

Introduction

20.1 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, which were originally introduced in 1961 as a surrogate benefits charge on luxury cars, have been identified by business as an area that would benefit from reform. As a result the Government announced in the 2004 Corporation Tax (CT) Reform Technical Note¹ that it was appropriate to consider options for modernisation. The Technical Note also explained that, while the main aim of any reform would be deregulatory, it was important that any reforms were consistent with wider government objectives on the environment and on maintaining sound public finances.

20.2 Since then the Government has been looking in more detail at possible options, taking account of initial business responses to the 2004 Technical Note (a summary of the responses is provided in Annex A), and has published a consultation document entitled “Modernising tax relief for business expenditure on cars” alongside Budget 2006². This consultation document sets out the results of this work and, outlining criteria for assessing possible options, uses these to develop the Government’s preferred option.

20.3 The purpose of the consultation document is to seek business views on the Government’s preferred option. In particular, on the extent to which it would reduce the compliance costs associated with the current regime, and modernise the regime in a way that supports the Government’s wider objectives. A summary of the questions asked by the consultation document are contained later in paragraph 20.42.

20.4 This Partial Regulatory Impact Assessment summarises many of the arguments and conclusions contained in the main body of the consultation document. 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 Regulatory Impact Assessment.

Purpose and Intended Effects of the Measure

The Policy Objectives

20.5 The aim of the reform is to modernise the existing tax rules that restrict tax relief on business expenditure on cars costing more than £12,000 (the “expensive car rules”) in a way that reduces associated compliance costs whilst ensuring consistency with the Government’s wider objectives on the public finances and the environment.

Background

20.6 A full description of the current regime is set out in Chapter 2 of the consultation document. In summary, there are special rules for calculating capital allowances on cars that cost more than £12,000:

¹ This is available at: www.hmrc.gov.uk/pbr2004/sup-ct-reform-tech-note.pdf

² Details on how to obtain a copy of this consultation document are set out in paragraph 1.39

- the car is not included in the general plant and machinery pool but accounted for separately in an individual pool;
- the writing down allowances are restricted to a maximum annual amount of £3,000; and
- when the car is disposed of, a balancing charge or allowance is likely to be generated.

20.7 There are also related restrictions on the amount of car rental payments that businesses can offset against profits for cars costing more than £12,000.

Rationale for Government Intervention

20.8 From businesses' responses to the 2004 Technical Note, and from wider discussions, it is clear that Businesses have three main problems with the current rules:

- the separate calculation of capital allowances for each "expensive" car and the resulting need to track all such cars imposes a significant compliance burden on businesses;
- the rules are outdated: The benefit in kind element of the provision of company cars are more effectively captured through the personal company car tax rules, and the value of £12,000, above which cars are deemed to be expensive, has not been changed since 1992; and
- the rental restriction is much more restrictive than the capital allowance restrictions, and introduces a tax distortion between cars that are purchased and cars that are leased.

20.9 In response, the Government announced that it was appropriate to consider options for modernisation that addressed these concerns.

Consultation

20.10 These issues were first raised in the 2004 CT Reform Technical Note. A summary of responses is provided in Annex A.

Options

20.11 The Government has considered three options for reforming the current capital allowance rules for cars:

Option 1

20.12 Abolish the current restrictions and treat all cars in the same way as most other plant and machinery in the general pool.

Option 2

20.13 Introduce a new car pool for all cars with a writing down allowance of less than 25 per cent.

Option 3

20.14 Introduce a new car pool for all cars with a writing down allowance of less than 25 per cent, and a range of first year allowances for cars depending on CO2 emissions. This is the Government's preferred option.

20.15 In addition, the Government is willing to revisit the lease rental restriction, but Exchequer constraints mean this could only be achieved as part of an overall package.

20.16 All these options attempt to meet the reform objectives by changing the tax regime, as this is the source of the compliance costs. Non-tax measures were not considered, as they would not achieve this reform objective.

Costs and Benefits

Sectors and Groups Affected

20.17 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.

20.18 As discussed later, the impact of the options on unincorporated business owners, who also use business cars for private purposes, may be more limited. The possible removal of the lease rental restriction would benefit all firms that lease "expensive" cars.

Benefits

20.19 As outlined in the Consultation Document the Government intends to use the consultation period to gather more evidence on the potential benefits the preferred option would bring to businesses, and would be grateful for any assistance commentators can give in this area. This information will then be used to inform a final decision.

Economic

Option 1

20.20 Of all the options considered Option 1 offers the most significant compliance cost savings. It means there would be no difference between the calculation of capital allowances for "expensive" cars and most other plant and machinery. Cars would therefore be included in the general capital allowance pool and there would be no need to track "expensive" cars for tax purposes.

Option 2

20.21 Option 2 would also deliver compliance cost savings as it also removes the need to track individual "expensive" cars for tax purposes. These benefits would be partly offset by the need for businesses to set up a new capital allowance car pool, and the resulting required changes to tax computation software, although these costs are unlikely to be significant.

20.22 Option 2 also has the benefit that the rate of writing down allowance of the car pool can be set to ensure the option does not result in Exchequer costs, which is also an objective of the reform. However, as the focus of the consultation document is on the basic framework of the various options, and not on possible allowance rates, it is not possible at this stage to produce Exchequer costings.

Option 3

20.23 As with Option 1 and Option 2, the main economic benefit of Option 3 comes from the reduction in compliance costs associated with the current regime, as it removes the need to track individual “expensive” cars for tax purposes. Although businesses would need to identify each car’s CO2 emissions when they are purchased, in order to calculate the appropriate first year allowance, many businesses already have to do this for their company car tax calculations. It is unlikely therefore that this aspect of the option would offset the more substantial compliance cost savings that come from pooling. This option would also significantly reduce the size of the tax return computations.

20.24 As with Option 2, Option 3 also has the economic benefit that the rate of writing down allowance of the car pool and the first year allowances can be set to ensure that the option does not result in Exchequer costs.

Environmental

20.25 Of the three options considered only Option 3 has the potential to deliver any environmental benefits. By linking the rate of first year allowances to CO2 emissions this option would tie-in with other forms of vehicle taxation, and the Government’s wider environmental objectives. Moreover, the option would produce tax incentives for businesses to purchase cars with lower CO2 emissions, which may influence car purchasing behaviour. However the impact on CO2 emissions is hard to predict accurately, given the wide range of factors that influence car-purchasing decisions.

Costs

Economic

Option 1

20.26 Over the first 5 years, the removal of the restriction on capital allowances could reduce tax revenues by around £750 million. This option would therefore run counter to the Government’s fiscal objectives.

Options 2 and 3

20.27 The tax rates and allowances within Options 2 and 3 could be set such that they avoided the additional Exchequer costs described above.

20.28 All the options would involve one-off costs to businesses from changing their systems to cope with the new rules, e.g. learning new rules, upgrading software, form filling, staff training, etc... The Government intends to use the consultation period to gather more evidence on these potential one-off compliance costs.

Environmental

Options 1 and 2

20.29 Option 1 and 2 would both result in cash flow benefits for expensive cars, which tend to have higher CO2 emissions. These options would therefore be inconsistent with recent reforms to other forms of vehicle taxation, which have attempted to use the tax system to incentivise drivers to purchase cleaner cars. They could possibly result in some environmental costs, although these are extremely difficult to quantify given the lack of evidence on the extent to which capital allowances influence car purchasing decisions.

Option 3

20.30 As this option would incentivise the purchasing of more environmentally friendly cars it would not create any environmental costs.

20.31 The Government intends to use the consultation period to gather more evidence on the magnitude of the potential costs that would be incurred by options 1 & 2.

Small Firms Impact Test

20.32 The main compliance benefits from the lead option come from moving “expensive cars” from being treated individually to being treated in a single pool. However self-employed car owners, who partly use their cars for private purposes, have to keep separate pools for any assets that are used for non-business purposes in order to make the necessary private use adjustments. It is therefore unlikely that they will see a reduction in their compliance burden.

20.33 However from the environmental perspective there would still be a clear case for including the self-employed in these reforms to incentivise the purchasing of cleaner cars. Also to the extent that self-employed individuals and other unincorporated businesses (e.g. partnerships) provide cars for their employees, or own cars they do not use privately, those unincorporated businesses would enjoy the same compliance cost savings as companies would from the preferred option for reform.

20.34 As outlined in the Consultation document the Government intends to use the consultation period to gather extra information on the impact these proposals would have on self-employed individuals and other unincorporated businesses and would be grateful for any assistance commentators can give in this area.

Competition Assessment

20.35 A competition filter test was applied to these options.

20.36 It is expected that vehicle manufacturers are most likely to be affected by reforms to the capital allowances regime for cars. However options 1 and 2 are unlikely to raise competition concerns for UK customers, despite the business fleet market being highly concentrated. Rather reform would result in the equal treatment of all business cars for capital allowances purposes as the current restrictions, limiting the amount of allowance available by car price and financing method, would be removed in both cases.

20.37 Option 3 is similar in design to the reforms to company car tax introduced in April 2002, pegging (company car) tax to CO2 emissions. The latter was selected as a

case study in a report commissioned by the Department of Trade and Industry on competition issues in the automotive sector. The report concludes that: "...given the size of the industry, the ongoing nature of R&D activities, the impact of the voluntary agreement and the short product lifecycles, it is unlikely that manufacturers' long term ability to compete will be significantly threatened by the reforms. We suggest, therefore, that the reforms to company car tax are unlikely to raise a competition concern for UK customers."

20.38 We believe that the conclusions of the report are also valid for Option 3.

Enforcement, Sanctions and Monitoring

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

Summary and Recommendation

20.40 In summary the Government has been considering a range of options for modernising the current restrictions on relief for expenditure on business cars to address the concerns raised by business, whilst ensuring consistency with the Government's wider objectives on the public finances and the environment.

20.41 The analysis summarised in the Partial Regulatory Impact Assessment suggests that modernisation can be best achieved by introducing a new car pool for all cars with a writing down allowance of less than 25 per cent, and a range of first year allowances for cars depending on CO2 emissions. The Government is also willing to revisit the case for abolishing or modifying the lease rental restriction, but only as part of an overall package.

20.42 The main purpose of the consultation document is to seek views on the Government's preferred option. In particular, the Government would be grateful for views on and any assistance businesses or others can give in estimating:

- The extent to which the Government's preferred option offers compliance cost savings compared with the current rules. In particular, the Government would appreciate any detailed evidence business can provide that would help quantify the size of the compliance cost savings;
- 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 current Vehicle Excise Duty bands or based on a variant of the company car tax bands?
- The effect the environmental incentives could have on businesses' car purchasing strategies;
- The extent to which changing the Lease Rental Restriction rules, so that they only applied to the first lessee or only to the final end user of a leased vehicle, would reduce market distortions and reduce compliance costs?
- Whether the compliance cost benefits for the self-employed car owner, who is subject to the private use adjustment rules, would be more limited than those for unincorporated businesses that are not subject to those rules and for companies?

- Whether, for those self-employed who only have cars that they partly use for private purposes, these measures would act as a sufficient incentive to buy cars with low CO2 emissions?

20.43 The consultation document is available electronically at www.hm-treasury.gov.uk/consultations.

20.44 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 telephoning: 020 7270 4558.

Annex A: Responses to the Cars Element of the 2004 Technical Note

A.1 Of the responses received, 50 commented on the proposals for capital allowances and cars including the leasing restriction.

Context of the Technical Note

A.2 The Technical Note offered the opportunity to look at the current rules for giving capital allowances on cars and at the leasing restriction that apply where businesses lease cars with an original market value of more than £12,000.

A.3 The Technical Note did not give any specific options but floated the idea of pooling the expenditure but with a rate of writing down allowance less than 25 per cent, or considering some form of environmentally based reform.

A.4 The Technical Note outlined a number of issues and asked respondents one specific question namely: “What are the views of business on the possible options for the reform of “expensive” cars?”

Compliance Burden

A.5 Without exception all respondents who commented agreed that the current rules were due for reform. A significant number of the respondents said that the current regime imposes a significant administrative burden on businesses, and that the current compliance burden was disproportionate. There was a consensus that any measure to reduce the compliance burden and simplify the capital allowance treatment of cars costing more than £12,000 was to be welcomed.

Pooling

A.6 There was a wide disparity of views on how the current regime for giving capital allowances should be reformed.

A.7 A number of the respondents argued that there was no longer a need to distinguish between the purchase of a car and the purchase of any other business asset qualifying for capital allowances and all expenditure on cars should be taken to the general pool (and so get 25 per cent writing down allowances).

A.8 A number of the respondents welcomed the idea of a single pool for expensive cars. A few went as far as suggesting a reduced rate of writing down allowance.

A.9 Some respondents suggested that if there was a need to keep the current rules then the threshold should be raised to reflect the real cost of an expensive car under present economic conditions.

Environmental Option

A.10 Business had reservations about environmentally based reforms. The main reason given for the lack of support was that it was thought that by necessity this would be more complicated.

A.11 Some respondents also said that the environmental options were unlikely to actually deliver any environmental benefits.

A.12 Those that did think there was scope for an environment-based approach suggested various ways this could be done:

- Using a first year allowance for green cars, which could be an administratively simple inducement;
- Having separate pools with differing rates for cars within given CO2 emission bands; and
- A permanent disallowance on expenditure where the car had emission levels above certain levels.

Leasing Restriction

A.13 A significant number of respondents suggested that the leasing restriction was an unnecessary distortion and should be scrapped.

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