What Is Hire Purchase?

Under an HP agreement, you technically only hire the equipment for the term of the agreement and then have an option to buy it at the end of that period.

Typically, there will be a small additional charge added to your last payment which is the fee for exercising your purchase option and gives you legal ownership of the asset.

For tax purposes, you are treated as if you had purchased the asset at the beginning of the HP agreement. This has the advantage of providing tax relief via the capital allowances system.

Any agreement which gives you legal title to an asset at the end of its term, or which gives you an option to purchase the asset at that time for a modest additional fee, is treated as HP for tax purposes, regardless of what the agreement is actually called.

As well as claiming capital allowances on the purchase price of an asset acquired under HP, you will also be able to claim a tax deduction for the interest charges arising under the agreement.

HP and Capital Allowances

One critical point about an asset acquired under HP is that it is only eligible for capital allowances if it is brought into use in the business before its accounting date.

In one case a few years ago, a haulage firm with a 31st March year end purchased some new trucks on HP just before its year end but only bought road fund licences (tax discs) for them from 1st April.

Leasing Assets

What Is a Finance Lease?

In practical day-to-day terms, holding an asset under a finance lease is very much the same as buying an asset on HP.

The lessee is treated as if they owned the asset (for the period of the lease), is generally free to use it as they please (subject to any restrictions under the lease) and is responsible for repairs, maintenance and running costs.

The key difference between a finance lease and HP is that the lease does not include an option or right to purchase the asset at the end of its term or, if it does, it is at a more commercial price and not the notional £50 or so found in a typical HP agreement.

In other words, it is far from certain that the lessee will purchase the asset at the end of the lease. (Whilst it is not absolutely certain that a hirer will buy an asset under a HP agreement, it is pretty likely, in view of the negligible size of the option price in most cases.)

Under a finance lease, you are not treated as owning the asset for tax purposes during the period of the lease and cannot claim capital allowances on it during that time (except in the case of some leases of five or more year's duration, known as 'long funding leases').

Instead, you can claim your lease payments, including any finance element, as a tax deductible expense. From 1st April 2021 if the car has CO2 emissions greater than 50g/km, 15% of the lease payments are disallowed (the previous threshold was 110g/km).

The simple approach will generally be acceptable if the lease payments arise evenly over the period of the lease but should not be used if there are any 'balloon payments' (a larger payment at either the beginning or end of the lease).

The theoretical approach should be used, however, this is open to all businesses and is worth considering as it can create some timing advantages.

HP v Finance Leases

So, now that we have looked at the tax treatment of both financing methods, we come back to our original question: 'lease or buy', what is better, HP or finance lease?

As we have seen, the treatment of the interest or finance costs is broadly similar, so it all comes down to the capital value of the asset itself.

At this point, we need to distinguish cars from other assets used in the business. For the moment we will concentrate on other assets, such as computers, furniture, equipment, machinery, vans and trucks.

Where the expenditure on these items qualifies for capital allowances it will probably qualify for immediate 100% tax relief thanks to the annual investment allowance.

From a tax perspective, HP seems to come out a clear winner: where the annual investment allowance is available.

Where an asset purchase is not covered by the annual investment allowance then, in most cases, it will attract a writing down allowance at the rate of just 18%.

In Summary

From a tax perspective alone, it is generally better to purchase machinery and equipment under HP rather than lease it under a finance lease: provided that the purchase price will be covered by the annual investment allowance.

Where the annual investment allowance is not available, however, a finance lease will provide better tax relief.

Finally, however, remember that we have only been looking at tax issues here. In practice, there are many other considerations to take into account: including the fact that you get to keep an asset bought on hire purchase, but a leased asset usually has to go back to the leasing company one day.

Finance Lease v Operating Lease

Finance leases differ from 'operating leases', where you simply hire a piece of equipment for a pre-determined period and have none of the risks or rewards of ownership (e.g. you are not responsible for maintenance). Rent paid under an operating lease is simply allowed as it is paid and is a very different 'kettle of fish' to finance lease or HP payments.

Hire Purchase Example

A machine is bought under HP, the cash price is £12,300 and the total interest charge is £3,000. The business pays 36 monthly instalments of £425 (total £15,300) plus an administration charge of £50 which is added to the first instalment and an option fee of £50 which is added to the last instalment.

The two small amounts of £50 would be claimed as additional finance costs when they are paid.

In simple terms, if there are 12 instalments during the first year, the business can claim –

Annual Investment Allowance	£12,300 (purchase price)
Interest Paid	£1,648.65
Finance Charge	£50.00
Total	£13,998.65

Finance Leasing Example

The business takes out a finance lease over a new piece of machinery with a purchase price of £20,000. They have an option to purchase the machine for £5,000 at the end of the three year lease (but has no intention of doing so as, in their view, it will not be worth that much by then).

They pay £500 per month over the life of the lease - £500 x 36 months - £18,000.

If not running business as a company, simply claiming the lease payments as they arise would give a tax deduction of £6,000 (12 x £500) for each year of the lease.

The business can use the more complicated method (Rule of 78), this would give a deduction of £1,649 for the interest in the first year of the lease.

At the same time, they could also charge depreciation on the capital value of the asset £20,000 at the rate of 37% on the reducing balance basis. This would produce an allowable deduction for depreciation of £7,400 in the first year of the lease.

37% will reduce the machines written down value to £5,001 after three years a good reflection of its actual value at that time.

Therefore, they can actually claim deductions of £9,049 for the first year 50% more than if they had just claimed the lease payments.

The depreciation policy used must be reasonable