Porsche plans

What is the best way to acquire a car for a business? Jonathan Coletta and Debbie Bray explain the differences between outright purchase, hire purchase and finance leasing.

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Consider the situation where a sole trader needs a car to use in their trade. They have seen a nice new red Porsche Boxster that will fit the bill nicely and were about to pay £60,000 to buy the Porsche until their accountant mentioned that there were other ways of acquiring the Porsche which did not involve spending such a large amount of money up front. Now the sole trader is interested to know what these alternative methods are and how they compare – from a tax point of view – with buying the car, before making a final decision.

This is a very relevant topic for the ATT examinations and one which is frequently tested in paper 2 so let's have a look at the options and the tax consequences.

> "The rate at which tax relief is given on the cost of the Porsche is determined by the carbon dioxide emissions of the car."

Buying outright for cash

The sole trader spends £60,000 to buy the Porsche outright.

Their accountant will put the £60,000 cost into the balance sheet as a fixed asset (also known as a 'capital asset') and depreciate it and that depreciation charge will be disallowed for tax purposes. It makes no difference from an accounting point of view whether the business owner or one of their employees uses the car, the accounting treatment is the same.

From a tax point of view, relief is instead available for the £60,000 cost through capital allowances. We need to ask two questions to determine how those capital allowances are calculated:

- What are the carbon dioxide emissions of the Porsche?
- Who is going to use the Porsche?

The rate at which tax relief is given on the cost of the Porsche is determined by the carbon dioxide emissions of the car. If the car is electric with 0g/km of emissions, tax relief is available on the whole £60,000 cost in the accounting period of purchase as a 100% first year allowance (FYA) (see ***Car 1***).

If the car has emissions of between 1-50g/km, the £60,000 cost goes into the general pool (also known as the main pool) and tax relief is claimed through a writing down allowance (WDA) at 18% a year on a reducing balance basis (see ***Car 2***).

If, however, the car has emissions of more than 50g/km, the £60,000 cost goes into the special rate pool and the WDA claimed is 6% a year on a reducing balance basis, giving lower capital allowance claims each year (see ***Car 3***).

If the car is bought for the use of an employee, tax relief will be given on the whole cost of the Porsche over the period it is owned. It will not matter that the employee is likely to use the car for some private mileage because this does not affect the

Key points

- The trader can claim capital allowances on the cost of a car purchased outright.
- The rate of relief is determined by the car's carbon dioxide emissions.
- Private use by the sole trader reduces the tax relief available for the car however it is acquired.
- The extra cost of a hire purchase agreement is written off to the profit and loss account over the period of the agreement and allowed for tax.
- Unusually tax relief is given on the depreciation charge of finance leased assets.
- Tax relief for both finance leased and operating leased assets is restricted where there are high carbon dioxide emissions and where there is private use by the sole trader.

Car 1 – electric	FYA @ 100%	CAs claimed
	£	£
Year 1		
Addition – Car 1	60,000	
FYA@ 100%	(60,000)	60,000
Tax WDV c/f	nil	

Car 2 – carbon dioxide emissions 1-50g/km	General pool	CAs claimed
	£	£
Year 1		
Addition – Car 2	60,000	
WDA @ 18%	(10,800)	10,800
Tax WDV c/f	49,200	
Year 2		
WDA @ 18%	(8,856)	8,856
Tax WDV c/f	40,344	
		and so on

Car 3 – carbon dioxide emissions more than 50g/km	Special rate pool	CAs claimed
	£	£
Year 1		
Addition – Car 3	60,000	
WDA @ 6%	(3,600)	3,600
TWDV c/f	56,400	
Year 2		
WDA @ 6%	(3,384)	3,384
Tax WDV c/f	53,016	
		and so on

capital allowances available to the business. Instead, the employee will 'pay tax' on this private mileage by being assessed on a taxable benefit for the car included as part of their employment income in their income tax computation.

When this car is sold, the lower of the sale proceeds received and the original £60,000 cost will be deducted from the capital allowances computation to ensure that tax relief is only given on the net cost to the business of using the car. Bear in mind that if the car was given a 100% FYA on purchase the disposal will be dealt with through the general pool.

If the Porsche is instead being bought for the sole trader to use, the private mileage they incur will matter. A sole trader cannot be taxed on an employment benefit in respect of the car because they are not an employee, instead they pay income tax on the tax adjusted trading profits of their business. As they will use the car for private mileage as well as business mileage, the £60,000 cost must be kept in a separate 'private use asset' column within the capital allowances computation and only the business use percentage of the capital allowances can be deducted from trading profits each year. In other words, the private use restricts the capital allowances that are deductible.

Assuming the Porsche has carbon dioxide emissions of 90g/km and that the sole trader uses the car 70% of the time

Car 3 with private use	Private use car (carbon dioxide more than 50g/km)	Business use %	CAs claimed
	£		£
Year 1			
Addition– Car 3	60,000		
WDA @ 6%	(3,600)	x 70%	2,520
Tax WDV c/f	56,400		
Year 2			
WDA @ 6%	(3,384)	x 70%	2,369
Tax WDV c/f	53,016		

for business purposes, the capital allowances claimed would be £2,520 in year 1 and £2,369 in year 2. The reason that the tax written down value is reduced by the full writing down allowance each year is to ensure that no tax relief is ever given for the cost of using the Porsche for private purposes (see above ***Car 3 with private use***).

This time when this car is sold, the lower of the sale proceeds received and the original £60,000 cost will need to be deducted from the 'private use car' column and a balancing adjustment will arise.

This balancing adjustment could either be a positive number, known as a balancing allowance (if there is some cost remaining which has not yet received tax relief) or it could be a negative number, known as a balancing charge (if too much tax relief has been given and some of that tax relief needs to be clawed back on sale). Whatever the balancing adjustment is, again only the business use percentage of it would be taken across into the capital allowances column and used to adjust the trading profits.

> "A sole trader cannot be taxed on an employment benefit in respect of the car because they are not an employee."

Hire purchase

If the sole trader does not have a spare £60,000 to buy the car outright (and does not want to borrow the money from a bank), an alternative option would be to buy the Porsche through a hire purchase agreement. Here, the seller in effect lends the money to buy the car and charges interest on the loan.

Legally the car is the sole trader's at the end of the hire purchase agreement. This is important because it affects the tax treatment.

So, let's say the Porsche can be purchased by hire purchase by paying a deposit upfront of £10,200 followed by £1,800 a month for the next three years. The £60,000 car is now going to cost a total of £75,000.

Hire purchase	£
Deposit	10,200
Instalments (36 months x £1,800)	64,800
Total payable	75,000
Less: Cash price	(60,000)
Finance charge or interest expense	15,000
Finance charge of £15,000 spread over three year HP agreement	£5,000 a year

The extra cost is, in effect, a finance charge or interest of £15,000 which the accountant will write off to the profit and loss account over the three years of the hire purchase agreement and which is allowed for tax. See ***Hire purchase*** above.

The cash price of £60,000 will again go to the balance sheet as a fixed asset and the depreciation on this will again be disallowed for tax purposes. Instead, capital allowances are claimed on this cash price of £60,000 in the same way as we saw earlier for an outright cash purchase.

Bear in mind that if the sole trader uses the car and there is any private use, the private use percentage is also applied to the interest charged to the profit and loss account and this amount is also disallowed for tax purposes.

Finance lease

In simple terms, a finance lease looks very similar to an HP agreement – an upfront deposit is usually required followed by monthly instalments throughout the period of the finance lease agreement. The sole trader will use the car for most of its useful life and at the end of the finance lease will give the car back.

> “Technically with a finance lease the sole trader does not own the finance leased asset and never will.”

It is likely the sole trader will think the tax treatment of a finance leased asset must be the same as hire purchase as well. This is not the case. Technically with a finance lease the sole trader does not own the finance leased asset and never will.

The accountant will not worry about this legal difference between hire purchase and finance leases – they will treat the finance lease in the same way as hire purchase. The cash price of £60,000 will go onto the balance sheet as the cost of the car and be depreciated over the three year finance lease agreement. Let’s assume the depreciation charge will be £20,000 each year.

Finance lease	£
Finance lease depreciation £60,000/three years	20,000
Finance lease interest expense £15,000/three years	5,000
Total expense in profit and loss account each year	25,000

The total interest expense of £15,000 will again be written off to the profit and loss account spread over the same three year period.

In this article I will not discuss further why the accountant treats assets acquired by hire purchase and assets leased under finance leases in the same way; it is an accounting matter.

Unfortunately for tax purposes the fact that the sole trader never legally owns the car is important because it means that they cannot claim capital allowances on the car. So we have the unique situation where the sole trader is given tax relief on the finance lease depreciation charge instead of capital allowances in addition to the finance lease interest expense. See ***Finance lease*** above.

To further complicate matters, we still need to ask two questions to determine whether tax relief will be available for the whole finance lease depreciation charge and interest expense that has gone through the profit and loss account:

- What are the carbon dioxide emissions of the Porsche?
- Who is going to use the Porsche?

If the Porsche has carbon dioxide emissions of more than 50g/km we have to disallow 15% of the finance lease expenses that have gone through the profit and loss account. In the ***Finance lease*** example above that means an add back of £3,750 (15% x £25,000) would be required for tax purposes.

If the car is being used by an employee, any private usage would be ignored for the sole trader’s tax purposes.

However, if the sole trader uses the car for some private mileage we will need to adjust the amounts allowed for tax purposes further to ensure that no tax relief is given for the private use as shown in the computation below, ***Adjustments required***.

Adjustments required	£
Allowed for tax purposes = £25,000 x 85%	21,250
Added back in adjustment to profits = £25,000 x 15%	3,750
Emissions more than 50g/km and 70% business use by sole trader	
Allowed for tax purposes = £25,000 x 85% x 70%	14,875
Added back in adjustment to profits = £25,000 – £14,875	10,125

Leasing the Porsche through an operating lease

An operating lease is an accounting term and this type of leases tends to be used for short term leases – or what might be called renting assets. So, let's say we enter into an operating lease for the Porsche for ten months at a cost of £2,000 a month.

The accountant will simply put the rental expense of £20,000 (ten months x £2,000) through the profit and loss account (since we are not operating under international accounting standards).

As before, we need to determine whether tax relief will be available for the rental expense that has gone through the profit and loss account by again asking the following questions:

- What are the carbon dioxide emissions of the Porsche?
- Who is going to use the Porsche?

Operating lease	£
Allowed for tax purposes = £20,000 x 85%	17,000
Added back in adjustment to profits = £20,000 x 15%	3,000
Emissions more than 50g/km and 70% business use by sole trader	
Allowed for tax purposes = £20,000 x 85% x 70%	11,900
Added back in adjustment to profits = £20,000 – £11,900	8,100

If the Porsche has carbon dioxide emissions of more than 50g/km we have to disallow 15% of the rental expense resulting in an add back of £3,000 (15% x £20,000) for tax purposes.

Again, private use by an employee would be ignored for the sole trader's tax purposes but private use by the sole trader would result in a further adjustment to the amount allowed for tax purposes. See ***Operating lease***.

The rules we have covered would apply equally to a company considering whether to buy or lease a car, with one key difference – there are never any private use adjustments in the corporation tax adjustment of trading profits for a company irrespective of any private usage by the directors. Remember that a director's private use is taxed by including a car benefit in their employment income in their income tax computation.

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