New Wheels: Lease Or Buy?

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Buying a car can be overwhelming. In fact, the pleasure of getting a new car can be quickly clouded during the financing decision-making process and price negotiations. Besides price haggling, many car shoppers are plagued with the decision to lease or buy. Which financing decision is right and why? This article will focus on rationalizing that choice. (To learn more, see *10 Tips For Buying A Car Online.)*

TUTORIAL: Budgeting Basics

Trends
For those who have never leased a car, leases can seem confusing, complicated and geared more toward business owners (who might deduct the expense) or individuals who simply can't afford car payments. But these perceptions may be outdated. Before eliminating leasing as a financing option, car buyers need a solid understanding of the different purchasing processes.

Buying
The Benefits
By far, the greatest benefit of buying a car is that you may actually own it one day. Implied in this benefit is that you'll one day be free of car payments. The car is yours to sell at any time, and you are not locked into any type of fixed ownership period.

When you buy a car, the insurance limits on your policy are typically lower than if you lease. In addition, by owning a car, you're free to rack up the mileage without economic penalties or restrictions. (To learn more, see *Top Tips For Cheaper, Better Car Insurance.*)

The Drawbacks
The most obvious downside of owning versus leasing is the monthly payment, which is usually higher on a purchased car. Additionally, the dealers usually require a reasonable down payment, so the initial out-of-pocket cost is higher when buying a car.

Presumably, as you pay down your car loan, you have the ability to build equity in the vehicle. Unfortunately, however, this is not always the case. When you purchase a car, your payments reflect the whole cost of the car, usually amortized over a four- to six-year period. But depreciation can take a nasty toll on the value of your car, especially in the first couple of years. As a result, buyers who put down modest down payments can end up financing a considerable portion of the car and even find themselves in an "upside-down situation," in which the car comes to be worth less than what the buyer stills owes on it at a given time. (To learn more, see *Buying A Car: The Worst Investment?*)

Like the monthly payments of a mortgage, monthly car payments are divided between paying principal and interest, and the amounts dedicated to each vary from payment to payment. In the first years in which you pay back your car loan, the majority of each payment goes toward interest rather than the principal. But in the first couple years after being purchased, most new vehicles depreciate 20 to 40%. The loss in equity is a double whammy: your car depreciates dramatically, and because the monthly payments you've been making have mostly gone towards the interest rather than the principal, you are left with very little equity in the car.

Leasing

The Benefits

Perhaps the greatest benefit of leasing a car is the lower out-of-pocket costs when acquiring and maintaining the car. Leases require little or no down payment, and there are no upfront sales tax payments. Additionally, monthly payments are usually lower, and you get the pleasure of owning a new car every few years.

With a lease, you are essentially renting the car for a fixed number of months (typically 36 to 48 months). Therefore, you pay only for the use (depreciation) of the car for that period, and you are not forced to absorb the full depreciation cost of the vehicle. Leasing a car will never put you in an upside-down position.

Leasing also provides an alternative when buying a car is not an option. Most banks will not lend more than $30,000 for a car loan. If you are planning to acquire a car worth more than that, leasing may be your only option.

Finally, for business owners, leasing a car may offer tax advantages if the vehicle is used for business purposes.

The Drawbacks

By leasing a car, you always have a car payment, and if you don't like that prospect, then leasing is probably not right for you. As long as you lease, you will never really own it. However, depending on your type of lease, when your lease term is up, you either hand the keys over to the car dealership and look for another vehicle, or finance the remaining value of the vehicle and go from making lease payments to loan payments.

The mileage restrictions of leasing pose another drawback. If you drive a great deal during the year, instead consider a loan or an open-end lease (which we discuss below). Most leases restrict your mile usage to 15,000 miles per year (sometimes even lower at 12,000 per year). If you go over your allotted miles, you pay extra: the going rate is about 15 cents for every mile over your limit, and 20 to 25 cents for luxury cars. So, if you go over your limit by 4,000 miles, you can expect to pay about $800 at the end of the lease. (For related reading about some of the expenses of owning a car, read *Getting A Grip On The Cost Of Gas* and *Extreme Commuting: Is It For You?*)

Finally, insurers usually charge higher coverage costs for leased vehicles. However, depending on your age, driving record and place of residence, that additional cost may be nominal.

Words of Caution for Leasing a Car

A downside to leasing is that you essentially pay for the most expensive years of a vehicle's life instead of the dealer. The amount for which you lease is the difference between the purchase price and the salvage, or residual value, which is the predetermined value of the car at the end of the lease period. The amount of the salvage value that the dealer includes in your contract, directly impacts your monthly payment.

When leasing, it's important to consider a vehicle that best retains its value and rethink cars with a high depreciation rate. Devious dealers try to shift more of the depreciation cost onto you by embedding an unfairly low residual value.

Also, when entering a lease agreement, be aware of any clauses in the contract regarding additional charges for "excess wear and tear" or above-average costs for additional mileage. You want to minimize any surprise costs as much as possible.

Leasing Options

There are two types of car leases: closed-end and open-end. Closed-end leases allow you to walk away from the car at the end of the lease term. If you owe for any mileage coverage or unusual wear and tear, this is when you'd have to pay for it.

With an open-end lease (also known as an equity lease), you must purchase the car at the end of the lease period for a predetermined amount. This is often the type of lease used by businesses or individuals who drive a lot. Most consumer groups suggest that the closed-end lease is the best option, because it poses less risk upon the expiration of the lease term.

Conclusion

The decision to lease or buy will always depend on your personal circumstances. If your objective is one day to be rid of pesky little car payments and you actually want to take ownership, buying a car may be the best option. If, however, if your goal is to drive a new set of wheels every four years and minimize your monthly costs, leasing a car may be a good alternative. (To learn more, see *The True Cost Of Owning A Car.*)

Educating yourself about the two financing options will give you the confidence you need when you step into a dealer's showroom.

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