Modernising tax relief for business expenditure on cars: a consultation update

March 2007

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Contents

1 Introduction

1.1 The Government published a consultation document in March 2006[1] on "Modernising tax relief for business expenditure on cars", including a partial Regulatory Impact Assessment.

1.2 Businesses currently face restrictions on the extent to which they are allowed to get tax relief for expenditure on cars costing more than £12,000. These "expensive car" rules have been identified by business as an area that would benefit from reform.

1.3 In brief, the Government indicated it was considering abolishing the current rules for restrictions on capital allowances for "expensive cars" and introducing new rules that would be simpler to administer and would also have a beneficial environmental focus.

1.4 **This document provides an update to the 2006 consultation document by refining the Government's preferred option and inviting further views from business. Comments should be received by 16 May 2007.**

Summary

1.5 A good level of response has been received to the March 2006 consultation document. Over the Summer, the Government will publish a summary of the responses made to the 2006 consultation document and to this update, together with its formal response to the consultation as a whole and a revised Regulatory Impact Assessment. It will also publish draft legislation with a view to further discussion with stakeholders.

1.6 This document provides an update on the Government's proposal for reform, reflecting consultation and policy development to date. It sets out a refinement to the Government's preferred option for:

- capital allowances; and
- the lease rental restriction.

1.7 It also sets out a number of other issues and next steps.

[1] Modernising tax relief for business expenditure on cars: A consultation document. This is available at http://www.hm-treasury.gov.uk/budget/budget_06/other_documents/bud_bud06_odcars.cfm

2 Options for reform

2.1 This chapter outlines the Government's preferred option for reforming the current rules and considers it against its stated aims, taking into account responses from business received since the publication of the 2006 consultation document.

The current rules

Capital allowances

2.2 Businesses receive capital allowances for their expenditure on cars in a variety of ways depending on a car's price, carbon dioxide (CO_2) emissions and use. In particular, there are special rules for cars that cost over £12,000, which affect the timing of relief given. For these cars, as long as the car is not a qualifying hire car (mainly day hire cars or cars leased to the disabled), or a qualifying car with very low CO_2 emissions (up to 120 grams per kilometre (g/km)), the expenditure is put into a single asset pool for each individual car. The writing-down allowances are calculated in the normal way and then restricted to an annual amount not exceeding £3,000 per car.

Lease rental restriction

2.3 There is also a related restriction on the amount of car lease rental payments that businesses can offset against profits for cars costing more than £12,000.

Problems with the current rules

Compliance costs

2.4 From the consultation with stakeholders, it is clear that businesses see the current rules as imposing a disproportionate compliance burden, requiring them to keep separate capital allowance computations for each "expensive car" they own, identifying when the car has been purchased and disposed of.

Outdated

2.5 Furthermore, the principle behind the "expensive car" restriction is outdated. The distinction between expensive and non-expensive cars so defined does not reflect: the reality of today's car market, given that over 50 per cent of the entire car population is now classed as "expensive" under this definition; or the Government's wider environmental concerns.

Distortions

2.6 Business considers that the lease rental restriction (paragraph 2.3) introduces a distortion in the business car market. Business also considers that the effects of the lease rental restriction may be viewed as particularly harsh when a car is leased through a chain of businesses, as the restriction applies to every lease in the chain.

Aims of the reform

2.7 The case for change was set out in the March 2006 consultation document, which stated the Government's aims for reform. Those aims centre upon:

- **Reducing compliance costs** – which currently include the cost of tracking cars in the accounts at an individual, rather than aggregate, level.
- **Consistency with environmental objectives** – the Government has a goal of moving towards a 20 per cent reduction in CO_2 emissions by 2010 and a number of measures have been pursued in the transport sector, which provide a framework of tax incentives to promote the switch to cars with lower CO_2 emissions.
- **Consistency with sound public finances and the Government's fiscal rules.**

2.8 It is the objective of the Government to ensure any possible reform package strikes an appropriate balance between these aims.

DISCUSSIONS SINCE THE 2006 CONSULTATION DOCUMENT

2.9 The 2006 consultation document set out the following options for reform, based on the abolition of the "expensive car" restriction and its replacement with one of the following regimes:

1. Treatment of expenditure on cars in the general plant and machinery capital allowances pool. It was pointed out, however, that this option would be inconsistent with the Government's environmental and fiscal objectives (paragraph 2.7).

2. Treatment of expenditure on cars in a new pool with a lower writing-down allowance than that of the general plant and machinery pool. It was considered, however, that this option would also run counter to the Government's environmental objectives.

3. Treatment of expenditure on cars in a new pool alongside a range of first-year allowances based on CO_2 emissions.

Government's preferred option (Option 3)

2.10 The Government's preferred option for reform at the commencement of the consultation exercise was for a range of first-year allowances for cars, which would be based on a car's CO_2 emissions. The balance of unrelieved expenditure would be taken to a new pool with writing-down allowances at a lower rate than the general pool. Writing-down allowances would be given thereafter yearly on a reducing balance basis. By linking the rate of allowances to CO_2 emissions, the third option would help to advance the Government's environmental aims.

Consultation exercise to date

2.11 The Government has been consulting on the options set out above and is grateful that the exercise has stimulated a good level of response, clarifying the trade-offs linked to the various options. In particular, it has been necessary to weigh the environmental benefits against the administrative burden of any new tax structure; the balance naturally turns on the design of the option.

2.12 The Government has sought to assess the extent to which a tax relief based on CO_2 emissions would influence car purchase decisions. Businesses consider that the tax regime is one of many factors (alongside, for example, price, employee choice, prestige etc.) that affect their car purchasing and leasing decisions. Stakeholders emphasised that the deregulatory benefits of the reform should be maximised by avoiding a long range of allowance rates and bandings, and invited the Government to present further design detail. In light of the responses, the Government has refined its preferred option, which is set out below.

REFINEMENT OF THE GOVERNMENT'S PREFERRED OPTION

2.13 A key design parameter of this option is the number of rates and corresponding CO_2 bands. A general message from responses has been that if the Government decides to take forward an environmental option then, in order to maximise the compliance cost savings: the bandings should be kept to a minimum; and should be consistent with recognisable precedents in the tax system. A preference was expressed for the Vehicle Excise Duty bandings.

Capital allowances

2.14 The Government has listened carefully to the responses from stakeholders and has refined its preferred option as follows:

- Retain the existing 100 per cent first-year allowance for cars with CO_2 emissions up to 120g/km;
- Utilise the general plant and machinery capital allowances pool for cars with CO_2 emissions between 121 and 165g/km; and
- Introduce a new pool, with a lower writing-down allowance than that of the general plant and machinery pool, for cars with CO_2 emissions above 165g/km.

2.15 The Government believes that such a proposal could reduce the administrative burden of identifying, tracking, computing and checking business expenditure on "expensive cars". The proposed option limits the number of rates that business would have to identify. It also ensures that the value of the allowance across the CO_2 range represents a significant percentage of the typical car's price in order to provide an incentive towards the purchase of cars with lower CO_2 emissions. In particular, the option utilises the existing general plant and machinery capital allowances pool for many cars as a means of reducing compliance costs.

2.16 Noting responses received so far, the Government welcomes supplementary views on the refined option for capital allowances. It would appreciate any evidence business can provide that would help quantify the compliance time and cost savings in relation to identifying, tracking, computing and/or checking business expenditure.

Lease rental restriction

2.17 The 2006 consultation document indicated that the Government is considering abolition or reform to the lease rental restriction for "expensive cars". The Government has been considering the possibility of reform that addresses business' concerns about the possibly distortionary aspects and compliance costs of the current rules while being consistent with its fiscal and environmental objectives. Furthermore, in moving the tax deduction onto a CO_2 emissions basis, the Government believes that it is appropriate to reflect the CO_2 bands proposed for capital allowances purposes.

2.18 In line with the Government's aims for reform, an option would be to:

- Abolish any lease rental restriction for all cars with CO_2 emissions up to 165g/km, permitting the full allowance of leasing payments against the profits of businesses leasing those cars; and
- Apply a uniform fixed percentage disallowance on all the leasing payments that businesses can offset against profits for all cars with emissions above 165g/km.

2.19 By reforming the lease rental restriction to a fixed percentage disallowance for cars with higher CO_2 emissions and having no restriction for other cars, the proposal seeks to limit computational requirements and reduce compliance costs.

2.20 The Government is still considering the position with regards to chains of leases.

2.21 Noting responses received so far, the Government welcomes supplementary views on the refined option for the lease rental restriction. It would appreciate any evidence business can provide that would help quantify the compliance time and cost savings in relation to identifying, tracking, computing and/or checking business expenditure.

Summary **2.22** The option described above is intended to meet the stated aims of the reform. It should reduce the compliance costs of the current tax treatment for business cars in a way that would be consistent with the Government's wider fiscal and environmental objectives, and could go further in delivering environmental benefits. It therefore represents the Government's preferred option.

OTHER ISSUES

2.23 There are certain other issues connected with the Government's preferred option. These are:

- The question of whether and how to include **cars that are currently exempt** from the existing capital allowance restrictions in any reform.
- The treatment of expenditure, incurred by the **self-employed**, on cars which are used partly for business and partly for non-business purposes.
- The treatment of **diesel cars**.

2.24 Noting responses received to the consultation so far, the Government welcomes supplementary views on the Government's refined option in relation to any or all of the above issues.

3 NEXT STEPS

3.1 The Government has refined its preferred option, taking into account the responses from business.

FURTHER CONSULTATION AND FOLLOW-UP

3.2 A number of responses have been received to the March 2006 consultation document. **Noting those responses, the Government welcomes supplementary comments on the refined option set out. It would appreciate any evidence business can provide that would help quantify the compliance time and cost savings in relation to identifying, tracking, computing and/or checking business expenditure.**

3.3 Over the Summer, the Government will publish a summary of the responses made to the 2006 consultation document and to this update, together with its formal response to the consultation as a whole and a revised Regulatory Impact Assessment. It will also publish draft legislation with a view to further discussion with stakeholders.

CONTACT POINT

3.4 Comments are invited on the matters set out in this document. If you have any comments on the issues above or more generally on the content of this document, or if you have any technical queries then please send them to:

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Telephone (Treasury switchboard): 020 7270 5000

3.5 **Comments should be received by 16 May 2007.**

DISCLOSURE OF RESPONSES

3.6 Information provided in response to this document, including personal information, may be published or disclosed in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004).

3.7 If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals, amongst other things, with obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances.

An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on the Department.

3.8 If you have any queries concerning confidentiality or FOI then queries should be directed in the first instance to Janice Houghton at the above address.

3.9 This document is available electronically at www.hm-treasury.gov.uk/consultations. You may also photocopy it if you wish or additional hard copies may be ordered, free of charge, from the HM Treasury Correspondence and Enquiry Unit by email to ceu.enquiries@hm-treasury.gov.uk or by telephone on 020 7270 4558.

3.10 The Government's Consultation Code of Practice is attached at Annex B.

A REVISED PARTIAL REGULATORY IMPACT ASSESSMENT

A.1 This revised partial Regulatory Impact Assessment (RIA) summarises many of the arguments contained in the main body of this document. **It is intended to build on the partial RIA of March 2006, adding commentary with respect to the refinement of the Government's preferred option. It should be read alongside the 2006 partial RIA, included in the 2006 consultation document.**

A.2 In addition, it highlights areas where the Government intends to carry out further analysis through discussions with business, in order to inform policy decisions and the full RIA.

PURPOSE AND INTENDED EFFECT

A.3 The purpose and intended effect of the reform is set out in the partial RIA of March 2006.

CONSULTATION

A.4 There were a number of responses to the 2006 consultation document. In general, business recommended that, further detail on the design of the Government's preferred option would be valuable in taking consultation forward (Options 1 and 2, were better understood given their simpler structure).

A.5 In light of the consultation, the Government has refined its preferred option and has therefore also revised its partial RIA.

A.6 Over the Summer, the Government will publish a summary of the responses made to the 2006 consultation document and to this update, together with its formal response to the consultation as a whole and a revised Regulatory Impact Assessment. It will also publish draft legislation with a view to further discussion with stakeholders.

OPTION 3: REFINEMENT OF THE GOVERNMENT'S PREFERRED OPTION

A.7 This revision to the RIA is based on the refinement of the Government's preferred option (Option 3). For Options 1 & 2, the March 2006 partial RIA stands as a current assessment.

Current rules

A.8 From the consultation with stakeholders, it is clear that businesses see the current rules as imposing a disproportionate compliance burden, requiring them to keep separate capital allowance computations for each "expensive car" they own, identifying when the car has been purchased and disposed of. This process requires businesses to:

- identify the acquisition cost of a car;
- decide on whether to include or exclude it from the general plant and machinery pool, with vehicles costing more than £12,000 having to be allocated into a tracking process;
- restrict the writing-down allowance to £3,000 per annum on a reducing basis, which has to be calculated individually;

- apply this figure to offset the amount against taxable profits;
- retain and check supporting documentary evidence; and
- record and identify on disposal the sale price in order to calculate whether a balancing charge or allowance is generated to be adjusted against taxable profit for the tax year.

A.9 The Government estimates that the administrative burden of conducting those activities for capital allowances is approximately £10 million per annum, affecting 750,000 businesses. This figure acts as a broad baseline estimate.

A.10 With respect to the lease rental restriction, a similar set of compliance activities as outlined above is required for businesses leasing "expensive cars". The level of restriction is computed for each car by applying a formula based on the car's acquisition cost (identified, for example, by requesting a copy invoice from the leasing company) and the £12,000 threshold, to the car's particular lease payment.

All sectors and groups affected

A.11 The proposed reforms would impact on all sectors that purchase cars, and would therefore impact on a vast number of businesses. The impacts would be greatest for businesses that operate large vehicle fleets. They would also potentially impact on all sectors that construct, develop and sell cars as the environmental incentives could change businesses' purchasing behaviour.

A.12 As discussed in the 2006 partial RIA, the impact of the options on unincorporated business owners, who also use business cars for private purposes, will be more limited. The preferred option for the lease rental restriction would: benefit significantly all firms that lease cars with CO_2 emissions up to 165g/km by abolishing all the administrative requirements associated with the current system. It would also benefit, to a lesser extent, those business purchasers of cars with CO_2 emissions above 165g/km by reducing computational requirements.

Benefits

A.13 The Government's preferred option seeks to reduce the costs of the activities listed above whilst introducing environmental incentives. **The Government intends to use the consultation period up to 16 May 2006 to gather supplementary evidence on the potential benefits the preferred option would bring to businesses.**

Economic

A.14 The Government's preferred option seeks to reduce compliance costs for businesses purchasing cars with CO_2 emissions up to 165g/km by allowing those cars to be treated in the same way as most other plant and machinery in the general pool. For those cars, this option shares the significant compliance costs savings attached to Option 1 of the 2006 consultation document, apart from the need to identify the CO_2 emission of the car (see section on "costs" below).

A.15 For cars with CO_2 emissions above 165g/km, the Government's preferred option removes the requirement to track individual cars once their CO_2 emission has been identified, although cars would still need to be identified when they are disposed of in order to allocate the disposal proceeds to the correct pool. The rate of writing-down allowance for these cars would be set to ensure the overall package achieves the Government's public finance and deregulatory objectives.

A.16 With respect to the lease rental restriction, abolition of the restriction for cars with CO_2 emissions up to 165g/km achieves significant compliance cost savings by abolishing all the requirements to compute and apply a restriction, and check and retain the supporting documentary evidence. For cars with CO_2 emissions above 165g/km, the preferred option aims to reduce the computational requirements associated with the lease rental restriction formula by replacing the current formula with a uniform fixed percentage rate of disallowance.

Environmental **A.17** The Government's preferred option has the potential to deliver environmental benefits by linking the rate of writing-down allowance treatment for expenditure on cars to their CO_2 emission. This should act as an appropriate incentive towards the purchase of cars with lower CO_2 emissions around 165g/km range, where the key boundary sits. It is difficult to predict the impact on CO_2 emissions accurately, given the wide range of factors that influence car purchasing and leasing decisions. However, the Government's preferred option chimes with the other forms of vehicle taxation.

A.18 Furthermore, since it is proposing to reform the capital allowances rules to a CO_2 emissions basis, the Government believes that it is appropriate to adopt a similar framework for the lease rental restriction. This would act to maintain and support the environmental signals within the leasing market. The rate of disallowance for cars with CO_2 emissions above 165g/km is still being considered within the overall reform.

Costs

Economic **A.19** For the Government's preferred option, there would be one-off, though in some cases sizeable, costs to businesses from changing their systems to cope with the new rules, e.g. learning the rules, upgrading software, staff training etc. For cars with CO_2 emissions above 165g/km, the benefits of pooling would be partly offset by the need for businesses to set up a new capital allowance pool, and the resulting required changes to tax computation software. **The Government intends to use the consultation period to gather supplementary evidence on the potential compliance time and/or costs, based on the design of the preferred option.**

A.20 Under the preferred option, businesses will be required to identify the CO_2 emission of the car they purchase. The company car taxation scheme already requires businesses to keep records of vehicle CO_2 data and the information is readily available from the V5C vehicle registration certificate. Therefore, moving to a CO_2 based regime should not impose any more than minimal information retrieval and record keeping obligations.

A.21 Since the consultation process commenced, the Government's preferred option has been refined to maximise the possible compliance cost savings available under a CO_2 based regime by:

- keeping the number of bands and rates to a minimum; and
- aligning the thresholds with the Vehicle Excise Duty bandings, which represent a recognisable precedent in the tax system.

A.22 Moving away from the current system would also help to future-proof the regime, which could be modified over time to keep it aligned with the CO_2 fiscal incentives being utilised under the company car tax and Vehicle Excise Duty regimes.

Environmental **A.23** As this option would seek to create incentives towards the purchase of cars with lower CO_2 emissions it would not create any environmental costs.

Small firms impact test

A.24 Please see the partial RIA of March 2006.

Competition assessment

A.25 Please see the partial RIA of March 2006.

Enforcement, sanctions and monitoring

A.26 None of the proposed options are likely to require any further resources to secure compliance.

Summary

A.27 A number of responses have been received to the March 2006 consultation document.

A.28 Noting responses received to the consultation so far, the Government welcomes supplementary views regarding the refined option and would **appreciate any evidence business can provide that would help to quantify compliance time and cost savings identified in this revised partial RIA**.

A.29 Over the Summer, the Government will publish a summary of the responses made to the 2006 consultation document and to this update, together with its formal response to the consultation as a whole and a revised Regulatory Impact Assessment. It will also publish draft legislation with a view to further discussion with stakeholders.

Contact point

A.30 Enquiries relating to this RIA should also be addressed to:

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A.31 **Comments should be received by 16 May 2007.**

B THE GOVERNMENT'S CONSULTATION CODE OF PRACTICE

B.1 Consult widely throughout the process, allowing a minimum of 12 weeks for written consultation at least once during the development of the policy.

B.2 Be clear about what your proposals are, who may be affected, what questions are being asked and the timescale for responses.

B.3 Ensure that your consultation is clear, concise and widely accessible.

B.4 Give feedback regarding the responses received and how the consultation process influenced the policy.

B.5 Monitor your department's effectiveness at consultation, including through the use of a designated consultation co-ordinator.

B.6 Ensure your consultation follows better regulation best practice, including carrying out a Regulatory Impact Assessment if appropriate.

CONTACT POINT

B.7 The Government confirms that these consultation criteria have and will continue to be followed. Any complaints or enquiries concerning this consultation should be addressed to:

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