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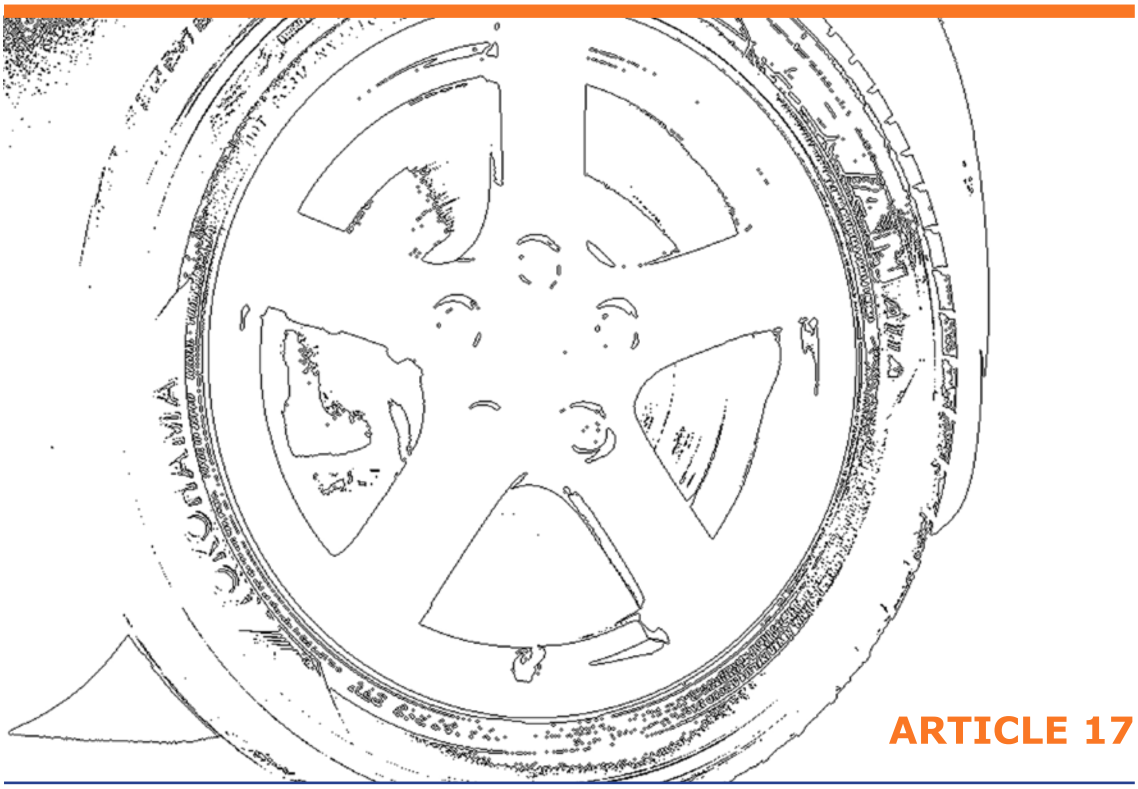

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Finance Lease

Finance Lease

Features of finance lease

A finance lease is defined in SSAP21 as a lease that transfers 'substantially all of the risks and rewards of ownership of the asset to the lessee'. In plain English this means that it puts the lessee in much the same position as he would have been if he had bought the asset.

A finance lease is a financing device. It gives you an alternative way to obtain the use of a vehicle other than hire purchase, conditional sale or one of the other methods of vehicle purchase. It is also known as a 'full pay-out lease' or, in the United States, an 'open-ended' lease.

The general assumption with a finance lease is that there will be only one lessee. This distinguishes it from an operating lease, where the lessor has to lease the vehicle to several parties in succession, or sell it, before he recovers his investment.

In a finance lease, the lessor will charge you rentals that are sufficient to repay their investment in full during the primary period of the lease, that is, to clear their books. You are committed to paying the rentals for at least this period. A finance lease is therefore said to be non-cancellable. This is rather odd, because almost all leasing companies will early terminate a finance lease as willingly as a contract hire agreement; nonetheless, finance leases are still considered by many to be non-cancellable.

The key difference between a finance lease and an operating lease (contract hire) is the treatment of the vehicle at the end of the lease. Depending on the wording of the finance lease agreement, one (or more) of the following will occur:

- You will sell the vehicle as the lessor's agent
- You will allow the lessor to recover the vehicle and sell it or
- You will elect to enter into a secondary lease period.

Whoever sells the vehicle, the lessor will retain a small proportion of the sale proceeds and you will retain the majority of the sale proceeds. These are normally given to you as a rebate of rentals.

It is worthwhile dwelling for a moment on how this normally works.

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In a finance lease you have an obligation to pay all of the rentals, including the balloon rental. Once you have paid these the lessor will have recovered its full investment in the vehicle, covered its interest and other costs and made a profit. But it still owns the vehicle and the lease will stipulate very clearly that you cannot become the owner. To ensure that it does not then sell the vehicle, retain the sales proceeds and make a windfall profit, the lease will stipulate an amount of money that the lessor has to pass back to you once the vehicle has been sold. This payment will normally be described as a rebate of rentals, which makes it clear that, for tax purposes, the payment is a revenue (trading) item rather than a capital receipt of sales proceeds. Typically, the amount payable might be 95% of the sale proceeds of the vehicle.

Technically, the lessor has to:

- invoice you for the balloon rental
- receive this from you
- sell the vehicle
- receive the sales proceeds
- raise a credit note to you for 95% of the sales proceeds and then
- refund this to you.

In reality, many lessors do not collect the balloon payment but simply raise an invoice for this amount and a credit note for the rebate of rentals, and pay you (or recover from you) the difference.

A finance lease has two distinct phases. The first period is called the primary period and this is the initial non-cancellable period of the lease. It runs for the fixed period set out in the agreement, by the end of which the lessor will normally have no balance outstanding in its books relating to the lease.

The primary period is followed by the secondary period. This may last for an indefinite period of time. The lessor allows you to continue leasing the vehicle, perhaps for many years. The secondary period ends when both parties agree or when the vehicle is sold.

Vehicle finance leases often include a balloon rental payable by you at the end of the primary period. The amount of the balloon rental will be set out in the lease and will usually be equal to the estimated residual

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value of the vehicle at the end of the primary period. Hence the monthly amount payable under a finance lease will often be similar to the rentals in an operating lease or contract hire agreement (excluding maintenance in all cases). The difference, of course, is that you will be obligated to pay the balloon rental in the finance lease but you have no such obligation in contract hire.

Normally, any secondary period rental will be very much smaller than the primary period rental, perhaps only a few per cent of the capital cost of the vehicle. This is often called a peppercorn rental, reflecting the fact that a peppercorn is an item of very little value. It is normally paid annually. This is a small additional amount of income for the lessor and therefore most welcome, particularly as they no longer have any investment in the vehicle. However its primary purpose is to provide an ongoing acknowledgement from you that the vehicle is still under lease and that you are not the owner. You cannot just sell it and retain the proceeds.

In a finance lease you bear the risk of obsolescence of the vehicle. You cannot hand it back mid-term if it no longer suits your requirements, unless you pay an early termination charge.

Under a finance lease you will normally be responsible for the maintenance of the vehicle, though often if required the lessor can add a maintenance package to the agreement (as in contract hire), or they can pay for maintenance and recharge the cost to you as it is incurred.

The lessor's VAT treatment of finance leases is the same as for contract hire. They can recover the input VAT on the purchase of the vehicle and have to charge you output VAT on the rentals. You can recover this in full as input VAT so long as your business is not partially or wholly VAT-exempt.

However, your corporation tax treatment of the finance lease rentals can differ from that of an operating lease or contract hire. A government order called SP3/91 sets out to ensure that you do not get accelerated corporation tax relief by paying uneven rentals, for example, large initial rentals. Instead, if uneven rentals are payable under the lease, you can only claim corporation tax relief on the rentals on a straight-line basis, taken evenly over the life of the lease.

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The 'half the excess' rule provisions for tax deductibility of contract hire rentals apply for finance leases. The higher the cost of the vehicle in excess of £12,000, the less you can claim as a deductible expense for corporation tax purposes. For leases written by companies on or after 1 April 2009 (or 6 April 2009 for partnerships and sole traders), these rules will be changed and the rental will be fully tax deductible for cars emitting up to 160 g/km of CO_2; otherwise 15% of the rental is disallowed for tax purposes.

As you are bearing the residual value risk on the vehicle, it has to be shown on your balance sheet. This was not the case before SSAP21 was introduced.

Normally, finance leases are offered as fixed interest rate products. The rentals remain fixed throughout the life of the lease and you are not exposed to the risk of interest rates changing during this time. Some financiers offer variable interest rate finance leases too.

Most vehicle lessees do not like finance leases. They consider that finance leases have few advantages over contract hire. Hence finance leasing represents around 1% of the business vehicle finance market, down from 14% 15 years ago.

Benefits of finance lease

Finance leases allow the lessor to recover the VAT on the purchase price of the vehicle, thus reducing the starting point for calculating your finance lease rentals. They offer you the flexibility to retain the use of the vehicle at the end of the lease for a modest annual outlay.

Disadvantages of finance lease

They suffer the 'half the excess' rule corporation tax disallowance that also applies to expensive vehicles acquired on contract hire (except as noted above for new business car expenditure from April 2009). The vehicles must be shown on your balance sheet and you have to take the residual value risk.