

# Financing your car



One of the more difficult decisions facing any individual, sole trader or small business is the purchase of a new car. Apart from choosing the vehicle, one needs to consider the best method of acquisition in terms of tax allowances, VAT implications, accounting issues and cash flow.

## Cash Purchase or Bank Loan

**Accounting Treatment.** The car is capitalised in the balance sheet and an annual charge for depreciation is deducted as an expense in the profit and loss (P&L) account, reducing the balance sheet value of the asset. The depreciation charge is calculated in accordance with accounting standards, based on the useful economic life of the asset and residual value.

**Tax Treatment.** Depreciation is not allowed for tax purposes, but capital allowances are available, usually in the form of a writing down allowance of 25% on the tax written down value. Where the car costs over £12,000, the annual allowance is restricted to a maximum of £3,000.

**VAT.** VAT on cars is recoverable only in very rare circumstances.

## Hire Purchase

This method is very popular, because it is so simple. You pay a small deposit or use the value of your existing vehicle as part exchange, and the remaining balance plus interest in equal instalments over a period of between one and five years. To change your car during the repayment period, you can pay the settlement figure furnished by the finance company to take title of the vehicle, so that you can enter a new agreement for a different vehicle.

**Features.** Option to purchase. Low initial outlay. Flexible repayment. No interest rate risk.

## Accounting Treatment (for businesses)

The car is capitalised in the balance sheet, and depreciated annually. The obligation to pay future instalments is recorded as a liability in the balance sheet. Repayments are apportioned between a finance charge and a reduction of the outstanding liability. The total finance charge is allocated to the accounting periods during the HP term and shown as a P&L expense.

**Tax treatment.** Depreciation is not allowed for tax purposes, but capital allowances are available. The finance charge is normally allowable against tax.

**VAT.** Most businesses will not be able to reclaim any VAT.

## Finance Lease

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.** As for Hire Purchase, with the finance charge being allocated to accounting periods during the primary lease term.

**Tax Treatment.** Where accounts have been prepared in accordance with accounting standards, the accounting treatment will be acceptable for tax purposes. Where they have not, 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 car has an acquisition cost of £12,000 or over, there is a restriction 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. Special rules apply to cars financed this way and most businesses will be able to recover 50% of the VAT.

## Personal Contract Purchase (PCP)

For individuals, PCP is the fastest growing acquisition method because it allows drivers to change their vehicles more often. A small initial deposit or advance rental is paid, a pre-determined estimated value is the deferred 'guaranteed future minimum value' (GFMV) and the resulting balance is repaid over between one and four years in equal instalments plus interest.

At the end of the agreement period, the GFMV can be paid as follows:

1. Pay the GFMV and take ownership of the vehicle.
2. If the vehicle is worth more than the GFMV then the difference may be used to buy a new vehicle and pay all or part of the deposit / advance rental.
3. If the vehicle is worth less than the GFMV, the vehicle can be returned to the finance company and a new vehicle can be purchased.

**Features.** Low deposit. Low monthly payment. No interest rate risk. Accounting and Tax Treatment. Same as Hire Purchase. Note: For drivers receiving a car allowance from their employers, the initial payment can be substantially reduced.

## Contract Hire

Popular with businesses, this is now available to private motorists. Use of the vehicle is obtained by paying an advanced rental ranging from one to six months, dependent on status, and the remaining rentals paid in equal amounts over a one to four-year period, after which the vehicle is simply handed back.

**Features.** Use of car, no ownership. Low initial outlay. Flexible rental pattern. Off balance sheet borrowing. Fixed budgeting. No disposal or depreciation risk.

**Accounting Treatment.** The car is not capitalised; rentals for the lease term are charged to the P&L.

**Tax Treatment.** Where the car costs over £12,000 there is a restriction for the amount of rental payments allowed for tax purposes. Capital allowances not available.

**VAT.** Each rental attracts VAT, so that the VAT cost is spread across the period of the agreement. Only 50% of VAT on rentals can be reclaimed; any maintenance that attracts VAT can be reclaimed in full.

## Personal Contract Hire

This as the name suggests is essentially the same as contract hire but for private individuals.

**Features.** Use of car, no ownership. Low initial outlay (suitable for company car opt outs). Flexible rental pattern. Fixed budgeting. No interest rate on residual value risk. Maintenance packages available if required.

**VAT.** VAT is included within the monthly payment but is not reclaimable by private individuals.

Personal loans are another finance option to consider. The decision whether to finance through the business or in one's personal name should take your specific circumstances into account, so it is best to seek professional advice.

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*Accounting and tax treatment details were provided by James Abbott of Baker Watkin.  
See [www.bakerwatkin.co.uk](http://www.bakerwatkin.co.uk)*