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SALARY PACKAGING AND NOVATED CAR LEASES

Are they worth it?

Stuart Sheary

For employees who do not have enough money saved to buy a car outright there are a number of options. They can finance the purchase through a private loan, private car lease or via a novated car lease agreement.

Many employers provide the opportunity for their staff to include a novated car lease in their salary package. The following benefits of novated leases are often promoted:

- The benefit of having one known amount deducted from an employee's pay each month/week/fortnight, which includes the loan repayment amount and the costs of running the car, such as servicing, insurance and fuel.
- Car running costs are deducted from pre-tax income – effectively reducing an employee's taxable income, which may mean less personal tax.
- They can generate GST credits – which employers may choose to pass on to their employees.
- Lease providers can often obtain fleet discounts on the price of cars.

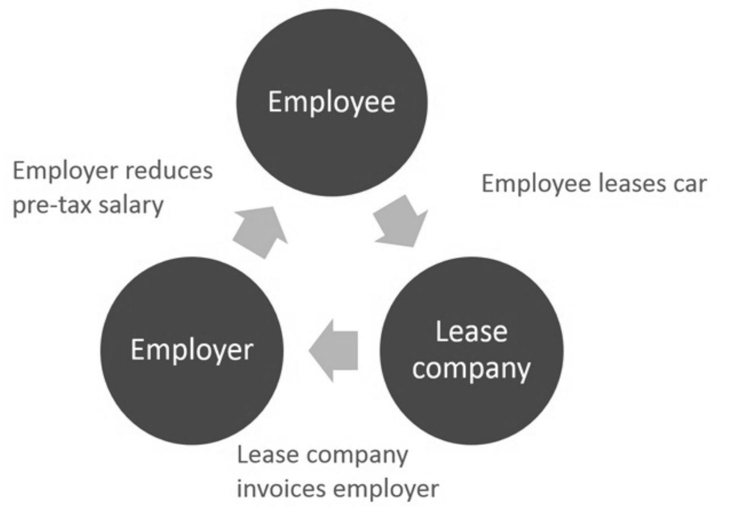
In this article we outline the benefits of novated leases, how they work and the possible tax benefits for your clients.

What is a novated lease?

A novated car lease allows a person to use a car owned by a lease company for an agreed lease period. The person will not own the car during the lease period but may have the option to purchase the car at the end of the lease period. This purchase typically requires a final lump sum residual payment as prescribed by the ATO. The lease company will often include in the lease payments the running costs, such as petrol, tyres, insurance and servicing.

A novated lease is a three-way agreement between the employee, the lease company and the employer – as shown in the diagram below. Rather than paying lease payments themselves, an employer may allow their employees to salary package novated lease payments. Under a novated lease the employer agrees to meet the car lease payments and obligations. The employer will reduce the employee's pre-tax salary by the amount of the lease payments and any associated fringe benefits tax (FBT) liability.

Figure 1.Novated car lease arrangement



The quote

Many employers provide the opportunity for their staff to include a novated car lease in their salary package.

Salary packaged car and fringe benefits tax

Employers who pay the novated lease expense may be liable for FBT. The formula for calculating fringe benefit tax is currently 47% x grossed up taxable value.

The taxable value is normally the cost of the benefit. The taxable value is grossed up by 2.0802 (which is the rate for a type 1 benefit, FBT year ending 31 March 2019) when the employer is entitled to claim back GST credits. When the employer is not entitled to claim back GST credits, the taxable value is grossed up by 1.8868 (which is the rate for a Type 2 benefit, FBT year ending 31 March 2019).

As an example, the FBT on a type 1 fringe benefit (i.e. the employer is entitled to claim back any GST credits) with a taxable value of $1,000 would be $978 (47% x 2.0802 x $1,000 = $978).

Methods for calculating the taxable value of a car fringe benefit

The taxable value of a fringe benefit is ordinarily the cost of the benefit. However, for car fringe benefits the taxable value might be less than the actual cost. The taxable value of a car fringe benefit can be calculated by two different methods, which are:

- The operating cost method, and
- The statutory method.

Under the operating cost method, the taxable value is the actual operating cost of the car during the FBT year multiplied by the percentage of private use. The taxable value may then be reduced dollar-for-dollar by any after-tax employee contribution towards costs. This method may be favourable if there is a low percentage of private use.

Under the statutory method, the taxable value of a car benefit is a portion of the cost price of the car in each FBT year during the leasing period. The taxable value is reduced by any after-tax contribution paid by the employee towards costs. This method can result in a dollar value of a car fringe benefit, such as a novated lease, incurring less FBT compared to non-car benefits of the same dollar value.

Example of using the statutory method for a novated lease

Let us assume an employee entered into a novated lease agreement on 1 April 2018 for a car costing $31,150, excluding registration and stamp duty.

Let us also assume the employee did not make any after-tax contribution towards costs. Using the statutory method, the formula for calculating the taxable value of the car is:

$$\textit{Taxable value} = \frac{A \times B \times C}{D} - E$$

Where		Amount
A	Base value of car (original cost price paid excluding registration and stamp duty)	$31,150
B	Statutory percentage (20% for agreements from 1 April 2014)	20%
C	Number of days in FBT when car was available for private use	365
D	Number of days in the FBT year	365
E	Number of days in the FBT year	Nil

In this example this formula results in a taxable value of $6,230, as shown below:

$$\textit{Taxable value} = \frac{31{,}150 \times 0.2 \times 365}{365} - 0$$

$$\textit{Taxable value} = \$6{,}230$$

Case study: Meghan

Meghan is considering getting a novated lease through her employer. Under the novated lease Meghan's employer will reduce her pre-tax salary by the lease costs plus any associated FBT.

Meghan obtains a quote from a novated lease company for a new Mazda CX-5 (Table 1).

Meghan gives this quote to Harry from her company's payroll department to confirm how much her after-tax salary will reduce by if she proceeds with the novated lease.

Meghan asks Harry to calculate a couple of options, including making an after-tax contribution equal to the taxable value of $6,230. Harry provides Meghan with a comparison of her different options (Table 2).

The company is entitled to claim back GST credits on packaged car expenses (type 1 benefit).

Table 1. Meghan's quote on a car lease

Variable	Amount
Purchase price (excluding stamp duty and registration)	$31,150
Annual kilometres travelled	20,000 KM
Item	**Annual cost (includes GST)**
Comprehensive car insurance	$1,430
Estimated fuel and tyres	$2,895
Estimated maintenance	$540
Registration	$880
Roadside assistance	$120
Subtotal – ongoing running costs	***$5,865***
Lease company management fee	$265
Annual finance payments (assuming a three-year lease period)	$8,200
Total costs	**$14,330**

Table 2. Comparison of FBT where an employee makes an after-tax contribution

	No employee contribution	Employee contribution
Taxable value	$\frac{31,150 \times 0.2 \times 365}{365} - 0$	$\frac{31,150 \times 0.2 \times 365}{365} - \$6,230$
	$6,230	$0
Grossed-up taxable value	$6,230 x 2.0802*	$0 x 2.0802
	$12,960	$0
Fringe Benefits Tax	47% x $12,960	47% x $0
	= $6,091	**= $0**

**Gross-up rate for type 1 benefit*

Harry has agreed to pass on any available GST credits to Meghan via a smaller reduction in pre-tax salary.

After taking into account any FBT and available GST credits, Harry estimates that the total cost to the company is as follows:

Table 3. Cost of car

	No employee contribution	Employee contribution
Cost	$14,330	$14,330
Less employee contribution	$0	$6,230
Cost (including GST)	$14,330	$8,100
GST credits (1/11 of cost)	$1,303	$736
Cost of car (excluding GST)	$13,027	$7,364
FBT (see Table 2)	$6,091	$0
Cost to employer	**$19,118**	**$7,364**

Meghan decides to compare the out-of-pocket cost of a novated lease with a private lease. Under a private lease she will meet all lease repayments using her after-tax money.

Meghan conducts an after-tax comparison between the options.

Table 4. After tax comparison

	No car	Private car lease	With packaging	Employee contribution method
Assessable income	$100,000	$100,000	$100,000	$100,000
Packaged car costs	$0	$0	$14,330	$8,100
Packaged car costs less GST	$0	$0	$13,027	$7,364
Fringe Benefits Tax	$0	$0	$6,091	$0
Taxable income	$100,000	$100,000	$80,882	$92,636
Tax and Medicare levy	$26,117	$26,117	$18,921	$23,135
After-tax costs or contribution	$0	$14,330	$0	$6,230
Net cash	**$73,883**	**$59,553**	**$61,961**	**$63,271**

Note: Based on 2018/19 tax rates (includes any available LITO and new LMITO)

The comparison reveals that Meghan's best option is to enter a novated lease and make an after-tax contribution towards costs of $6,230. This equates to a reduction in after-tax salary of $10,612 per year.

Meghan wonders whether leasing a car is worthwhile at all. She is thinking of simply getting a car loan. The money saved on lease payments could be spent on car expenses and loan repayments.

If we assume Meghan's ongoing car expenses relating to running costs are $5,865, then she may spend $4,747 on loan repayments and be in the same after-tax cash flow position as if she had entered a novated lease.

Table 5. Cash flow breakdown of a novated car lease and private car loan

	Employee contribution method	Private car loan
Assessable income	$100,000	$100,000
Packaged car costs (see table 4)	*$8,100*	*Nil*
Packaged car costs less GST	$7,364	Nil
Fringe benefits tax	Nil	Nil
Taxable income	$92,636	$100,000
Tax and Medicare levy	$23,135	$26,117
After tax costs or contribution	$6,230	Nil
Car expenses	Nil	$5,865
Car loan repayments	Nil	$4,747
Net cash	**$63,271**	**$63,271**

Under the novated lease agreement Meghan has the option of purchasing the car at the end of the three-year lease period for the ATO prescribed residual amount of $14,603 (46.88%).

If Meghan's outstanding car loan after three years is greater than what it would cost to purchase the car from the lease company, namely $14,603, which is the ATO prescribed residual amount, then Meghan would benefit by leasing the car. If the remaining loan after three years was less than $14,603, which is how much it would cost to purchase the car from the lease company after three years, she might benefit by borrowing the money.

Meghan finds a finance company that charges 6% interest, compounding monthly, on car loans. She also has the option of using her mortgage redraw facility. The interest rate on her mortgage redraw facility is 3.9%, compounding monthly.

Meghan intends to use the annual amount saved by not proceeding with a novated lease of $4,747, after car expenses of $5,865, on meeting her principal and interest repayments. She calculates the cost of her different options and discovers the following in Table 6.

Meghan finds that her total after-tax cost of running the car plus buying it outright after a three-year lease is $46,439. This compares favourably with borrowing and making a final lump sum repayment after three years to clear any remaining debt on either a car loan or on a mortgage redraw amount. If Meghan were to take out a car loan the total cost of running the car and owning it outright after three years would be approximately $53,552. Alternatively, if she were to redraw on her mortgage the total cost would be approximately $51,764.

Table 6 illustrates that a novated car lease will be approximately $7,113 cheaper compared to obtaining a car loan, at 6%, to purchase the car outright. A novated lease is also cheaper ($5,325) compared to financing the car purchase via a redraw facility assuming an interest rate of 3.9%.

Conclusion

When your clients want to buy a car, they should check with their employer as to whether they offer an option to salary package via a novated car lease. If a salary packaged novated car lease is an option they may want to obtain a quote and compare the after-tax cost of a novated lease with other funding options like getting a car loan or redrawing on a mortgage.

Please note the above case study is based on several assumptions. These assumptions may differ to those your client may be offered. Advisers should check with their licensee or their own license requirements or restrictions when assisting clients with novated leases. In addition, clients should speak to a qualified tax agent to confirm any tax implications arising from entering a novated lease agreement.

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Table 6. Total running costs and the cost to acquire the car after a three-year period

	Novated car lease		Car loan (6%)		Redraw facility (3.9%)	
	Year 1	**Year 3**	**Year 1**	**Year 3**	**Year 1**	**Year 3**
Lease						
After-tax cost of lease	$10,612	$31,836	Nil	Nil	Nil	Nil
Borrow						
After-cost running expenses	-	-	$5,865	$17,595	$5,865	$17,595
Loan repayments	-	-	$4,747	$14,241	$4,747	$14,241
Total			**$10,612**	**$31,836**	**$10,612**	**$31,836**
ATO residual value (after three years)	-	$14,603	-	-	-	-
Outstanding loan (after three years)	-	-	-	$21,716	-	$19,928
Total running costs and cost to acquire after three years		**$46,439**	**-**	**$53,552**	**-**	**$51,764**

Notes:

- *Interest compounded monthly*
- *Principal and interest loan repayments made monthly ($4,857/12)*
- *Annualised interest rates: car loan 6.168% and mortgage redraw 3.97%*