What's That Gaining On You?

big money *How to offset income from the sale of your truck.*

By Scott Taylor

If you've financed a new truck lately, you'll know that Canada Revenue Agency (CRA) has changed the way it assesses lease and purchase agreements. If you're coming up on a new deal, pay close attention.

The change stems from the cancellation of Interpretation Bulletin IT-233R in June 2001. IT-233R let you treat a bargain purchase option lease like a loan, with the truck added to the capital cost allowance (CCA) schedule.

When IT-233R was rescinded, CRA lost the authority to review your lease agreement and require you to treat the deal as a virtual purchase agreement. Now your lease payments are expensed and your truck is not capitalized.

In English, that means the policy change might complicate your taxes when you trade in your old truck. That's because you now have to declare any gain or recapture of depreciation as income.

Say your current truck is leased, and you plan to also lease its replacement. Your existing lease has a $500 buyout. On your new lease, the dealer shows a trade-in credit of $25,000 (seems high, but they want to make the financing "work").

CRA considers the $500 buyout on the old lease as the truck's purchase price, and this amount gets shown on your CCA schedule. That leaves a $24,500 taxable gain.

How are you going to offset $24,500 in extra income? The $25,000 down stroke on your new lease must be expensed monthly over the life of the lease, not when you pay it.

On a five-year lease, the $25,000 equals $416.66 a month as a lease expense deduction. At most, you'll be able to expense only $4,999.92 (12 months of expense at $416.66 a month) that first year. So you can see the tax problem.

Let's run through the same situation but change the new truck financing to a purchase. The $500 buyout is still the purchase price and gets added to your CCA schedule. The $25,000 trade-in is still the disposal value. But, because you're buying the new truck, it also goes onto your CCA schedule.

The $24,500 "gain" becomes a deduction against the price of the new truck. So yes, that $130,000 asset just became an addition of $105,500 and that will reduce your CCA expense in the next four to five years, but the $24,500 isn't considered income immediately. It's factored into the future calculations.

It's much cheaper to pay tax on the gain over several years than all at once. This isn't to say that purchasing a truck is the better option. Borrow, buy, lease… I don't think there's an absolute right or wrong, just a long list of pros and cons to consider. Taxes should be high on that list, and your accountant should be able to help you plan accordingly.

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For example, this CRA rule assumes that the trade-in value is also the fair market value (FMV) of the asset. CRA will recognize that a trade-in value can be overstated. If you can get an appraisal at the time of the buyout stating the true FMV of the vehicle, you can reduce the amount that must be shown as recapture on your income statement.

Let's go back to our lease-to-lease deal and leave all the details the same except your truck is appraised with a FMV of $10,000 when you buy out the lease. When you trade the truck in, the FMV becomes the disposal value. Your recapture is $9,500 ($10,000 FMV less $500). The difference between the $25,000 trade-in and the $10,000 FMV is considered capital gain, only half of which is taxable ($7,500). Now your total income inclusion is $16,500, not $24,500.

Finance companies have gotten into step with these tax rules and are now offering fair market value leases. If the contract is written that the purchase option price is based on an estimation of FMV (at the time of the contract signing), then any gain on the trade-in is a capital gain and not recapture. On the down side, your purchase option can't be $1 or some other cheap amount.

Keep this in mind when you're sitting with the F&I people at the dealership. They may not be thinking about your taxes. But you should be. ▲

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