Buying vs. leasing basics for cars

Comparing the two major finance choices in car buying

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If you are deciding whether to pay for a new car or just get a loaner, check out some of the major differences between buying and leasing.

In general it makes financial sense for most to buy a vehicle especially if you drive a lot of miles and have kids that may dirty or damage the interior.

	Buying	**Leasing**
Ownership	You own the vehicle and get to keep it as long as you want it.	You don't own the vehicle. You get to use it but must return it at the end of the lease unless you decide to buy it.
Up-front costs	They include the cash price or a down payment, taxes, registration and other fees.	They typically include the first month's payment, a refundable security deposit, a down payment, taxes, registration and other fees.
Monthly payments	Loan payments are usually higher than lease payments because you're paying off the entire purchase price of the vehicle, plus interest and other finance charges, taxes, and fees.	Lease payments are almost always lower than loan payments because you're paying only for the vehicle's depreciation during the lease term, plus interest charges (called rent charges), taxes, and fees.
Early termination	You can sell or trade in your vehicle at any time. If necessary, money from the sale can be used to pay off any loan balance.	If you end the lease early, early-termination charges can be almost as costly as sticking with the contract.

Vehicle return	You'll have to deal with selling or trading in your car when you decide you want a different one.	You can return the vehicle at lease-end, pay any end-of-lease costs, and walk away.
Future value	The vehicle will depreciate but its cash value is yours to use as you like.	On the plus side, its future value doesn't affect you financially. On the negative side, you don't have any equity in the vehicle.
Mileage	You're free to drive as many miles as you want. (But higher mileage lowers the vehicle's trade-in or resale value.)	Most leases limit the number of miles you may drive, often 12,000 to 15,000 per year. (You can negotiate a higher mileage limit.) You'll have to pay charges for exceeding your limits.
Excessive wear and tear	You don't have to worry about wear and tear, but it could lower the vehicle's trade-in or resale value.	Most leases hold you responsible. You'll have to pay extra charges for exceeding what is considered normal wear and tear.
End of term	At the end of the loan term (typically four to five years), you have no further payments and you have built equity to help pay for your next vehicle.	At the end of the lease (typically two to four years), you'll have to finance the purchase of the car or lease or buy another.
Customizing	The vehicle is yours to modify or customize as you like.	Because the lessor wants the vehicle returned in sellable condition, any modifications or custom parts you add will need to be removed before you return the car. If there is any residual damage, you'll have to pay to have it fixed.

Understanding leasing

To decide whether or not to lease your new car, it’s important to understand how the financial mechanics of leasing compare with a loan. In some ways, leasing is just like taking out a loan. When you lease, you borrow the entire value of the car (minus any trade-in or down payment). For example, when you drive away in a $36,000 leased vehicle, you’re immediately tying up the entire $36,000 that the finance company gave the dealership, the same as if you had bought the car with a loan. And just as with a loan, you’ll be charged monthly interest on that amount, minus whatever you pay back along the way.

And it’s the amount you pay back that’s the biggest difference between a lease and a loan.

With a loan, your payments are based on the entire cost of the vehicle. For a 36-month loan on that $36,000 car, for example, the principal portion of the payment averages $1,000 a month. But with a lease, you pay back only the vehicle’s decline in value—the depreciation—while you’re using it.

Since that $36,000 vehicle might depreciate about $18,000 over that same 36 months, the principal portion of the monthly lease payment would be based on $500, about half as much as for the loan. Of course, at the end of the lease, you have to return the car (unless you come up with the remaining $18,000 of the residual value to buy it).

Note that in both cases, the net principal you pay back is $18,000.

Add finance charges

In addition to the principal portion of the payment, there are also finance charges, the interest rate to borrow money. These are much higher for a lease because you're paying back the cost of a leased car more slowly, $500 a month compared to $1,000 with a loan. That leaves a greater unpaid balance that's subject to that finance charge month after month.

Put another way, in exchange for those lower monthly payments that come with a lease, you pay significantly higher finance charges compared to an equivalent loan, about $1,435 more for that $36,000 car. That additional cost would be partly offset by the sales tax break lessees get in most states. Also, lessees can invest the extra amount that otherwise would go toward a monthly loan payment.

Taken together, those benefits might offset the higher lease finance charges. But even then, lessees often have to contend with various fees and other extra costs, including lease initiation and disposal fees, which can add hundreds more to the total cost.

All these additional costs are multiplied if you keep leasing whenever your old lease runs out, although some may be waived through lease-loyalty programs

Vanishing leases?

All this has been further complicated by the decisions of some manufacturers and independent finance companies to eliminate or curtail their lease offers.

The companies are reacting to high gas prices, which have undercut the resale values of many SUVs and other gas guzzlers. This means that those vehicles returned from expiring leases are worth much less than the finance companies anticipated when the leases were first created. Put another way, the depreciation lessees were charged in their monthly payments didn't cover the actual decrease in vehicle value, a good thing for the lessees but bad for the leasing companies, which now must sell those used vehicles at a loss.

The finance companies don't want to get caught in that trap again. Companies that continue to lease will want to make sure the vehicles are properly valued, which in some cases will result in larger depreciation estimates, especially for gas guzzlers. And the higher the depreciation, the higher the monthly lease payments, which in turn narrows the difference between monthly lease payments and loan payments, which aren't affected by depreciation rates.

Does it make sense to lease?

The financial workings of leasing are so confusing that people don't realize that leasing invariably costs more than an equivalent loan. And even if they did, the extra cost is difficult to calculate. Still, many people can't afford the higher payments of a typical loan, at least not without putting a substantial amount down. If payments are an issue, consider buying a lower-cost vehicle or a reliable used car.

Opting for a longer-term loan of, for example, six years, could result in roughly the same low monthly payments as a three-year lease. But longer loans make it easier to get “upside down” on your loan, where you owe more than the vehicle is worth. So, if you decide to get rid of the car early on or if it’s destroyed or stolen—the trade-in, resale, or insurance value likely will be less than you still owe on the loan. Indeed, if you want to drive a new car every couple of years, taking out a long-term loan but trading in early will leave you having paid so much in finance charges compared to principal, that you might as well have leased. If you can’t pay off the difference on an upside-down loan, you can often roll the amount you still owe into the new loan. You end up financing both the new car and the remainder of your old car.

If you decide on a long-term loan, hold on to the vehicle until it’s paid off. If low monthly payments and the opportunity to drive a new vehicle every few years with little hassle are worth the extra cost, consider leasing. Be sure, however, that you can live with all the limitations on mileage, wear and tear, vehicle modifications, and the like. Finally, keep in mind that you should be able to afford the lease for the entire period, since the early termination penalties can be costly.