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Comparison of Leasing vs. Buying

Wealth Managed to a Fiduciary Standard

At RDM, we help you coordinate what is often multiple financial goals (wealth accumulation, retirement income, legacy planning, etc.) through a maze of tax, legal and investment possibilities. It is critical to understand, develop and implement effective, long-term strategies that align with your objectives and prepare you for the future.

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Comparison of Leasing vs. Buying

Introduction

Neither leasing nor buying has a clear advantage over the other. Many of the advantages and disadvantages depend upon your own personal preferences and needs. The key is to make an informed comparison before you go car shopping. That way, you will not be rushed into making a bad decision while caught up in the excitement of driving home with a new car. The following discussion details the major points of comparison between leasing and buying.

Vehicle ownership

When you purchase a car using an auto loan, you own it free and clear once the loan is paid off. The car is an asset with value. You can drive it for a few more years, sell it outright, or trade it in for a new car.

When you lease a car, you must return the car to the lease company at the end of the contract (unless you have an option to buy and plan to exercise it). You don't own the car and you don't have an asset left over when all the payments are made. If you expect to trade cars every few years, then this probably doesn't concern you. If you like to keep your cars for more than four years, then it's probably better to buy.

Monthly payments

When you buy a car, your monthly payment is based on the purchase price of the car. Over the term of the loan, you will have to make payments equal to the price of the car, less your down payment, plus tax, registration fees, miscellaneous charges, and interest.

When you lease a car, your monthly payment is based on the purchase price of the car, less the residual value. This amount is called the automobile's depreciation. Over the term of the lease, you will make payments equal to the expected depreciation of the car plus a lease fee. The monthly lease payment is usually lower than the monthly loan payment for a comparable car (assuming you didn't make a large down payment in the case of a loan). If the size of the monthly payments is an issue, or if you want to get more car for your dollar, you probably will do better with a lease.

Down payment

When you buy a new car, you typically need a down payment or trade-in. You may have to come up with 10 percent or more of the new car's value. The required amount may vary depending upon your lender and your credit rating.

When you lease a car, there's typically no down payment. You're usually required to make the first lease payment and post a security deposit equal to one or two monthly payments. If you don't have cash for a down payment, but need a car now, then leasing might be the best bet for you.

Mileage limitations

When you buy a car, you're free to drive it as much and as far as you like. When you lease a car, your annual mileage is limited by the terms of the contract. The typical lease limits your mileage to 12,000 or 15,000 miles per year. In some cases, you can buy more mileage at the time of contracting. If you drive the car further than the contract permits, you're charged a per-mile fee for each mile over the contract limit.

In some cases, paying excess mileage fees is still less expensive than buying

Excess mileage fees are designed to compensate the lease company for the extra use of the car. In some cases, it may be no more expensive to lease the car and pay the excess mileage fee than to buy the car and drive it the same number of miles.

Example(s): *Ted leases a car with a mileage limitation of 15,000 miles per year for two years. The excess mileage fee is 10 cents per mile. Ted drives the car 40,000 miles in two years, exceeding his mileage limitation by 10,000 miles. Ted must pay a $1,000 fee when he turns the car in. Bill buys an identical car and also drives it 40,000 miles over two years. When Bill goes to trade the* *car in, he learns that it is worth $7,500. The car would have been worth $9,000 had Bill driven it only 30,000 miles, but the additional miles caused the car to decline in value by a factor of about 15 cents per mile. Accordingly, it cost Bill $500 dollars more than Ted to drive the car an additional 10,000 miles.*

The big problem with excess mileage fees is that many consumers don't properly plan for them. They're agitated when they learn they have to come up with a big chunk of change at the end of the lease. Although Ted may have been unpleasantly surprised when he learned that he had to pay a mileage penalty, he still fared better than Bill. Additionally, Bill probably had to make a down payment and make larger monthly payments up front. During the term of the lease, Ted's money remained in his bank or in other investments, earning interest and/or dividends.

In some cases, exceeding mileage limitations will cost you more than buying

In the above example with Ted and Bill, the excess mileage fee was less than the amount by which the car actually declined in value as a result of the additional miles driven. All leases are different and cars decline in value at different rates. In some cases, paying the mileage fee at the end of the lease can cost you more.

Example(s): *Ted leases a car with a mileage limitation of 15,000 miles per year for two years. The excess mileage fee is 20 cents per mile. Ted drives the car 40,000 miles in two years, exceeding his mileage limitation by 10,000 miles. Ted must pay a $2,000 fee when he turns the car in. Bill buys an identical car and also drives it 40,000 miles over two years. When Bill goes to trade the car in, he learns that it is worth $7,500. The car would have been worth $9,000 had Bill driven it only 30,000 miles, but the additional miles caused the car to decline in value by a factor of about 15 cents per mile. Accordingly, it cost Ted $500 dollars more than Bill to drive the car an additional 10,000 miles.*

In this case, the excess mileage fee was more than the amount by which the car actually declined in value as a result of the additional miles driven. If you want to make a comparison, you must estimate how much the car will decline in value as a result of excess miles. Look in the National Automobile Dealers Association (NADA) Official Used Car Guide or other directory of used car values to see how similar cars have performed in the past. Use this information to make your comparison between leasing and buying.

Tip: *If you know you will exceed the mileage limitations in the contract, you should buy additional mileage at the time of contracting. Some lease companies will make you a deal if you buy additional miles up front. For example, they may charge you 8 cents per mile if you buy extra mileage up front, but 20 cents per mile if you don't. Further, automobile dealers will occasionally waive excess mileage fees as an incentive to lease another automobile from them. Similarly, dealers may offer you more for your trade-in than what it's really worth as an incentive to buy another car from them. Ultimately, it all comes out of the dealer's profit margin, but in the case of the lease, it eliminates the need to come up with the large mileage fee.*

If you don't need the extra miles, don't pay for them

If you know that you will be driving fewer miles than what the lease allows, you may actually do better by buying the car.

Example(s): *Ted leases a car with a mileage limitation of 12,000 miles per year for two years. Ted knows that he will only be driving about 8,000 miles per year. When Ted turns the car in with only 16,000 miles at the end of two years, the leasing agent smiles broadly and thanks Ted for his business. Ted doesn't get a refund for unused miles. Bill buys an identical car and also drives it 16,000 miles over two years. When Bill goes to trade the car in, he learns that it's worth $10,200. The car would have been worth only $9,000 had Bill driven it 24,000 miles, but because of the low miles, the dealer is willing to give him a 15 cents per mile credit for every mile below 24,000.*

Example(s): *Bill ends up with the better deal because his low mileage car yields him a benefit, namely more value at trade-in time. Ted ends up paying for miles he never used.*

Tip: *Don't sign a lease contract with a 15,000 mile per year limitation if you know you will never drive more than 12,000 per year. You will only be paying for miles you won't use.*

Normal wear and tear

When you purchase a car, there are generally no issues regarding wear and tear. You can bang it up, fill the back seat with garbage, or skid all the rubber off the tires. Provided you make your loan payments, the condition of the car rarely becomes an issue. It's your car.

When you lease a car, normal wear and tear can become a big issue. The lease company has to resell the car once the lease term expires. Excessive dings, dents, cracks, stains, tears, or unusual wear can result in penalties when you turn the car in. Your lease agreement dictates what will be deemed normal wear and tear. If you're fairly meticulous about maintaining and cleaning your cars, then this isn't a problem. If you tend to be rough on your car, then buying might be a better option.

Trading every few years

If you buy a car and trade it every few years, you have a number of problems to deal with. You must negotiate the value of your trade-in. This can be more stressful than negotiating the price of your new car. Generally, dealers want to sell you a new car at retail, and give you wholesale for your trade-in. That way, they can make a second profit when they sell your trade-in to someone else at retail. Your alternative is to sell your old car yourself. That can be a time-consuming and uncertain process. You must also be certain that you get enough for your old car to pay off any outstanding loan balance and to make a down payment on your new car. Otherwise, you will have to bring cash to the table.

In theory, leases are ideal for people who want to switch cars every few years. You lease a car for two to four years. At the end of the lease term, you drop the car off at the lease company, pick out a new car, sign a new lease, and drive away. There's no haggling over trade-in allowance and no worries about loan payoffs or down payments. That is a big advantage of leasing.

Caution: *Depending upon the condition of your car at the end of the lease term, you may be required to pay additional repair fees and mileage fees when you turn it in.*

Getting rid of your car early

When you buy a car, you can sell it or trade it at any time you like. Provided you can get enough for the car to pay off any outstanding loan balance, you can walk away from the car without paying another cent.

When you lease a car, you may be stuck with it for the term of the lease. There are generally steep penalties for early termination of a lease. You may be responsible for all remaining payments on the lease. Consider the likelihood that your situation could change. In the case of divorce or disability, you may no longer be able to afford the car and may not need it either. When you marry and discover that twins are on the way, you may have little need for that two-seater sports car you drove off the lot a year ago when you were single. A change of jobs might affect your automobile needs and the number of miles you drive. You may find yourself driving more in your present job due to a promotion, transfer, or company relocation. Or you may drive your new vehicle for six months and decide you just hate it. In any of these situations, it's generally easier to trade out of a purchased car than a leased car, especially if the lease is relatively new.

Caution: *This is not to say that it's not difficult to trade out of a recently purchased car, especially if you paid a minimal down payment. It's not uncommon to purchase a new car and discover that its actual cash value six months later is less than what you owe on the car loan. However, you will get some value for the car against the balance of your loan. In the case of the lease, you may be required to make all remaining payments due under the lease agreement.*

Cheapest alternative

If you plan to keep a car for only a short time period, you will shell out less money if you lease. You will only be paying for the use of the car and can walk away from it when the lease expires.

If you plan to keep a car for a long period of time, you will usually do better by purchasing it. The total cost of your lease payments plus the cost of purchasing the car at the end of the lease typically exceeds the cost of a basic car loan. Of course, there are always exceptions to these rules. You should run the numbers if you want to make a true comparison.

Insurance expense

When you buy a car, you must insure it up to the minimum amounts required by state law. Your lender may have additional requirements.

When you lease a car, you're usually required to carry more insurance than what the state requires. The additional coverage results in additional premiums. Find out what the coverage requirements are and contact your insurer for quotes. Be sure to include the additional insurance expense in your calculations when comparing a purchase to a lease.

Freedom to modify vehicle

One advantage of owning a car is that you can paint it, modify it, or turn it into a low-rider if you like. If you want these liberties, you should buy.

When you lease a car, you don't have these liberties. It's not your car. Provisions in your lease agreement typically prevent you from making any material changes to the vehicle. If you fail to comply with the lease agreement, you could be penalized when it comes time to return the car to the lease company.

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