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FACTSHEET

Should you lease or buy equipment?

We are often asked by clients if they should buy or lease capital equipment for their businesses. The answer, as usual, is not simple and it depends upon the nature of your business, but there are nevertheless a few guidelines you can follow to help you decide what you should do.

Broadly speaking, if you have the money available, and the item is necessary to your business, then it will usually benefit you to buy the item outright. If there is no way you can find the finance to buy (i.e., you have no money) then you will have to finance the purchase out of cash flow, which means leasing it.

Questions to ask yourself before buying!

It goes without saying that you shouldn't buy an item if you are at the risk of not being able to meet your bills in the next month. Only use surplus cash—and then only if it really is 'surplus', not just temporarily in the bank account. You should work all this out in terms of your cash flow forecast and your forthcoming liabilities.

If the options are not so clear cut, then you have some thinking to do. Ask yourself these questions:

- ***How often will you use the item?***

If the item is only going to be used every now and then, there is no real point in buying one. It will lie around for most of the year unused and is, therefore, a waste of your resources. So, lease or hire the equipment when you require it.

- ***What else could you do with the money?***

Could you earn a better rate of return on the capital required for the item if you invested it in your business? Your business might be at the stage where a few thousand ploughed back in as working capital will give you a far better rate of return than tying up the money in equipment. For example, would the money be better spent on marketing? In this case, it might pay you to lease.

The effect on net profit

The bottom line is always: how will your decision to buy or lease affect net profit?

Let's take a simple example and calculate the net profit results for both options. Suppose you decide the business needs a machine worth £2,000 (we'll ignore VAT). You can either buy the machine outright or lease it/rent.

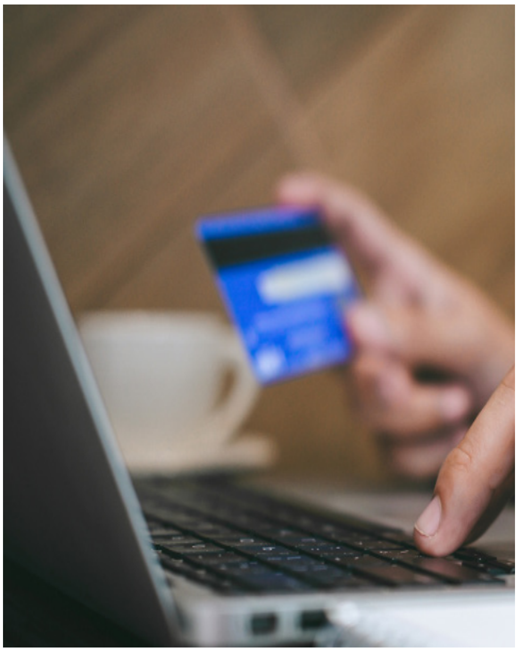
- ***Option One***

If you rent, the machine it will cost you around £100 per month, or £1,200 for the year. This can be added to your business expenses and is fully tax deductible.

- ***Option Two***

If you buy the machine, the total cost of £2,000 cannot be deducted from the net profit, as it will now be regarded as an asset. Suppose you can depreciate the machine at 33% a year. This means you can claim £660 as an expense for the year (£2,000 x 33%).

The effect on profit of a lease then in year 1 is a £1,200 reduction and to buy it is £660.



What about tax?

HMRC in their wisdom does not allow depreciation as a taxable deduction but they do allow capital allowances. Most assets qualify for 100% deduction under the Annual Investment Allowances.

So, the tax position of leasing in year 1 is a £1,200 deduction but the tax position is a £2,000 deduction.

In year 2 the tax position under leasing is a £1,200 deduction but the tax position is a £0 deduction.

It's important to compare the actual cash flows

- ***Option One***

You've spent £1,200 in cash and can claim this £1,200 as a business expense. By having £1,200 as expenses, you'll pay £228 less tax (assuming a tax rate of 19%). So, you could say that you've spent £1,200 and 'saved' £228, giving net cash out for the business of £972 for that tax year.

- ***Option Two***

You spend £2,000 in cash and get a tax 'saving' of £380 (19% of £2,000) (Assuming the asset qualifies for the Annual Investment Allowance) So, your net cash out is £1,620.

Therefore, in the first year, it would have been better for the business, as far as cash flow is concerned, to have leased the machine.

Total Cost over 1 year with leasing is £972 and with a purchase £1,620

But what about year two?

In Option One you'd still have to pay £1,200 in rent for that second year, and the net cash out is still £972.

But in Option Two, you have no further cash to pay and no tax relief as you have had this in year 1.

This comparison shows, therefore, that whilst you might have gained a slightly better cash flow situation in year one, the lease option becomes far less attractive in subsequent years.

Total Cost over the two years with leasing is £1,944 (£972 * 2) and with a purchase, it is £1,620

So as a rule of thumb, if you lease equipment you will make a cash saving in the first year or possibly year two, and this is a viable alternative if you do not have the cash (especially for equipment that may cost thousands of pounds or items you do not use regularly).

However, long term, it's much better to buy equipment outright, provided you can safely ride out the initial heavy cash commitment.

Obsolete Tech

One additional factor is worth considering, though. When it comes to equipment that is strongly technology-based (such as computers or even photocopiers) then people often choose to lease, with terms in their lease that allow them to update to new technology as it becomes available.

In this way, you avoid being stuck with outdated equipment that has little resale value or no longer serves your needs. This is often very much a judgement call that you can only make after speaking to the salesperson concerned.

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