

# The Audi Guide to contract hire

## Getting the most from your leasing provider

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# Introduction: why choose contract hire?

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**Contract hire is the most popular funding method in the fleet industry, providing fixed payments over a fixed period, low risk to the customer, peace of mind and simplicity. There are also numerous tax and accounting advantages to the lessee, covered elsewhere in this Guide.**

A major advantage of contract hire is that the vehicle does not appear on the operator's balance sheet, so a company does not have a depreciating asset on its books that it has to write down each year.

Because of this, financial ratios can be improved and working capital freed up for other uses. Most companies can also claim back a proportion of the VAT charged on the finance element of the monthly rentals well as all of the VAT on the service and maintenance part of the rental (if this is included).

Most contract hire suppliers are also experts in providing additional services to fleets, enabling you to tailor your agreement to include extra items such as breakdown cover, accident management, driver support and gap insurance.

## **Low risk, predictable cashflow**

One of the key attractions of contract hire is its low risk to the customer. Predicted (rather than actual) depreciation is included as part of the monthly rental, meaning rates are unaffected by external forces such as fluctuations in the used car market.

Customers can choose to include maintenance in a contract hire agreement, or opt to pay for any service or repair work themselves. If maintenance is included, it will eliminate the risk and cost of unexpected repair bills.

A tailored contract hire package enables fleets to budget reliably over the duration of the agreement, while the risks involved in predicting future residual values, managing resale and achieving the best prices at disposal are borne by the leasing company.

Many fleet decision makers also find contract hire attractive because it offers a clear and simple cost benchmark between

competitor vehicles. Comparing a monthly payment structure for similar vehicles is more straightforward than drawing up complex comparisons of models, prices and specifications.

## **How are rentals calculated?**

Monthly rentals are calculated by the leasing provider based on factors including the predicted future residual value of the car, its likely maintenance costs, manufacturer incentives, funding costs and a profit margin. Contracts mostly run for between two and four years, with the industry benchmark generally set at three years/60,000 miles.

## **Age and mileage profiles**

Historically, fleets have opted to lease vehicles for three years because in years four and five the costs of maintenance start to increase due to mileage and age.

A vehicle tends to depreciate more slowly once it is three years old, so the depreciation portion of the lease is more thinly spread over four years than three. However, against this is the increased cost of maintenance during the later years, especially if vehicles are covering high mileages, which may offset any advantages of leasing for longer.

## **Research your mileage**

It is essential to ascertain clear usage profiles of each car you intend to lease and determine likely annual mileage: once the car exceeds the pre-agreed mileage, it will start to incur excess mileage charges which can be extremely costly if left unchecked.

If you cannot be sure of the mileage of particular vehicles over a given period, it is worth exploring a pooling system whereby the entire mileage of your leased fleet is taken into account, with those vehicles that are below their agreed level offsetting those that are above it.

Close communication with your account handler at the leasing company will pay dividends. It should be possible for them to predict annual mileages for your cars, but if discrepancies occur it is usually possible to adjust the contract terms to avoid high penalties.



# Taxation: where do you stand?

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## Capital allowances and contract hire

A capital allowance is the amount of money a company is permitted to deduct from its pre-tax profits due to the annual depreciation of certain assets.

In April 2009, the capital allowance system for company cars was reformed to reflect the CO<sub>2</sub> emissions of those cars.

There are three categories in the current capital allowance system: cars with emissions above 160g/km of CO<sub>2</sub>, those with emissions of 160g/km or less, and those with emissions of 110g/km or less.

Whereas the previous system treated each car individually if it cost more than £12,000, with a £3,000 annual maximum, now all cars are grouped into their relevant emissions pool, and the £3,000 cap has been removed.

Cars with CO<sub>2</sub> emissions above 160g/km are written down at 10% on a reducing balance basis – effectively, how much of the vehicle's depreciating value that can be deducted annually from pre-tax profits. Cars with emissions of 160g/km of CO<sub>2</sub> or less are written down at 20% on a reducing balance basis.

As before, however, there is a first-year allowance of 100% for cars emitting 110g/km of CO<sub>2</sub> or less. Electric vans will be eligible for a 100% first year capital allowance from April 2010, joining electric cars which have qualified for the allowance since 2002.

## What relevance does this have for leasing?

As leased cars are not on your balance sheet, you are not directly subject to capital allowances.

But the new rules mean that cars in the 10% pool – those with CO<sub>2</sub> emissions above 160g/km – are written down more slowly than cars in the 20% pool. Accordingly, they will continue to appear on the leasing company's balance sheet for a considerably longer time, especially higher value models that suffer proportionally heavier depreciation in their early life.

So while these cars are not on your books, the leasing company will have to account for the extra cost of the above-160g/km vehicles – charges that may well be passed on to you in the form of higher rentals.

## Lease Rental Restriction

Under the previous capital allowance system for leased cars with a list price above £12,000, an element of their lease payments was disallowed for corporation tax purposes, which increased as the list price rose.

Now, cars with CO<sub>2</sub> emissions of 160g/km or less are eligible for 100% of their lease payments to be offset against corporation tax. For cars above the 160g/km threshold, only 85% of their lease payments can be offset, resulting in cars at a given price with lower emissions being less expensive to lease.

## What this means for fleets

Hardest hit will be cheaper cars with CO<sub>2</sub> emissions of 160g/km or more; more expensive vehicles with CO<sub>2</sub> of 160g/km or less will gain the most. It is now considerably less expensive to finance higher-priced cars with emissions of 160g/km or less through leasing.

## VAT efficiency

One of the advantages of contract hire over other forms of funding is its strong VAT efficiency.

The VAT on rentals is fully recoverable if the vehicle is used for business purpose only, for example as a 'pool' car. However, only 50% of the VAT on the rentals is recoverable if there is any element of private use – the case for most company cars.

The VAT payable on maintenance costs, for example servicing, tyre and exhaust system replacement, is 100% recoverable.

If customers have a choice of whether or not to opt for additional services such as roadside assistance, 100% of the VAT is also recoverable.



## Maintenance and repair: options available

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### Should maintenance be included in a contract?

Leasing companies quote service, maintenance and repair (SMR) costs of around £2,000 for a typical fleet vehicle over three years/60,000 miles, so some fleet managers are tempted to organise their own SMR arrangements.

### Opting in to SMR

Building an SMR element into your contract will fix costs for the duration of the agreement and hedge against unforeseen repairs or rises in maintenance charges.

The maintenance element of a lease usually includes all scheduled servicing, labour and parts, as well as tyre replacement, but is based on an average cost prediction over the duration of the agreement. Often, a margin is built in to cover items such as clutch or battery replacement – some will fail, some will not.

Allowing the leasing company to deal with SMR removes this burden from the fleet manager and enables the provider to use its buying power to negotiate the best repair arrangements.

### Opting out of SMR

Fleet managers who prefer to undertake SMR themselves need to consider the scale of the task, dependent on the number of vehicles on the fleet.

Maintaining records of when each vehicle is due for service can be time-consuming, but it does enable the fleet to monitor vehicle condition based on repairs required, and can reveal usage patterns or driver attitudes. It also enables you to build a relationship with local suppliers and negotiate fixed rates for certain jobs. Larger fleets may well have their own workshops and manage all their maintenance themselves.

But if your fleet is spread across several locations, negotiating terms on, for example, labour rates can cause problems. For smaller fleets it can be difficult to leverage the rates that leasing companies can achieve through their buying power.

If managed poorly, a company could end up paying retail prices for SMR, and the operation may well prove more costly than outsourcing to the leasing company.



# Wear and tear policy: educating your drivers

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## Minimising wear and tear charges

Leasing companies have a set of pre-agreed standards by which they judge the condition of end-of-contract cars. Any that fail to meet those standards are usually subject to charges to return them to a marketable condition.

It is imperative that you know and acknowledge what these standards are and that your drivers adhere to them, as penalties could be payable at the end of a contract in the event a car does not meet the criteria.

The standards of condition that leasing companies should accept as reasonable are set out thoroughly by the British Vehicle Rental and Leasing Organisation (BVRLA) in its Fair Wear and Tear Guide, which you can also refer to in case of dispute with your supplier.

To view the BVRLA guide, click on the following link:

[www.bvrla.co.uk/Advice\\_and\\_Guidance/Fair\\_wear\\_and\\_tear\\_standards.aspx](http://www.bvrla.co.uk/Advice_and_Guidance/Fair_wear_and_tear_standards.aspx)



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**Financial pressures and the recession have seen several fleets and leasing companies extend contracts to ease cashflow and defer the cost of renewal.**

But unless the contract includes a clause about the lessee's right to extend, that right doesn't exist: the leasing company will expect to the car to be returned at the contract-end date.

If a contract is extended, whether or not it is under an existing clause, it is important the extension is not written at rates higher than those in the original lease period.

The originally agreed monthly rental is based on the original term of the agreement. Beyond that point, the cost profile changes as a car depreciates considerably more over the first couple of years than over the next two or three years of its life.

If an extended contract is agreed at the same rental rates as the original three, for example, you will be paying for depreciation that has mostly been covered.

Ensure you are clear about your supplier's policy. There may be differences between a formal extension of a fixed number of months and an ad-hoc extension on a month-by-month basis. With a formal extension, a decision to return the vehicle before expiry will result in early termination penalties.

Don't always assume, either, that extending a contract is a cost-effective option. Check carefully the whole-life cost of a potential replacement vehicle: with new car CO<sub>2</sub> emissions reducing all the time and efficiency improving, extending the lease on a three-year old model may be false economy.

