade in cars, you should find leasing more advantageous from a tax point of view.

After these tax considerations, you want to build in the car's residual value at the end of the lease period, which will hopefully be less than its fair market value at that time. The value of that equity (profit) should be included in your analysis. Remember, on good leases, the residual value is set at the projected wholesale value, not the retail value. The difference between the two values can be as much as 20%, and that difference is equity for you and lowers the overall cost of leasing.

* * *

Don't take lease agreements lightly. Although the annual lease payments may be only a few thousand dollars on an auto lease, the cost over the entire lease term can be substantial — and you will have to come up with more money at the end of the lease if you want to purchase the auto or equipment. As a precaution, invest the

time and money in having your insurance broker, accountant, and lawyer review the lease *before you sign it*.

Part Two — *Auto Leasing*: An interview with a Leasing Expert; please see the next page.

Part Two — *Auto Leasing:* Interview With a Leasing Expert

In this Part Two on auto and equipment leasing, we present an interview with a leasing expert and a summary checklist of the questions you should ask before entering into a leasing transaction. But first, let's review again the two principal types of leases.

- Almost all auto leases are *closed-end leases* with the leasing contract entered into with the manufacturer of the car (e.g., GM or BMW). The lessee usually has the right — but not an obligation — to purchase the auto at the end of the lease period at a predetermined price. *Note:* When the lease agreement is with the manufacturer of the car, it's called a factory-sponsored lease.
- In contrast, equipment leases are usually *open-ended* with the buy-back price of the equipment set in the initial lease at a nominal price, many times only \$1.00. These leases are really conditional sales contracts and do not qualify for favorable tax deductions as do closed-end leases.

Now to our interview with Robert J. Brower, a leasing expert for more than 25 years. Mr. Brower is General Manager and a Principal of Finance Distribution Corp. in Islip Terrace, New York. He processes about 1,000 auto and equipment leases a year, at a total value of \$20 million.

How to Negotiate the Best Lease

Question. *Let's start with the first question our readers ask: What is your advice on negotiating the best auto lease?*

Brower: Just as new car dealers make their money on the "extras" they sell on a car, so do lessors. Try to lock in as many allowances and provisions as possible. A good auto lease contains the following:

1. You can use the car at least 12,000 miles a year *without* incurring added charges. In a soft market, some lessors will allow 15,000 miles.
2. Any excess use above the 12,000 miles is charged at no more than 10 to 15

cents per mile. (Some lessors charge up to 18 cents.)

3. You can buy the auto at a *fixed* price at the end of the lease. That price is *today's* anticipated *wholesale* value. Stay away from a to-be-determined price based on the auto's *projected* fair market value or retail price. When the *projected* retail price is used, you really have zero equity at the end of the lease since you must buy the auto at the then fair market value.
4. The manufacturer's warranty should be for the full term of the lease. If not, ask to shorten the lease period to correspond to the warranty period. That should incentivize the lessor/dealer to increase the warranty for the full term of the lease.

Q. *What about GAP insurance for the balance due on the lease if the auto is stolen or destroyed? Who pays for it?*

Brower: In most leases today, many lessors will provide *free* GAP insurance coverage, which costs only about \$300 to \$400 for the full term of the lease. If you have to pay for it personally, note that this cost may be marked up 100%, to \$600 to \$800. This area is negotiable.

Q. *Any ideas on how to reduce the cost of leasing?*

Brower: The biggest area for potential savings is the intrinsic financing cost. This can be greatly reduced by buying a car through a factory-sponsored lease whereby the manufacturer holds the paper (lease). Many of these leases have effective financing costs (interest rates) *below* the prime rate. In the trade, these low-cost leases are referred to as factory-sponsored leases. As an example, just recently, there were several ads in the New York papers offering annual percentage rates (APRs) of 1.9% on leases. As with many big-dollar purchases, look for the special deals and comparison shop.

Q. *What is the typical cost when a lessee exceeds the annual milage allowance?*

Brower: In a typical auto lease, you pay about 15 cents per mile for all miles

exceeding 12,000 to 15,000 miles a year. If your annual use will be *much greater* than the annual allowance, it's usually better to purchase the auto outright or negotiate a higher minimum allowance upfront because these excess mileage charges can add up fast.

Q. *Any thoughts on upfront charges?*

Brower: Most lessors charge a one-month's security deposit or the last month's lease payment at lease signing. Other costs, such as license, registration, and title fees, are paid upfront by the lessee as in an outright purchase of the auto.

Q. *In your experience, what are the biggest mistakes lessees make?*

Brower: By far the biggest mistake is not locking in the four items discussed earlier on pages 13 and 14: maximum annual miles, excess mileage charges, purchase price at end of lease, and manufacturer's warranty.

Another big mistake is not understanding the residual value and its effect on your overall leasing cost. Without a reasonable purchase option at the end of the lease, the cost of leasing can be prohibitive. You protect yourself by fixing the option price in the lease contract at a reasonable level and making sure it truly reflects the anticipated wholesale value of the particular model at the end of the lease.

Q. *How do you make sure your option price to purchase the car is fair and reasonable?*

Brower: Do some comparison pricing and check the dealer's *blue book* for current prices. Although it is difficult to project an auto's wholesale and retail value to the specific dollar, you will be in the ballpark after doing some homework. Remember, you want your purchase option to be at the anticipated wholesale value, not the retail value. As a general rule, look for a 20% difference between the retail and wholesale value (your potential equity); the range between the two prices, depending on market conditions, can vary from 5% to 40%.

Some other thoughts: Recognize that the lower the APR and the higher the residual value, the lower your monthly payment will be. However, a residual value

(purchase option) that is overly high or optimistic will cancel out much of your future equity in the car. Thus, you must balance what you want or need most: less or more monthly cash outflow throughout the term of the lease versus a high or low residual value at the lease's conclusion.

Q. Based on the current market, which cars have the best resale value?

Brower: Traditionally, the models with very high resale values are Mercedes SL, Honda, Lexus, Corvette, BMW, and most four-wheel-drive sport vehicles.

Q. What about personal guarantees when the company is the lessee? Is it customary that the owner of the business personally guarantee the lease payments?

Brower: Yes, in many cases, we get the personal guarantee. However, if the business' credit is very good, we won't require a personal guarantee, particularly for long-time customers.

Q. I've been told by other business owners that it makes more financial sense to purchase the car if you are going to keep it for five years or longer. Is that true?

Brower: Not necessarily. If you negotiate a good lease, and here again we're talking about the four basic components on pages 13 and 14, you will find leasing very competitive. It becomes even more attractive if you obtain a factory-sponsored lease where the interest rate is as low as 2% to 4%. In contrast, the interest rate on conventional bank financings on auto purchases can be as high as 12%. That 8-point potential interest rate difference on an \$18,000 auto loan represents a \$1,400 interest savings from leasing in just the first year. In year two, the savings would be another \$1,000.

Also remember that a lease with a good residual value is really "ownership" with a balloon payment, i.e., you purchase the car at the end of the lease period for the residual value. That's why understanding and carefully negotiating both the interest rate and the residual value are the keys to obtaining the best lease. That's where your attention should be focused.

But you have some flexibility. For example, if your cash flow is tight, you can opt for lower monthly payments with a higher residual value. Basically, what you save in lower monthly payments is added to the residual value. You're the only one who can decide which is more important to you — lower monthly payments over the next few years or a low residual value down the road.

Q. Would you please explain what is meant by the term "capitalized cost"?

Brower: The capitalized cost is the purchase price of the car plus any extras, such as a sun roof. Sometimes lessees ask that the sales tax and other initial, one-time expenses (e.g., fees and plates) be included in the capitalized cost. You can do this, but your interest expense and monthly charges will increase accordingly. Most buyers prefer to pay these costs upfront unless they have real cash flow problems.

Q. Can leases be assigned to another party?

Brower: As a general rule, no. Most leases contain the following provision:

"I have no right to assign any of my rights under this lease."

However, many lessors will give you the right to assign the lease to family members or to your business provided you are still the guarantor on the lease. Beyond that, you usually don't have any assignability rights.

Q. Any other advice for our readers before we move to our example on auto leasing?

Brower: Yes, check out the reputation of the dealer who is selling you the car and obtain comparable prices and lease payments from two or three sources. A savings of just \$50 a month adds up to \$1,800 over a 36-month lease. Second, be sure you understand all the money factors: purchase price, monthly lease payment, capitalized costs, the APR, residual value, and termination charges if you have to cancel the lease.

Third, know what you're responsible for. Here are two important provisions in all auto leasing contracts:

"I will pay all expenses for Vehicle use and operation, including maintenance, repair, gasoline, oil, tires, and other expenses. At my expense, I will have the Vehicle serviced in accordance with the manufacturer's minimum recommendations, have the service validated, and be able to provide proof that such service has been performed."

"When I return the Vehicle, it will have all parts and accessories in good running order. I will pay the costs of all repairs to the Vehicle that are not the result of normal wear and tear."

Auto Leasing Example

Q. My company has always purchased and owned cars outright but I'd like to know how to evaluate the lease versus purchase decision in the future. Can you show the mathematics of a typical lease transaction?

Brower: Yes. We'll assume the purchase of a \$20,000 auto with a 10% interest rate over 36 months and compare it to leasing the auto. To simplify the math, we will exclude the sales tax, downpayment, and security deposit, which is applied to the last payment of the lease. The monthly lease payment will be \$500 for 36 months. *Other particulars:*

Table #1 — Purchase vs. Leasing

Purchase via Bank Loan

Purchase Price of Auto	\$20,000
10% Finance Charges	<u>4,000</u>
Total	<u>\$24,000</u>

Leasing the Auto

Total Lease Payments (36 x \$500)	\$18,000
Residual Value at End of Lease	<u>6,000</u> *
Total	<u>\$24,000</u>

* The price to purchase the car (30% times \$20,000).

By separating your \$18,000 total lease payments into interest and depreciation, you obtain the following from the lessor:

Table #2 — Monthly Payments

	<u>Total</u>	<u>Monthly</u>
10% Finance Charges	\$ 4,000	\$111.11
Depreciation	<u>14,000</u>	<u>388.89</u>
Total Lease Payments	<u>\$18,000</u>	<u>\$500.00</u>

Now to the residual value. Based on the \$500 monthly lease payment, your \$6,000 residual value (which is 30% of the \$20,000 purchase price) is about right since it results in depreciation of 70% (\$14,000 depreciation divided by \$20,000 total purchase price of the car). This lease produces good equity since your residual value is *not* overstated or inflated. The \$6,000 residual value plus \$14,000 depreciation equals the \$20,000 cost of the car. Now, if the residual value is \$7,500 (\$1,500 more) and the \$500 monthly payment stays the same, you're in effect paying \$1,500 more for the car. That's why the residual value (purchase option) is critical to negotiating the best deal.

What if you want lower monthly payments? The monthly payment of \$500 could be (and should be) lower with a *higher* residual value (purchase price). For

example, with a residual value of \$2,000 more (\$8,000 rather than \$6,000), your monthly lease payment drops to \$450 (from \$500) for a total savings of \$1,800 (36 months times \$50). Thus, the added residual value of \$2,000 is made up by the \$1,800 savings in monthly payments and \$200 in additional finance charges. The added finance charges of \$200 reflect your lower monthly lease payments (\$450 vs. \$500), which results in more principal amount outstanding during the term of the lease and thus more interest.

What about a downpayment? In traditional auto installment loans, the borrower usually puts down 20% of the auto's cost as a downpayment. In contrast, leasing an auto from a dealer or manufacturer generally requires only a security deposit of one to two months.

What about factory-sponsored leases? From the tables on page 19, you can see the importance of factory-sponsored leases with low APRs, sometimes several points below the prime rate. These low-cost manufacturer financings can substantially lower the finance charges for the full term of the lease. Manufacturers offer these attractive rates to sell their cars and win customers in a very competitive industry. You won't get a better interest rate on any other capital goods purchase and you're wise to take advantage of them. Reduce the 10% finance charges to 5% (table on page 19) and you save about \$2,000 interest over the full term of the lease, 50% of \$4,000. Now, work through the new numbers and compare those leasing terms with the outright purchase/bank financing.

What Should Our Readers Do?

Their homework. Use the tables on pages 19; obtain the necessary data from the lessor and work through the computation of the monthly payments and the residual value. On good leases, the residual value, i.e., the projected wholesale value of the car, *plus* depreciation should approximate the purchase price for the car. If the residual value, i.e., your price to purchase the car, is less, you have a good deal; if it's more, negotiate harder and ask more questions.

* * *

For a checklist of questions to ask the lessor, seller, or salesperson, please see the next page.

Checklist of Questions For Negotiating a Good Lease

- What are my rights if the equipment or vehicle doesn't perform as warranted?
- At any time while the leased equipment or auto is being repaired, do I get a replacement to use?
- Can I use the car for personal/business purposes? My family also?
- Can I cancel the lease at *any time* during its term and, if so, what are the added charges and penalties?
- Is the maintenance clause in the contract reasonable? How is "abnormal wear and tear" defined in the lease?
- Does the manufacturer's warranty cover the full term of the lease or just a specified milage level? Check to make sure the mileage is cumulative.
- Must I buy GAP insurance or is it provided free of charge? Remember, GAP insurance also protects the lessor and some lessors will provide it free.
- Is my projected annual usage within that covered by the lease? If not, do the excess milage charges make it a better deal to purchase the car with a downpayment and bank loan?
- How are monthly lease payments calculated and what is the effective interest rate for the full term of the lease? *Note:* Many states now require "full disclosure" of capitalized costs and money factors.

- Can I buy the car at any time during the lease period and at what price?

- What is the *residual value* at the end of the lease? If I want to exercise my option to buy the car, what is the car's projected market value and what is my cost to buy it? (*Note:* The difference is your potential gain *and* it will reduce your effective financing costs.) *Reminder:* You want to purchase the car at its projected wholesale value, not its retail value.

- Can I renew the lease, at what cost, and for how long?

- How can I protect myself against the lessor's subrogation claims and indemnification?

- Can I assign the lease to my business or another party who may want to assume the lease payments?

- Would you please provide a *written summary* of the extra charges I'm going to pay at closing, during the term of the lease, at termination, and if I decide to purchase the vehicle?

Each question, by itself, may seem like a minor issue. But, as you well know, problems have a way of multiplying. Also, if you have a difficult time negotiating the lease with the lessor *beforehand*, you can imagine what problems may arise after it is signed and you're legally bound by its terms. □

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The company was formed in 1974 by Thomas J. Martin. Martin has written more than 900 articles and advisories and presented *hundreds* of workshops and seminars to *thousands* of business owners and executives on many of the subjects covered in *The Business Library*. He is an Investment Banker and an expert witness in Valuation and Succession Court Cases. He has helped *hundreds* of business owners and executives raise capital, refinance debt, prepare for succession, and value and sell their businesses.

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