

Buy, HP, or Lease?

The decision to buy, hire purchase, or lease an asset will generally depend on the financing available to your business.

There are different treatments for tax and accounting purposes, depending on the type of finance contract entered into, and these will need to be considered together with the VAT treatment.

Buy

This section covers outright purchase for cash or by bank loan, etc.

Accounting treatment

The asset is capitalised in the balance sheet and an annual charge for depreciation is deducted as an expense in the profit and loss account, which in turn reduces the value of the asset in the balance sheet.

The annual depreciation charge is calculated in accordance with accounting standards, based on the useful economic life of the asset and the residual value.

Tax treatment

Depreciation is not allowed for tax purposes, but capital allowances are available. The first £100,000 of investment in plant and equipment (not cars) each year attract an annual investment allowance (AIA) of 100%. Any annual expenditure over £100,000 enters either the 10% pool or the 20% pool, attracting a writing down allowance (WDA) at the appropriate rate.

Any business that invests in energy-saving or environmentally beneficial equipment is entitled to claim a 100% FYA. Cars with CO₂ emissions of up to 110 g/km also qualify for a 100% FYA. Cars with CO₂ emissions of more than 110 g/km and up to 160 g/km are allocated to the main pool and attract 20% WDA. Cars with CO₂ emissions exceeding 160 g/km enter the special rate pool and attract WDA at only 10%.

With effect from 1 April or 6 April 2010, there is a new 100% capital allowance for the purchase of new, unused (not second-hand) vans, which cannot produce CO₂ emissions under any circumstances when driven (eg "electric vans").

VAT

Unless the asset is a car, the VAT shown on the supplier's invoice will generally be recoverable by the purchaser, if he or she is registered. Buying at the beginning of a VAT period will entail a wait of three months or more to recover the tax. VAT on cars is recoverable only in very rare circumstances.

Hire purchase

An HP agreement usually includes an *option to purchase* at the end of an initial period. Payment of this nominal fee transfers title of the asset and brings the legal agreement to an end.

Accounting treatment

The asset is treated as if it had been purchased. It is, therefore, capitalised in the balance sheet and depreciation is provided on an annual basis.

The obligation to pay future instalments is recorded as a liability in the balance sheet.

The payments are apportioned between a finance charge and a reduction of the outstanding liability.

The total finance charge should be allocated to accounting periods during the HP term and is shown as an expense in the profit and loss account.

Tax treatment

Capital allowances are available. See “Buy” section above for details.

The finance charge in the accounts is normally allowed against tax.

VAT

VAT charged by the finance company will be payable with the initial instalment. There will be a delay of up to four months in recovering this from HM Revenue & Customs. In the case of a car, most businesses will be unable to recover any of the VAT.

Finance leases

A finance lease typically has a *primary* period for a fixed period at full cost, followed by a *secondary* period, usually of an indefinite length, at a very low cost.

Accounting treatment

The asset is treated as if it had been purchased. It is therefore capitalised in the balance sheet and depreciation is provided on an annual basis.

The obligation to pay future rentals is recorded as a liability in the balance sheet.

The rents payable are apportioned between a finance charge and a reduction of the outstanding liability.

The total finance charge should be allocated to accounting periods during the primary lease term and is shown as an expense in the profit and loss account.

Tax treatment

Where accounts have been prepared in accordance with accounting standards, the accounting treatment will be acceptable for tax purposes and no adjustments to profit need be made.* see note

Where accounts have not been prepared in accordance with accounting standards, for tax purposes the rentals are deductible in computing profits under the accrual concept. The rentals are, therefore, allocated over the period of the lease.

Where the asset is a car with CO₂ emissions exceeding 160 g/km, there is a flat rate disallowance of 15% on the amount of rental payments allowed for tax purposes.

Capital allowances are not available.

VAT

VAT charged by the finance company will be payable with the initial instalment and each subsequent rental. There will be a delay of up to four months in recovering this from HM Revenue & Customs. In the case of a car, most businesses will be able to recover 50% of the VAT.

Operating leases

An operating lease is where an asset is rented for a period, not necessarily fixed, and returned to the owner at the end of the period. Contract hire is a typical form of operating lease.

Accounting treatment

The asset is not capitalised; the rental payments are charged on an acceptable basis over the lease term to the profit and loss account.

Tax treatment

The accounting treatment is an acceptable treatment for tax purposes, where the accounting standard has been applied. No adjustments to profits, therefore, need be made. * see note

Where the asset is a car with CO₂ emissions exceeding 160 g/km, there is a flat rate disallowance of 15% on the amount of rental payments allowed for tax purposes.

Capital allowances are not available.

VAT

Each rental or instalment will have VAT added so that the VAT cost is spread throughout the period of the agreement.

Where the asset is a car, only 50% of the VAT on the leasing charges can be reclaimed. If identified separately, the VAT on any maintenance element of the contract can be reclaimed in full.

The disposal proceeds of leased cars will be VAT inclusive.

***Note:** Legislation is being introduced to ensure that any business that accounts for lease transactions using a leasing accounting standard that is newly issued or changed on or after 1 January 2011 continues to apply to all tax rules as if the change to leasing accounting standards had not taken place.

Summary

| | Buy | HP | Finance Lease | Operating Lease |
|---|--------------------------------|---|---|-----------------------------|
| Accounting treatment | Asset Depreciation | Asset/liability Depreciation Interest | Asset/liability Depreciation Interest | Rental expense as you go |
| Tax treatment (deductions normally allowed) | Capital allowances Interest | Capital allowances Interest | Depreciation Interest | Rental |
| VAT (normal treatment) | Up front | Up front | On each instalment | On each instalment |

Do call us if you would like any further help or advice in this area.