IT 2509 - Income tax : income tax and fringe benefits tax consequences of an employee leasing a car to an employer which is subsequently provided back to the employee

TAXATION RULING NO. IT 2509

INCOME TAX : INCOME TAX AND FRINGE BENEFITS TAX CONSEQUENCES OF AN EMPLOYEE LEASING A CAR TO AN EMPLOYER WHICH IS SUBSEQUENTLY PROVIDED BACK TO THE EMPLOYEE

F.O.I. EMBARGO: May be released

REF N.O. REF: 88/1608-5 DATE OF EFFECT: Immediate

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F.O.I. INDEX DETAIL

REFERENCE NO:	SUBJECT REFS:	LEGISLAT. REFS:
I 1211497	CAR FRINGE BENEFITS PROPERTY FRINGE BENEFITS ANTI AVOIDANCE PROVISIONS	FRINGE BENEFITS TAX ASSESSMENT ACT; SECTIONS 43, 50, 53, 67, 136
	ASSESSABLE INCOME ALLOWABLE DEDUCTIONS	INCOME TAX ASSESSMENT ACT; SECTIONS 19, 25, 26AAB, 51, 51AF, 51AH, 82KT

PREAMBLE Recently, articles have appeared in newspapers and business magazines describing what has been called "a company car plan" to beat fringe benefits tax. The plan is centred on a prestige car being provided for the private use of an employee. The provision of a car is a component of the employee's overall remuneration package with the employee being given the opportunity of eventually purchasing the car for a price well short of its actual market value.

2. The advertising material promoting the car plan suggests that employees should liaise with their car dealer as well as their employer and adopt the following steps:-

(a) With the assistance of the car dealer arrange a lease in their own name. The lease in the name of the employee would be a standard finance lease with a finance company.

(b) Having arranged for the finance company to purchase the car from the dealer and to lease it to the employee, the employee then goes to his or her employer and arranges a sublease of the car to the employer by means of a simple operating lease document.

(c) The employer then provides the employee with the exclusive use of the car.

3. The difference between the two types of leases is that the standard finance lease has a residual value and in practice the lessee is given the opportunity at the expiration of the lease

to purchase the car from the finance company for its residual value while an operating lease is simply a contract for the use of the car for a fixed term. It appears the car plan structured in this way raises the possible argument that the employer is not providing any benefit with respect to the opportunity to purchase the car because the employer is not a party to the finance lease.

4. As well as the straightforward dual lease arrangement outlined above there are two variations which have also been promoted. These variations are:-

(a) As consideration for the sublease, the employer pays the employee's obligations under the finance lease. The employer advises the leasing company that it (the employer) has agreed to sublease the car selected by the employee and that the arrangement forms part of the employee's remuneration and will subsist for the employee's period of employment during which the employer will assume the employee's obligations under the finance lease.

(b) A novation, where the finance lease between the leasing company and the employee is varied so as to create a tripartite contract with the employer which shifts the obligation to make lease payments from the employee to the employer and whereby the employee forgoes the right to receive rent under the sublease.

(c) An associate (a family member, usually the spouse) of the employee is a party to the finance lease and sublease instead of the employee.

5. When the employer enters into the sublease with an employee or an associate, the car effectively remains in the employee's hands at all times but it is claimed that it will be "held" by the employer for fringe benefits tax purposes and be "provided" to the employee as a car fringe benefit. The employer will have a fringe benefits tax liability based on the taxable value of the car fringe benefit as calculated using the statutory formula method.

6. The employer pays the consideration under the sublease either to the employee, associate or directly to the finance company and also reimburses all the expenses the employee incurs in relation to the car, e.g., any insurance, registration, petrol, repairs etc. These reimbursements would normally be subject to fringe benefits tax but it is claimed that as they relate to car expenses and are provided at the same time as the employer is paying fringe benefits tax on the car fringe benefit, they are exempt under section 53 of the Fringe Benefits Tax Assessment Act.

7. The promoters of the car plan also maintain that, under their plan the employer is not liable for fringe benefits tax on any benefit the employee obtains from being able to purchase the car for less than its market value at the expiration of the

lease, a benefit which the advertising material assumes the employee will obtain.

8. The claimed fringe benefits tax advantages are highlighted in the material promoting this car plan. An example is given of a prestige car worth $43,700, that after 3 years has a residual value of $20,300 compared with its market value of $39,300. If such a car is leased by an employer under a normal finance lease and the employer allows the employee to purchase the vehicle at its residual value, the employer has provided the employee with a fringe benefit having a taxable value of $19,000 i.e., the difference between the car's market value and the amount paid by the employee. The fringe benefits tax of $9,310 (49% of $19,000) is described as "unnecessary" because it can be avoided by using this car plan.

9. The purpose of this Ruling is to explain how the taxation laws apply to employers, employees and associates of employees who enter into this type of car plan.

RULING

10. The taxation implications for taxpayers who enter into this car plan can be summarised as follows:-

For the employer:

- income tax deductions will be allowable for the sublease rentals and for the cost of reimbursement of the employees' car running expenses.
- fringe benefits tax will be payable on the car fringe benefit.
- fringe benefits tax will be payable on the cost of reimbursement where, in addition to any consideration paid for the sublease, the employer also reimburses the employees' lease rentals.
- fringe benefits tax will be payable on the benefit the employee obtains by purchasing the car for less than its market value.

For the employee:

- any payments by the employer under the sublease will be assessable income of the employee, whether paid directly to the employee or to the finance company on the employee's behalf.
- the employee will not be entitled to any income tax deductions for any expenses relating to the leased car.
- where there is a novation of the finance lease and the sublease the employee will not be assessed on any sublease rentals and will not be entitled to any deductions for lease rentals.

For an associate of the employee:

- where an associate of the employee is a party to the finance lease and the sublease, the rentals paid under the sublease will be assessable income of the associate who will be entitled to claim deductions for rentals paid under the finance lease. However, where the employer has become legally liable to pay the rentals under the finance lease no deductions for such payments would be available for the associate.

- in certain circumstances the profit - calculated in accordance with section 26AAB of the Income Tax Assessment Act - made on the disposal of a car which had formerly been the subject of a lease, would be included in the assessable income of the associate.

TAX IMPLICATIONS FOR EMPLOYERS

11. Returning to the tax implications for the employer, income tax deductions would be allowable under subsection 51(1) of the Income Tax Assessment Act for consideration paid under the sublease and for the reimbursement of employee's car running expenses. Such expenses are incurred in relation to the provision of remuneration, in one form or another, to employees.

12. To the extent that the reimbursement of the car running expenses by the employer qualify as "car expense payment benefits" they are exempt from fringe benefits tax under section 53 of the Fringe Benefits Tax Assessment Act. A "car expense payment benefit" is defined in subsection 53(3) of the Fringe Benefits Tax Assessment Act as meaning an expense payment benefit where the recipient's expenditure is a "car expense". "Car expense" is defined in subsection 136(1) of the same Act as meaning an expense incurred in respect of registration, insurance, repairs, maintenance or fuel for the car. Accordingly, only the reimbursement of those expenses would be exempt fringe benefits. No exemption would be available for reimbursement of other expenses such as rental payments.

13. Where novation occurs, the finance lease between the leasing company and the employee is varied so as to create a tripartite contract with the employer which shifts the obligation to make lease payments from the employee to the employer and the employee forgoes the right to receive rental payments under the sublease. Novation is defined in Osborn's Concise Law Dictionary as,

> "A tripartite agreement whereby a contract between two parties is rescinded in consideration of a new contract being entered into on the same terms between one of the parties and a third party. A common instance is where a creditor at the request of the debtor agrees to take another person as his debtor in the place of the original debtor. It involves the substitution of one party to a contract by another person, and its effect is to release the obligations of the former party and to impose them on the new party, as in the case of a change in the membership of a

> partnership firm. The creditors of the old firm will usually be deemed to have accepted the new firm as their debtor by continuing to trade with the new firm as if it were identical with the old."

14. The employer would be allowed deductions under subsection 51(1) of the Income Tax Assessment Act for the lease payments and since there is no question of reimbursement where the employer assumes the liability to pay rent under the finance base, no fringe benefits tax liability arises in respect of the lease payments.

15. The employer will have to pay fringe benefits tax on the car fringe benefit provided to an employee and on the benefit the employee obtains from purchasing the car for less than its market value at the expiration of the finance lease. This latter benefit would be a property fringe benefit or alternatively a residual fringe benefit.

16. In the promotional material, this car plan is presented to employers and employees as one where an employee can choose the type of car he or she would eventually like to own, the employer assists by paying the consideration under the sublease in lieu of additional salary, the finance company agrees to the employer's involvement in the sublease and, because of industry practice, it is understood by all parties that the employee will be able to buy the car at its residual value at the expiration of the lease. Viewed in its totality this car plan is an arrangement to enable the employee as part of the overall remuneration package to obtain a car he or she wants at less than market value at the expiration of the lease.

17. The word "arrangement" is given a wide definition in subsection 136(1) of the Fringe Benefits Tax Assessment Act and means any agreement, arrangement, promise or undertaking whether expressed or implied and whether or not enforceable by legal proceedings and includes any scheme, plan, proposed course of action or course of conduct.

18. The provision of the car to the employee at the expiration of the lease is the provision of a benefit by the finance company under an arrangement to which the finance company and the employer are parties. The arrangement is properly attributable to the employment relationship and the benefit is therefore a fringe benefit. As the provision of a car is the provision of property the benefit is an "external property fringe benefit".

19. The taxable value of an external property fringe benefit valued under paragraph 43(c) of the Fringe Benefits Tax Assessment Act is the notional value of the car at the time the employee acquires it less the amount contributed by the employee. "Notional value" is defined in subsection 136(1) and means the amount the employee could reasonably be expected to have been required to pay to obtain the car from the owner under an arm's length transaction.

20. At the expiration of a lease the finance company can either lease the car again or dispose of it. Where the finance company decides to dispose of a car which has been subject to a normal commercial lease - as opposed to a hire purchase agreement - one would expect this to be done by inviting offers from the public at large (as happens at a public auction) and would expect the sale price to fairly reflect the market value. Therefore, the amount the employee could reasonably be expected to have to pay to obtain the car from the finance company under an arm's length transaction is the amount the employee would have to pay for the car at a sale open to the general public. The residual value under the finance lease does not equate with the amount a person could reasonably be expected to be required to pay to obtain the car from the owner under an arm's length transaction because the residual value has been set having regard to the amount of lease rentals paid over the period of the lease and is not an estimation of the market value at the end of the lease period.

21. Alternatively, it is considered that the employee has obtained a "residual fringe benefit" in being able to buy the car at less than market value. The word "benefit" in section 136(1) of the Fringe Benefits Tax Assessment act includes any right, privilege or facility. Where an employee takes advantage of an opportunity given to him or her directly or indirectly through the employment relationship to acquire a car for less than its market value, then that opportunity is a residual fringe benefit. The taxable value of the residual fringe benefit is the market value of the car less the amount paid by the employee which is its residual value under the lease (see paragraph 50(c) of the Fringe Benefits Tax Assessment Act).

22. If, contrary to the view expressed above, the arrangement is effective in avoiding the operation of paragraphs 43(c) or 50(c) of the Fringe Benefits Tax Assessment, the general anti-avoidance provision contained in section 67 would apply to the arrangement. The participation by the employee (or an associate) in the finance lease, the sublease and the provision of the car back to the employee are pre-ordained, related steps in the overall arrangement which has arisen in the employment context, specifically the negotiation of an overall remuneration package. The employee is being encouraged to accept the provision of a car instead of additional salary and while this is acceptable where the only tax effect is that fringe benefits tax is payable instead of income tax, this is not the case here. The employer is fully aware of the overall arrangement and has expressly or impliedly consented to all the steps taken by the employee in implementing it. The manner in which the car plan is to be implemented is clearly designed to avoid the operation of the fringe benefits tax law, so that no tax whatever is paid by the employer or the employee on the benefit the employee obtains by purchasing the car for less than its market value. It can be fairly said in the circumstances of this arrangement that the dominant purpose is to avoid fringe benefits tax on that benefit.

TAX IMPLICATIONS FOR EMPLOYEES

23. Where novation of the finance lease and sublease does not occur the taxation consequence for an employee entering into this type of car plan is that any lease rentals he or she receives under the sublease are assessable income.

24. Where the employer is able to discharge the obligation to pay rentals under the sublease by making a payment direct to the finance company on the employee's behalf, assuming the sublease is not a sham and there is no novation, the payments are assessable income of the employee under sections 25 and 19 of the Income Tax Assessment Act. The payments are not expense payment fringe benefits because they are made under the contractual obligation to pay rental under the sublease.

25. The employee is not allowed any income tax deductions that he or she might incur on expenses that relate to the car. This is because of the application of sections 51AF and/or 51AH of the Income Tax Assessment Act.

26. Section 51AF of the Income Tax Assessment Act has application where, as in this case, the employer provides a car for the exclusive use of an employee. The section denies any deductions for expenses incurred by the employee in respect of "car expenses" that relate to the car provided. "Car expenses" in this context is defined in subsection 82KT(1) and includes lease rentals, depreciation, interest, registration, insurance, repairs, maintenance and fuel. Accordingly, the employee would not be able to obtain deductions for any expenses incurred that come within the definition of "car expenses", including deductions for any lease rentals paid under the finance lease with the finance company.

27. In the novation situation, the finance lease between the leasing company and the employee is varied so as to create a tripartite contract with the employer that shifts the obligation to make lease payments from the employee to the employer and whereby the employee foregoes the right to receive rent under the sublease. In these circumstances there is no assessable income in the form of lease payments derived by the employee nor is the employee entitled to any deductions under subsection 51(1) in respect of any lease payments.

TAX IMPLICATIONS FOR ASSOCIATES

28. Any lease rentals paid under the sublease to an associate (i.e., a family member, usually the spouse) would be assessable income of the associate. The associate would be entitled to income tax deductions for lease rentals paid under the finance lease and for any other car expenses paid unless such expenses were reimbursed by the employer, in which case section 51AH of the Income Tax Assessment Act would deny deductions.

29. Where an associate of the employee is a party to the lease arrangements and is allowed deductions for lease payments section 26AAB of the Income Tax Assessment Act must be considered. This section applies where the associate acquires the car at the expiration of the finance lease and subsequently

sells it for a profit. Section 26AAB provides for an amount to be included in the assessable income of the associate. The amount assessable is so much of the profit on the sale as does not exceed the lesser of the amount of depreciation that would have been allowable on a prime cost basis over the period of the lease or the amount of the deductible lease charges.

30. The fact that an associate enters into the leasing agreements does not alter any of the fringe benefits tax consequences for the employer. The employer remains liable to pay fringe benefits tax on the car fringe benefit, and on the benefit obtained by the associate purchasing, or being able to purchase, the car for less than its market value on the expiration of the lease. Under the fringe benefits tax provisions benefits provided to associates are treated the same as benefits provided directly to the employee.

31. On a general note, the discussions in this Ruling have proceeded on the basis that the financial lease arrangements with the financing or leasing companies are normal commercial leases. However, there are indications in the material promoting this car plan, especially in relation to the implied right of the lessee to purchase and the fixing of residual values, that the guidelines for leases being accepted as normal commercial leases for taxation purposes may not have been followed. The guidelines are fully set out in Taxation Ruling No. IT 28 as modified by Taxation Ruling No IT 2287. If the true nature of these so called financial leases are purchase and sale agreements rather than leases it would have consequences for the financing or leasing companies in the way in which they would be required to return assessable income derived from the agreements, particularly in relation to the operation of the trading stock and depreciation provisions.

COMMISSIONER OF TAXATION
17 November 1988