

Modernising tax relief for business expenditure on cars: A consultation document

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HM TREASURY



HM Revenue
& Customs

**Modernising tax relief for
business expenditure on cars:
A consultation document**

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INTRODUCTION

1.1 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.

1.2 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). This consultation document sets out the results of this work. It outlines criteria for assessing possible options, and uses these to develop the Government’s preferred option.

1.3 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.

SUMMARY

1.4 This document:

- explains how the current rules operate and the case for changing them;
- explains what the Government is trying to achieve with the reform and sets out criteria against which options can be assessed; and
- outlines a range of options, before setting out the Government’s preferred option.

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

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THE CURRENT RULES

Capital allowances **2.1** Businesses receive capital allowances for their expenditure on cars in a variety of ways depending on a car's price, carbon dioxide (CO₂) 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 CO₂ emissions (below 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. When the car is disposed of, a balancing charge or allowance may be generated to bring the total allowances given in line with the actual depreciation suffered.

2.2 Cars that cost less than £12,000 and qualifying hire cars are treated in the same way as most other plant and machinery and accounted for in a general pool with a writing down allowance of 25 per cent a year on a "reducing balance basis". Cars with very low CO₂ emissions qualify for 100 per cent first year allowances, regardless of cost.

Private Use **2.3** Some business cars have an element of private use. For employees earning more than a certain amount (whether employees of companies or of unincorporated businesses), this benefit in kind is taxed under rules known as the "company car tax rules". For the self-employed who own and use a car for mixed business and private purposes, capital allowances are restricted to the part of the car's value that corresponds to the proportion of total annual mileage attributable to business use. This means that, for each car a self-employed person uses privately, the business has to make a separate capital allowances calculation, followed by the appropriate private use adjustment. (Alternatively the self-employed may claim a mileage allowance, but in that case they cannot claim capital allowances.)

Rental restrictions **2.4** There are also related restrictions on the amount of car leasing payments that businesses can offset against profits for cars costing more than £12,000. Unlike the capital allowance restriction, which has only a timing effect, this restriction partially disallows relief on a proportion of leasing rentals of expensive cars.

PROBLEMS WITH THE CURRENT RULES

2.5 From businesses' responses to the 2004 Technical Note, and from wider discussions, it is clear they perceive that the main problems with the current system are almost entirely associated with the special treatment for cars over £12,000 (the "expensive car" rules). Businesses' main concerns with these rules are that they:

- impose high compliance costs;
- are outdated; and
- discriminate against leased cars and so may distort financing decisions.

Compliance costs 2.6 Business has often indicated that the “expensive car” rules impose a disproportionate compliance burden. As described in paragraph 2.1, unlike most plant and machinery, businesses are required to keep separate capital allowance computations for each “expensive” car they own, identifying when the car has been purchased and disposed of. For large businesses, the list of “expensive” cars separately tracked in this way can number hundreds. As a result, the “expensive car” computations are often the single largest component of the entire tax computation. There are similar compliance cost issues for the lease rental restriction.

Outdated 2.7 The current rules were introduced in 1961 as a surrogate benefits charge on luxury cars. The value of £12,000, above which cars are deemed to be expensive, has not been changed since 1992 when it was raised from £8,000. As a result business feel the distinction between expensive and non-expensive cars has become increasingly outdated; under this definition around 50 per cent of the entire car population is now classed as “expensive”, including models that are widely regarded as middle-range cars.

2.8 The context in which the rules operate has also changed considerably over recent years. The benefit in kind element of car ownership is now largely addressed through the company car tax regime, which was reformed in 2002 to provide additional incentives for individuals to use cleaner vehicles.

Distortions 2.9 It is possible that the rental restriction (paragraph 2.4) also introduces a distortion in the business car market. As mentioned above, the capital allowance restriction is only a timing issue, whereas the restricted rent deduction for “expensive” leased vehicles is a permanent disallowance. This may distort a business’s decision on whether to purchase or lease a vehicle.

2.10 In addition 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. That is, if a car is leased through multiple businesses to an end user, the restriction will apply to each firm. Some respondents to the 2004 Technical Note suggested that this restriction may particularly deter smaller businesses from entering the car hire market, as they may not have the capital to purchase cars outright and are therefore more likely to be subject to the lease rental restriction.

THE AIM OF THE REFORM

2.11 Because of the concerns identified above, the Government has been considering options for modernising the current regime. In particular it has been developing options that attempt to meet the following criteria:

- **reduced compliance costs** – the compliance costs associated with the current regime largely result from the fact that every year businesses have to track each “expensive” car they own in order to make the necessary capital allowance calculations. This tracking is not required for other assets, which are generally pooled and accounted for at a much more aggregated level. The options that will deliver the greatest compliance cost savings will tend to be those that remove this need to track individual cars;

- **consistent with environmental objectives** – the Government has an obligation under Kyoto to reduce greenhouse gas emissions by 12.5 per cent on 1990 levels by 2008-12, and a domestic goal of moving towards a 20 per cent reduction in CO₂ emissions by 2010. Over the past five years the Government has pursued a wide range of measures to help meet this target, including in the transport sector, which is the second largest source of CO₂ emissions in the UK. These measures have included reforms to Company Car Tax and Vehicle Excise Duty, which have provided a framework of tax incentives to promote the switch to cleaner vehicles. A key criterion for the options being considered is that they are consistent with this framework and support the Government's environmental objectives; and
- **remain consistent with sound public finances and the Government's fiscal rules.**

3

OPTIONS FOR REFORM

3.1 This chapter outlines three possible options for reforming the current rules and considers them against the criteria set out in Chapter 2. It also takes account of the responses to the initial high level options contained in the 2004 CT Reform Technical Note.

OPTION 1: STRAIGHT ABOLITION

3.2 Some respondents to the 2004 Technical Note suggested that the current restrictions on capital allowances should simply be abolished. Although this option would reduce compliance costs, it would clearly go against the other two objectives set out above. Straight abolition would result in significant cash flow benefits for “expensive” cars, which tend to have higher CO₂ emissions. There would therefore be gains for these cars in terms of the net present value of tax allowances which would run counter to recent reforms to other forms of vehicle taxation that have attempted to use the tax system to incentivise drivers to purchase cleaner cars. It would therefore be inconsistent with the Government’s wider environmental policy aims.

3.3 Moreover this option would be inconsistent with the Government’s fiscal objectives. In particular, over the first 5 years, the removal of the restriction on capital allowances could reduce tax revenues by around £750 million. This factor, together with the environmental impacts described above, means the Government is not attracted to taking this option forward.

OPTION 2: NEW CAR POOL

3.4 As indicated in the 2004 Technical Note, the adverse Exchequer consequences of the straight abolition option could be mitigated by introducing a new specific car pool with a lower writing down allowance than the current 25 per cent rate available for general plant and machinery. In order to deliver worthwhile compliance cost savings, cars that cost less than the current £12,000 threshold would also need to be included in this car pool, otherwise businesses would still need to track individual cars to ascertain which pool the proceeds should be subtracted from once the car is sold.

3.5 However, as with Option 1 above, this option would still be inconsistent with the Government’s wider environmental objectives. It would increase the cash flow advantages for the most expensive cars that tend to have higher CO₂ emissions, and would decrease allowances for most less expensive cars that tend to have lower CO₂ emissions. This option could therefore actually increase the number of higher emission cars being purchased by business.

3.6 The Government has therefore been exploring further options that would retain the compliance cost savings offered by pooling, without risking environmental costs. Options initially considered but then rejected, included having multiple car pools, each with a different rate of writing down allowance depending on a car’s CO₂ emissions, or retaining some kind of capping mechanism for very expensive cars. These options were not taken forward as they would retain the need for businesses to continue to track individual cars for tax purposes, which would largely or wholly negate any compliance cost savings.

OPTION 3: POOLING WITH FIRST YEAR ALLOWANCES

3.7 One option, which would appear to deliver all of the Government's criteria for reform (paragraph 2.11), would be to:

- introduce the single new car pool as described in option 2; and
- in addition introduce a range of first year allowances depending on a car's CO₂ emissions.

3.8 This option builds on the existing 100 per cent enhanced capital allowance for cars with CO₂ emissions below 120 g/km, and was suggested by some respondents to the 2004 Technical Note. It would also meet the primary aim of delivering compliance cost savings for businesses because it would remove the need to continually track individual cars for tax purposes. Although businesses would need to identify the car's CO₂ emissions in the year of purchase in order to calculate the appropriate first year allowance, many companies already have to do this for a number of purposes, including their company car tax calculations. It is unlikely therefore that this would offset the more substantial compliance cost savings that would come from pooling. This option would also reduce the size of the tax return computations.

3.9 By linking the rate of first year allowances to CO₂ emissions, this option would also help to advance the Government's environmental objectives. For example, if the first year allowances ranged from 100 per cent for cars with the lowest CO₂ emissions, downwards to rates significantly lower than the current writing down allowance of 25 per cent for cars with the highest CO₂ emissions, then the first year tax advantage from switching to cleaner cars could represent a significant percentage of the car's price. The impact over future years would be smaller, because of the pooling mechanism, but could still be significant. This option could therefore potentially influence car-purchasing decisions and generate environmental benefits.

3.10 A significant design parameter of this option would be the number of first year allowance rates and corresponding CO₂ bands. A key message from the responses to the 2004 Technical Note was that if the Government took forward an environmental option then, in order to maximise the compliance cost savings, this should be as simple as possible. In particular if the option involved various capital allowance rates, depending on a car's CO₂ emissions, then there should be as few rates as possible.

3.11 The tax system already has precedents regarding the number and corresponding ranges of CO₂ bands that can be used to calculate tax liabilities. For example:

- the Vehicle Excise Duty (VED) system;
- the "Green Car Label" scheme, which uses the VED bands for a new energy-efficiency style vehicle labelling scheme; and
- the company car tax regime.

3.12 One option therefore would be to match one or other of the existing banding systems. Alternatively the existing company car tax bands could be consolidated into a smaller set of capital allowance bands solely for the purpose of calculating the first year allowances. Finally an entirely new banding structure could be adopted.

Government's Preferred option **3.13** In conclusion, the pooling with first year allowances option (option 3) would seem to meet all the criteria set out above for assessing possible reforms. It should reduce the compliance costs associated with the current tax treatment of business cars in a way that would be consistent with the Government's wider fiscal and environmental objectives, and could potentially go further by delivering environmental benefits. It therefore represents the Government's preferred option.

3.14 The Government would therefore appreciate businesses' views on:

- 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? and
- the effect the environmental incentives would have on businesses' car purchasing strategy.

THE LEASING RESTRICTION

3.15 As mentioned in paragraph 2.4, the current leasing restriction represents a reduction in the relief available, whereas the capital allowance restriction is only a timing issue. As such the leasing restriction could potentially distort a business's financing decisions. It also represents a significant compliance cost.

3.16 The Government is prepared to consider the possibility of abolishing the lease rental restriction as part of an overall reform package. However it is estimated that this would result in a significant Exchequer cost of around £100 million per year.

3.17 The Government is therefore also considering the possibility of reform to the current rules to reduce their potential distortionary effect and compliance costs with an acceptable level of cost to the Exchequer. Possible options would be for the lease rental restriction to apply only to the first lessee, or only to the last end user in a chain of leases, rather than at every level of a leasing chain. **The Government would welcome businesses' views on the impact such changes would have on reducing the perceived distortions in the market and on reducing compliance costs.**

OTHER ISSUES

3.18 There are two other issues connected with the Government's preferred option that have not been addressed in the analysis above. These are:

- the impact on self-employed car owners who use their cars for business purposes and could still be subject to compliance costs of the private use adjustment rules (paragraph 2.3); and
- the implications for cars that are exempt from the current capital allowance restrictions.

Private use and the self-employed **3.19** 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.

3.20 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.

3.21 The Government would welcome views on these issues, especially on:

- **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? and**
- **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?**

Exempt cars **3.22** A number of qualifying cars are exempt from the current “expensive” car restrictions; historically on the grounds that they were unlikely to be provided as a luxury benefit in kind. These exempt cars include cars for the disabled, the daily hire market and taxis. As indicated in the 2004 Technical Note, in developing possible alternative capital allowance regimes for business cars, it would be necessary to consider if any changes have implications for cars that fall into this area. For example, a first year allowance scheme could offer significant tax benefits if the users purchased cars that were significantly environmentally cleaner than the norm. However, whilst this could be attractive for providers of cars for the disabled where the typical holding period is in excess of three years, the issues for the daily hire sector, where holding periods rarely exceed nine months, would need careful consideration.

3.23 The Government is still considering whether, and how, currently exempt cars should be involved in any reform package. The Government would value the views of businesses on this area and intends to discuss these issues in more detail during the consultation period.

SUMMARY OF POINTS ON WHICH THE GOVERNMENT REQUESTS COMMENTS:

3.24 The Government would welcome views generally on the ideas discussed in this chapter and specifically on the following points:

- **the extent to which the Government’s preferred option (paragraph 3.13) 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. (paragraph 3.8);**

- 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? (paragraph 3.10);
- the effect the environmental incentives could have on businesses' car purchasing strategies. (paragraph 3.9);
- 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? (paragraph 3.17);
- 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? (paragraph 3.19); and
- 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? (paragraph 3.20).

CONTACT POINT

3.25 Comments are invited on the matter 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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3.26 Comments should be received by 22 September 2006.

DISCLOSURE OF RESPONSES

3.27 Information provided in response to this consultation, 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).

3.28 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.

3.29 If you have any queries concerning confidentiality or the FOI then queries should be directed in the first instance to Priyen Patel at the above address

3.30 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.

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 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 environmentally-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.

B

PARTIAL REGULATORY IMPACT ASSESSMENT

INTRODUCTION

B.1 This Partial Regulatory Impact Assessment summarises many of the arguments and conclusions contained in the main body of this 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 EFFECT OF THE MEASURE

The policy objectives

B.2 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 Governments wider objectives on the public finances and the environment.

Background and introduction

B.3 A full description of the current regime is set out in Chapter 2 of this document. In summary, there are special rules for calculating capital allowances on cars that cost more than £12,000:

- 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.

B.4 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

B.5 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.

B.6 In response, the Government announced that it was appropriate to consider options for modernisation that addressed these concerns.

CONSULTATION

B.7 These issues were first raised in the 2004 CT Reform Technical Note. A summary of responses is provided in Annex A.

OPTIONS

B.8 The Government has considered three options for reforming the current capital allowance rules for cars:

- **Option 1** - Abolish the current restrictions and treat all cars in the same way as most other plant and machinery in the general pool;
- **Option 2** - Introduce a new car pool for all cars with a writing down allowance of less than 25 per cent; and
- **Option 3** - 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.

B.9 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.

B.10 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.

All sectors and groups affected

B.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.

B.12 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

B.13 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 B.14 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 B.15 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.

B.16 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 B.17 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.

B.18 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

B.19 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 B.20 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 & 3 B.21 The tax rates and allowances within Options 2 and 3 could be set such that they avoided the additional Exchequer costs described above.

B.22 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 & 2 B.23 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 B.24 As this option would incentivise the purchasing of more environmentally friendly cars it would not create any environmental costs.

B.25 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

B.26 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.

B.27 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.

B.28 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

B.29 A competition filter test was applied to these options.

B.30 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.

B.31 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.”

B.32 We believe that the conclusions of the report are also valid for Option 3.

ENFORCEMENT, SANCTIONS AND MONITORING

B.33 None of the proposed options are likely to require any further resources to secure compliance.

SUMMARY

B.34 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. 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.

B.35 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? and
- 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?**

B.36 This document is available electronically at www.hm-treasury.gov.uk/consultations. Alternatively 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.

CONTACT POINT

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B.37 Comments should be received by 22 September 2006

C

THE GOVERNMENT CONSULTATION CODE OF PRACTICE

- C.1** Consult widely throughout the process, allowing a minimum of 12 weeks for written consultation at least once during the development of the policy.
- C.2** Be clear about what your proposals are, who may be affected, what questions are being asked and the timescale for responses.
- C.3** Ensure that your consultation is clear, concise and widely accessible.
- C.4** Give feedback regarding the responses received and how the consultation process influenced the policy.
- C.5** Monitor your department's effectiveness at consultation, including through the use of a designated consultation co-ordinator.
- C.6** Ensure your consultation follows better regulation best practice, including carrying out a Regulatory Impact Assessment if appropriate.

CONTACT POINT

HMRC 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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