Tax Representation

THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

Tax Faculty

TAXREP 28/06

BUSINESS EXPENDITURE ON CARS

Representations submitted on 22 September 2006 by the Tax Faculty of the Institute of Chartered Accountants in England and Wales in response to a consultation document issued jointly by HMRC and HM Treasury in March 2006

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MODERNISING TAX RELIEF FOR BUSINESS EXPENDITURE ON CARS: RESPONSE TO A CONSULTATION DOCUMENT ISSUED JOINTLY BY HMRC AND HM TREASURY IN MARCH 2006

INTRODUCTION

1. The Institute of Chartered Accountants in England & Wales is fully supportive of the Government's stated criteria in relation to the current proposals to modernise the current regime for tax relief for business expenditure on cars. These are:
   - Reduced compliance costs
   - Consistency with environmental objectives to reduce CO_2 emissions
   - Consistency with sound public finances and the Government's fiscal rules

2. The consultation document 'Modernising tax relief for business expenditure on cars', can be found at *http://www.hm-treasury.gov.uk/media/1E0/D7/bud06_cars_241.pdf*

3. The proposal on which views are being sought in the current consultation is as follows:
   - A new car pool would be introduced in which all cars would be pooled; and
   - In addition a range of first year allowances depending on a car's CO_2 emissions, would be introduced.
   - There would no longer be a specific distinction between cars costing more or less than £12,000.

4. Details about the Institute of Chartered Accountants in England and Wales and the Tax Faculty are set out in Appendix 1.

KEY POINT SUMMARY

5. The Faculty welcomes the recognition that the existing rules for expensive cars are overly complex and the need to simplify these rules.

6. We recognise that it is tempting to continue to use the tax system to influence behaviour, but consider that in this instance the proposals are not sufficiently targeted to achieve their environmental objective when there are better options.

7. We find the idea of a car pool for all cars an attractive simplification, although consider that for most company car purchases, simply raising the existing £12,000 threshold for 'expensive' cars would achieve the same effect without reams of new legislation. A new limit of £25,000 would restore the original purposes of the expensive car rules in identifying 'luxury' vehicles.

8. Alternatively cars could be de-pooled based not on cost, but on emissions, making the tax impact of acquiring a high emission vehicle significant from a cash-flow perspective.

9. Capital allowances are simply about cash flow and we consider that a more targeted incentive would be through a tax credit system, rewarding the capital cost of purchasing more environmentally friendly cars, or a charge penalising less friendly cars.

10. There has been no consideration of the environmental damage caused by building larger cars.

11. Emission levels are used in a growing number of aspects of the tax system. We have recently responded to proposals to change the VAT fuel scale charges to a system which would be based on CO_2 emissions. It is important that a decision should not be made on the changes to the capital allowances regime without taking into account the outcome of the VAT proposals.

12. If an emission based allowance system is required by the government we would suggest that there are no more than the current 7 bands used for Vehicle Excise Duty, and if possible to group these further into very low emissions, typical emissions, and very high emissions. This would minimise the compliance cost (since most vehicles would be 'typical') and make the impact of choosing a vehicle in a different tax band meaningful in cash terms.

13. The proposals fail to take into consideration how many miles a car actually travels in a year. The adverse environmental consequences arise from use of a car and not from ownership. Clearly a gas guzzler in the garage is less harmful than a very low emission vehicle which is used constantly.

14. Furthermore, focusing only on car ownership fails to take into consideration the other factors which cause damage to the environment. It has been estimated that around 30% of a car's life cycle energy consumption occurs during its manufacture; furthermore, mileage travelled rather than mere ownership causes emissions once a car has been brought into use. The Environment Agency has produced statistics which show that a 25% increase in car mileage per litre can be achieved through improved driving skills. Regular servicing and correctly inflated car tyres also improve mileage statistics. None of these factors has been considered in the statistics currently published by HMRC and we would support a much wider consultation with the experts, to produce a comprehensive programme for encouraging green expenditure, taking all factors into account rather than the current piecemeal approach.

15. The way to really achieve environmentally-friendly motoring is for manufacturers to make 'green' cars, and this will only be worthwhile if in the customer's eyes they are as good and affordable both to buy and run as what is presently available. We suggest that government should consider how the tax system and other levers might be used to persuade manufacturers to go green, rather than concentrating

just on the consumer and the businessman ,who have no choice but to buy what is available. The technology is there, but what incentive is there for manufacturers to have the will to make radical changes?

16. Widening the debate in this way leads onto considering, for example, how to improve public transport or encourage cycling to make people feel that there is a practical alternative to using a car.

17. Any change which aligns existing emissions based incentive schemes may involve compliance costs to implement initially, but would have the benefit of being joined up and so simpler to operate, easier to understand, and better for the environment overall.

Detailed comments

The questions in italic type which follow are taken from paragraph 3.24 of the consultation document

Question 1
The extent to which the Government's preferred option (a single car pool with first year allowanced based on emissions) offers compliance cost savings compared with the current rules (single car pool for each vehicle costing over £12,000 with fixed deduction rate). In particular, the Government would appreciate any detailed evidence business can provide that would help quantify the size of the compliance cost savings.

18. In general, we welcome the abolition of the price cap and the new specific car pool. However, much will depend upon the level at which the new FYA rates are set together with the WDA rate.

19. Inevitably a business will still need to review its records for the original vehicle purchase information, locate the emissions information for vehicle excise duty (VED) purposes as well as possible application of the benefits in kind legislation, before now also cross-referencing this information with the government approved first year allowance, and finally claiming the appropriate allowance in the company's tax return.

20. We would also like to emphasise that capital allowances merely alter the timing of tax relief and for some companies any additional administrative burden could deter them from claiming the FYA at all. For example, if the usual annual WDA deduction was set at say 10%, then a FYA increasing this to 20% would only save a large company 3% of the car's value in year one – hardly a great incentive to influence purchasing decisions at the margin.

21. Although as we have noted above, the change to a CO_2 based system for capital allowance purposes is unlikely to present considerable extra effort and cost for most company car fleets (since the CO_2 data for each car is already being collated as the basis for the VED, benefit in kind calculation and completion of forms

P11D, and should be readily available), it is likely that the information may currently be held by different departments within the business and a new system may be needed to make sure that information can be shared electronically on a timely basis.

22. In terms of the cost of software changes, we would imagine that the costs should be relatively minor and would perhaps just be a case of linking the calculation from a cost based table to CO_2 data which may already be held in the system or could be imported from elsewhere.

23. Conversely, we do not think that the cost savings will be significant either. Vehicles will still need to be tracked for the purposes of the accounts via their costs and a vehicle identifier, usually the registration number, to the fixed asset register. It is difficult to identify the compliance cost saving for a company as the cost relates to the number of vehicles held by a company and is a non-linear time function.

24. A smaller business which has only a handful of vehicles has low compliance costs under the existing system as typically only one or two vehicles will be sold in any given period making matching proceeds to each vehicle simple. A basic time cost of 20 to 30 minutes for the company would allow for the adviser asking the relevant questions, the company identifying the proceeds for each vehicle and informing the adviser, and the adviser updating the tax compliance system. For a small company where the accountant/auditor and the tax adviser are likely to be the same individual the proposed change is likely to generate only a minor time saving.

25. A larger business with a hundred or so vehicles on the other hand needs to maintain a record of each disposal in an accessible format and match from this format to the expensive car listing. This would typically take (including identifying errors, reconciling to the profit or loss on disposal, and changes in number plates etc) in the region of half an hour plus around 5 minutes per vehicle for a company with good records. This assumes that a computer system has been used to record the vehicles and calculate the individual deduction; a 'pen and paper' method for tracking is far more onerous as details of each car must be entered manually and tracked in the tax calculation each year which is very time consuming.

26. In this case there is minimal duplication of work with an auditor/adviser, as the majority of the time spent by the tax adviser will be on matching the proceeds from each sale to the specific vehicle in question and recording the allowance claimed on each vehicle in the tax computation.

27. A single pool would however reduce the occurrence of balancing charges, and make matching the proceeds to the specific vehicle unnecessary in the tax computation, reducing the ongoing compliance cost.

28. Overall we think that the change to a first year allowance system would lead to a short term increase in compliance (assuming that existing car pools were grandfathered) but reduce the on-going costs.

Question 2
What would be the most effective banding structure to maximise both environmental incentives and reduce the compliance burden. In particular, would the option be more coherent if the bands were aligned with either the Vehicle Excise Duty bands or based on a variant of the company car tax bands?

Environmental incentives

29. Since 31 March 2003, a FYA at the rate of 100% has been given for the cost of cars which produce CO_2 emissions of less than 120mg/km. We assume that government statistics exist giving evidence that company car fleet purchasing behaviour has changed during the past three years and that a greater proportion of the cars purchased have been more environmentally friendly.

30. If the first year allowance system is to be used to influence behaviour and encourage the acquisition of less polluting vehicles in this way, then we agree that an emissions based system of bands would seem sensible.

Compliance burden

31. In the interests of simplicity, there should be as few bands as possible. Following the income tax system would involve having 21 bands which would be over complex and burdensome for business. Having fewer bands will allow the differential cash flow benefit of differing rates of FYA to be more significant. Too many bands will mean that rates are too close together.

32. We suggest that the FYA rates be based on the VED bands in the first instance although this could be further simplified by 'grouping' the bands together so that for capital allowances there are less bands than the seven currently used for VED.

33. As to compliance costs, once people are familiar with the new system, then provided there are relatively few bands, the use of a CO_2 based system is of itself unlikely to present considerable extra costs.

Question 3
The effect the environmental incentives would have on a businesses' car purchasing strategy.

34. Whilst we support abolishing the price cap and introducing the single car pool as simplifying changes to the capital allowances system, we do not think that the proposed link between a car's CO_2 emissions and the rate of FYAs will have much influence on a businesses' car purchasing strategy.

35. FYAs just give a cashflow effect and from studies into the effectiveness of the FYAs for small and medium sized businesses so far put through by the government it has become apparent that to have any real impact on behaviour they

need to be far higher than government is generally prepared to go for large numbers (say 75% to 100%).

36. With the income tax benefits in kind rules the individual and the business actually pay less tax for a vehicle with lower CO_2 emissions – it is an absolute cash saving and not just cash flow.

37. An entirely separate incentive that provides an absolute tax advantage would seem to be more likely to encourage the purchase of more environmentally friendly vehicles. For example, a special deduction from taxable profits of, say, 20% of the purchase price of vehicles meeting a specified standard of greenness. If the company is making losses there could be a mechanism for claiming a cash payment such as for research and development tax credits. As the measures must be cost neutral, we realise that there would need to be cost savings elsewhere and if this suggestion finds favour we would be happy to meet and explore further possibilities.

38. We have set out in further detail the factors which our members have told us that they take into consideration when buying cars for their businesses as Appendix 3. This illustrates some of the many ways in which a company contributes to a cleaner environment. Rather than having tunnel vision over CO_2 emissions the government should go back to the drawing board and consult with the experts to produce a comprehensive programme for encouraging green expenditure. This would involve grants and targeted tax deductions where appropriate and although this might involve compliance costs to implement initially, it would have the benefit of being a joined up programme which would be simpler to operate as well as better for the environment overall.

Question 4
The Leasing restriction
The Government would welcome businesses' views on the impact such changes (the expensive leased car rental restriction for CT purposes would apply to either the first or the last user only in a rental chain) would have on reducing the perceived distortions in the market and on reducing compliance costs.

Lessor only

39. We consider that it would be administratively simpler to charge the lessor company only since these are fewer in number, and the majority of companies could then ignore the rules (since they would be unaffected by them). For example, this could be achieved by:
    - A surtax of say 5-10% of the related corporation tax profits.
    - A notional 'grossing up' of income from cars based on the emissions. (Say 0.25% for a low emission car to 2% for a high emission car)

Lessee only

40. If the levy is to be on a lessee rather than the owner of the vehicle the levy should be on the end user only, as there is no way of a company further up in the rental

chain of knowing whether the company above them in the chain owned the vehicle or simply rented it on.

Question 5
Whether the compliance cost benefits for the self employed car owner, who is subject to the private use adjustments, would be more limited than those for unincorporated businesses that are not subject to those rules and companies?

41. We assume that 'unincorporated' should read 'incorporated'.

42. We assume that single car pools will not be available for private use vehicles and therefore there will be no compliance cost saving under the proposed revised system for the self employed car owner. This seems to be a missed opportunity.

43. In many cases, private use adjustments can be quite complicated, varying from year to year. From a simplicity viewpoint, the system compares unfavourably with the 'flat rate' applied to benefits in kind for an employee. Whilst it is theoretically impossible for a benefit in kind to arise on someone who is self-employed it would be technically simple to apply such a system from a practical viewpoint and would have the side benefit of reducing the tax differentials between a sole trader and the same person following incorporation.

44. For example, a car could be taxed as follows:
    - A full deduction for the allowances available to the business for owning the car without the need to identify private use in calculating business profits
    - A compensating notional business profit arising from the benefit to the individual for the availability of the car could be added to the actual profit of the business. This could be dependent on the proportion of usage is private as opposed to business related.

45. This would directly align the taxation of the self employed and employees in this matter and therefore reduce the tax impact of incorporation which has been popularly known (if not necessarily understood) since the introduction of the low tax rates for micro-businesses.

Question 6
Whether, for those self-employed who only have cars that they partly use for private purposes, these measures [a single pool and first year allowances for 'green' cars] would act as a sufficient incentive to buy cars with low CO_2 emissions.

46. The impact on a self employed person is directly linked to the calculation of the taxable profits of the business and therefore the user of the vehicle can be motivated to choose a green vehicle by a tax charge on the business. As such the impact would be similar to the existing BIK rules for employees and could be expected to be substantial.

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APPENDIX 1

ICAEW AND THE TAX FACULTY: WHO WE ARE

The Institute of Chartered Accountants in England and Wales ('ICAEW') is the largest accountancy body in Europe, with more than 128,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.

The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department of Trade and Industry through the Accountancy Foundation. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy, including taxation.

The Tax Faculty is the focus for tax within the Institute. It is responsible for tax representations on behalf of the Institute as a whole and it also provides various tax services including the monthly newsletter 'TAXline' to more than 11,000 members of the ICAEW who pay an additional subscription.

APPENDIX 2

THE TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. **Statutory:** tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.

2. **Certain:** in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.

3. **Simple:** the tax rules should aim to be simple, understandable and clear in their objectives.

4. **Easy to collect and to calculate:** a person's tax liability should be easy to calculate and straightforward and cheap to collect.

5. **Properly targeted:** when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.

6. **Constant:** Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

7. **Subject to proper consultation:** other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.

8. **Regularly reviewed:** the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.

9. **Fair and reasonable:** the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.

10. **Competitive:** tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as **TAXGUIDE 4/99**

APPENDIX 3

FURTHER ISSUES

1 Factors influencing company buying decision
When reviewing the impact of a tax incentive, we think it is important to do so in the context of the other factors currently influencing a company's choice of vehicle:

1.1 Cost, after any discount for bulk purchasing
For example a Ford Mondeo (including extras) may have a retail price of roughly £17,000. A Subaru Impreza is also £17,000 to the individual customer. However as a Ford Mondeo is a very common car in plentiful supply, which is not the case for Subaru Impreza's, the company may be able to pay as little as £10,000 for the Ford Mondeo while still paying full price for the Subaru.

The company will therefore buy the Ford in preference to the Subaru regardless of the tax saving (maximum £5,100 over the life of the car with the company) attaching to the Subaru.

1.2 Availability of chosen make
In general many low emission vehicles are over-subscribed (due in part to the benefit in kind rules) and therefore discounts on these models tend to be low making these cars expensive from a company point of view.

1.3 Cash flow
It should be recognised that the cash-flow benefit of the tax saving on the car is outweighed by the cost of the car itself which is a direct up-front cost. Capital allowances can reduce the impact by up to 30% of the cost (a full tax deduction in year one) but a more typical impact would be 7.5% (assuming a 25% deduction in year one) which is unlikely to provide substantial motivation.

Furthermore, if the company is making losses there is no point making the capital allowances claim and the immediate cost saving will win hands down.

1.4 Employee motivation
Company cars are provided in most cases as employee benefits. The employee can be motivated to choose a car by tax considerations; however this is already dealt with via the benefit in kind rules.

With flexible benefits packages many employees can choose the car they want so the benefit in kind rules are more important than capital allowances. Unfortunately a significant number of employees still do not even know that the post 2002 rules are based on CO_2 emissions nor that the change was designed to try to reduce emission levels.

Extracts from HMRC Report on the Evaluation of the Company Car Tax Reform: Stage 2

(published 22 March 2006 at http://www.hmrc.gov.uk/budget2006/company-car-evaluation.pdf)

- *Nearly 50% of employers currently providing company cars and the majority of company car drivers were aware that list price and CO_2 (or at least pollution or fuel consumption in a more general sense) were the main determinants of tax and NICs liability on company cars.*

- *Just under 50% of current company car drivers and their employers knew that the reform was intended to reduce levels of harmful emissions from cars.*

The survey results suggest that around 60% of company car drivers who were given a choice of company car by their employers were influenced by the company car tax reform and as a result chose cars with lower CO_2 emissions figures.

The survey then goes on to claim that the statistics show the reform to be successful. The drop in the number of company cars and drivers receiving company fuel has apparently resulted in a reduction of 70-100 million private miles in cars in 2005. It fails to consider the possibility that there has been a switch from company cars to private cars with a business mileage allowance, with the total private mileage remaining unchanged.

Perhaps if more information were available to employees, focusing on the tax savings of choosing a car with a low CO_2 emission figure and letting them know that there are quite a lot of cars to choose from (not just cars they would not want to be seen dead in!) it might have a significant impact.

1.6 Size of company

With the exception of a small owner-managed business, the corporation tax deduction available on a vehicle is often too remote to influence decisions. Even in those companies with sufficiently advanced accounting systems to reward individuals on the post tax performance of their department, allocating the capital allowance deduction on a specific vehicle to a department is difficult and time consuming, if indeed it is possible at all..

As such the employee has no motivation to choose the car which gives an optimal deduction for their employer and even if they were aware of it, might not be motivated by the knowledge in any event

1.7 Corporate social responsibility (CSR)

Many companies consider environmental issues and in the absence of other commercial factors will choose the optimal result environmentally as part of their social responsibility.

In this case the decision is typically a ‘moral’ one – the company as part of its strategy wishes to buy environmentally friendly vehicles in order to present an appropriate marketing image. The company at this point will however choose between different environmentally friendly cars – not between high and low emission vehicles. As such the impact of the allowance will be reduced or nil (since the environmentally friendly cars will all have similar allowances available.)

Although it is not yet compulsory, many more companies are choosing to disclose details of the CSR plans in their annual accounts.

1.8 Company advertising / image
Where commercial necessity forces a company's choice or car the tax impact will have only a minimal effect on purchasing decisions if any. For example, a Mercedes dealer will equip all its staff with Mercedes cars; a builder will choose a vehicle based on durability and haulage ability, etc)

2 Overview of environmental taxation of vehicles.

2.1 Current position
Current environmental taxation regarding cars:

1. Surtax on oil producing companies: directly impacted by fuel economy.
2. Fuel duty on petrol / diesel: directly impacted by fuel economy.
3. VAT on petrol and diesel: directly impacted by fuel economy.
4. Benefit in Kind ("BIK") rules: currently based on emissions.
5. Road fund licence: currently based on emissions.
6. Congestion charges; low emission vehicles may be exempt.
7. Subsidies for bus / train / planes
8. Subsidy for conversion to LPG, bio-fuels.

Is it really necessary to add another tax motivator and would the environmental impact of a further targeted tax outweigh the additional complexity in the tax system?

Consideration could also be given to the following:
- 1-3 could be consolidated into a single fuel duty to reduce compliance costs
- 4 is highly effective on motivating employees to choose 'green' vehicles but has no impact on other taxpayers nor on car usage
- 5 is an optional tax – estimates of the number of unlicensed cars on Britain's roads range up to a million such vehicles, further the licence cost is of significance only to low income individuals, the more wealthy who acquire extremely inefficient vehicles (luxury or high performance cars and sports utility vehicles) barely notice the additional licence cost. Cars which have been converted to dual fuel benefit from relief even though large SUVs may largely rely on petrol option.
- 6 can have a significant impact on access to local businesses.
- 7 must be balanced against usage and accessibility of services and various overseas treaties (i.e. EU law on government subsidies).
- 8 tends to have a direct impact on the items on which subsidies are given but can discourage others - Particulate filters cost £500 and trap most of the soot and other particulates produced by diesel engines but attract no subsidy and are therefore often seen as 'expensive'.

2.2 Petrol vs Diesel: Fuel Duty and particulate filters.
Diesel engines are inherently far more effective than petrol engines (up to in the region of 40% efficiency as opposed to 27%). Fuel duty is higher for diesel however to reflect the higher particulate output of diesel cars. New innovations in exhaust filters can trap most of these particulates resulting in a far more efficient cleaner engine than a petrol engine of comparable power.

A filter costs in the region of £500 for a car. There are no tax incentives or government grants for fitting a filter, and no requirement to do so in new cars. Further the additional fuel duty on diesel is not waived where a filter is in place. The higher fuel duty on diesel encourages the use of petrol vehicles and therefore is counter-productive from a CO_2 emission point of view.

Alternative taxation methods

Corporation Average Fuel Economy (CAFE)

CAFE is an environmental tax that was highly effective (if politically unpopular) in California. This is a sur-tax on the car manufacturer based on the mpg of cars sold compared to the 'average' fuel economy. As CAFE only affects the car manufacturer it is relatively simple to apply.

i.e.: 1,000 cars sold @ (30 target average mpg – 29 achieved average mpg) * average 10,000 miles *£0.01 charge per gallon = £100,000 sur-tax.

A downside is that the charge has little effect on manufacturer that sell a large number of 'ok' vehicles and a small number of luxury vehicles.

Low mileage specific vehicle levy (LoMSVeL)

In this case a 'fine' is added to the price of cars dependant on fuel economy. For example when a distributor sells a 'green' vehicle no levy is charged. When a fuel inefficient vehicle is sold a duty of, say, £1,000 is payable by the seller. The exact LoMSVeL charged on the car sold could be based on the existing benefit in kind bands to reduce the red tape aspect.

As the LoMSVeL would directly impact the cost of the vehicle (to both companies and individuals) it would have a direct impact on purchasing decisions. A downside is that the LoMSVeL could be seen (and would likely be presented as such by the vendors) as a tax on the consumer.

This LoMSVeL is different to the CAFE in that it is charged on individual sales, not globally and that it takes no account of other vehicles sold. The distributor cannot therefore 'green out' by selling an environmentally friendly vehicle to reduce their charge. CAFE had little impact for example on Ford which sells a large number of 'average' mileage vehicles and only a small number of extremely low mileage vehicles, but did strongly impact Ferrari.

Similarly if the CAFE was charged on the distributor rather than the manufacturer they can discount or ‘bundle’ green cars (a Prius for the wife with your BMW sir?) with low mileage vehicles to avoid the charge.

Whether this ability to balance is a positive or negative step is difficult to determine, although if considered desirable a more complex levy system could offer a (non-refundable?) negative ‘levy’ on very low emission vehicles.

Both of the above options have a low compliance cost as they target the relatively small number of manufacturers / distributors of cars, not on the much larger number of car users.