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Environmentally sound reform of tax exemptions for the private use of company cars

The most important results of the research project FKZ UM 08 45 731/02 including proposals for reform¹

A. Problem, aims and objectives

The coalition agreement of the current German Federal government, agreed on 26th October 2009, committed to reviewing "the appropriateness of the taxation of benefits in kind from the private use of company vehicles". The research project "Tax treatment of company cars in Germany", commissioned by the Federal Ministry for the Environment, Nature Conservation and Nuclear Safety, did not have the explicit task of fulfilling this mandate. Nevertheless, the results of the joint study by FiFo, Institute for Public Economics at the University of Cologne, the NGO Green Budget Germany / Forum Ökologisch-Soziale Marktwirtschaft e.V. and Stefan Klinski, professor of law in Berlin, nevertheless provides a comprehensive review of the issue. In addition to analyzing the *benefit in kind* of the private use of company cars, the investigation analyzes the tax regulations associated with their *purchase*. Both these aspects of the tax treatment of company cars must be considered to provide a comprehensive review of current tax treatment and relevant exemptions for private use of company cars.

Tax legislation in Germany provides for tax privileges for employees who are recipients of company cars in addition to their monetary income. These so-called benefits in kind are calculated using the so-called "1% method", which adds 1% of the car's list price (not the actual price paid) to an employee's taxable income each month. This calculation is very inaccurate and is too low to reflect the actual benefit received. Thus, the calculation of benefit in kind currently acts *de facto* as a tax subsidy with a strong influence on behaviour. This subsidy not only results in significant losses in tax revenues and social security contributions, but also incentivizes employees to drive fuel-inefficient vehicles as much as possible, and thus in turn effectively incentivises the emission of greenhouse gases.

¹ *Disclaimer:* While this research was commissioned by the Federal Ministry of the Environment, conclusions and recommendations described in this research do not necessarily represent the views or opinions of the Ministry.

Furthermore, it is more attractive for companies to provide a company car than to increase employee salaries, not least because no social security contributions are due on parts of income relating to company cars. As well, regulations for the depreciation of company cars are advantageous for companies, all the more so for the most expensive and thus on the whole the least efficient vehicles.

Current regulations not only create perverse incentives in relation to the way people approach their mobility and encourage disproportionate private use of company cars, they also subvert the principles of tax equity. In effect, German company car taxation rules mean that the same economic performance is taxed differently - those who receive their income in cash pay more tax than those who receive an equivalent income, with part of this income in the form of a company car. As company cars are far more common in high-income brackets than for those on low- or middle incomes, regulations also subvert the principle of tax equity between income groups, and high earners can make use of tax privileges rarely accessible for those on lower incomes.

Approximately 2.5 million passenger vehicles and their users are affected in Germany by these rules. As a result of the subsidy, in a typical year – which, because of the impact of the scrappage scheme, 2009 was not – about 60% of all new passenger cars are registered as company cars.

This research proposes changes in the way benefit in kind is calculated as taxable income, as well as changes to the rules for the depreciation for company cars. These changes are intended to improve both tax equity and fiscal neutrality. In addition, the existing environmentally harmful effects of the subsidy would be avoided. Thus, the proposed amendment would make a contribution to the climate protection goals of the Federal Government to reduce greenhouse gas emissions by 40% by 2020 – compared to 1990 levels – and to the plan to phase-out fossil fuel subsidies, as agreed at the G20 summit in Pittsburgh.

B. Reform proposals

The proposed solution takes existing points of taxation as its starting point - first, in relation to income tax, the rules for the calculation of benefit in kind resulting from the private use of the company car and second, the tax treatment of company cars on the part of the company itself.

The proposed changes should intervene in the existing system as little as possible. In particular, the administrative burden on taxpayers and tax authorities should not increase. However, where oversimplification of the system in the past has resulted in the greatest inaccuracies in terms of taxation, some degree of more sophisticated differentiation will have to be introduced.

B.1. Taxation of benefits in kind: combined benefit in kind for private use

In order to eliminate distortions and subsidies favouring private users of company cars, a new and realistic way of calculating benefit in kind must be devised. This will correspond to the benefit in kind derived from the private use of the company car much more accurately, as it will e.g. take into account kilometres driven for private use. The reform proposal will realise the principle of tax equity by ensuring that income of the same value is taxed equally, regardless of whether this income includes a company car or is a purely monetary – and correspondingly higher – salary. Such a regulation will also lead to neutrality in decision-making for taxpayers, because there will not longer be a tax incentive in favour of receiving income in the form of benefits in kind.

This will be implemented by calculating benefit in kind not only on the basis of existing lump sum calculation for car purchase price, but also by making an additional calculation to reflect benefit in kind relating to vehicle use. This new combined benefit in kind for private use will increase according to number of kilometres driven and specific fuel consumption, so that current incentives to include as much private driving as possible in benefit in kind - and thus to keep revenues from the Treasury - will be removed.

(a) Purchase component: The component related to the cost of purchase will no longer be based on the list-price, but on the actual price paid for the vehicle. The current proportion of the price used can be retained (i.e. 1% per month of the cost of purchase).

(b) Use-related component: An additional component of benefit in kind will encompass a percentage of the private, variable cost of using a vehicle, i.e. primarily the cost of maintenance and fuel. These costs mainly depend on two factors: distance driven and fuel consumption. These two parameters should be determined as simply as possible.

Distance driven: Relevant for the benefit in kind is the proportion of private distances in total mileage – not including travel to / from work. The latter is reported to the tax authorities in any case. From the remaining distance driven, 75% will be considered to be private use.² The only additional reporting requirement to the tax authorities is the annual total kilometres driven in the vehicle, requiring virtually no additional effort.

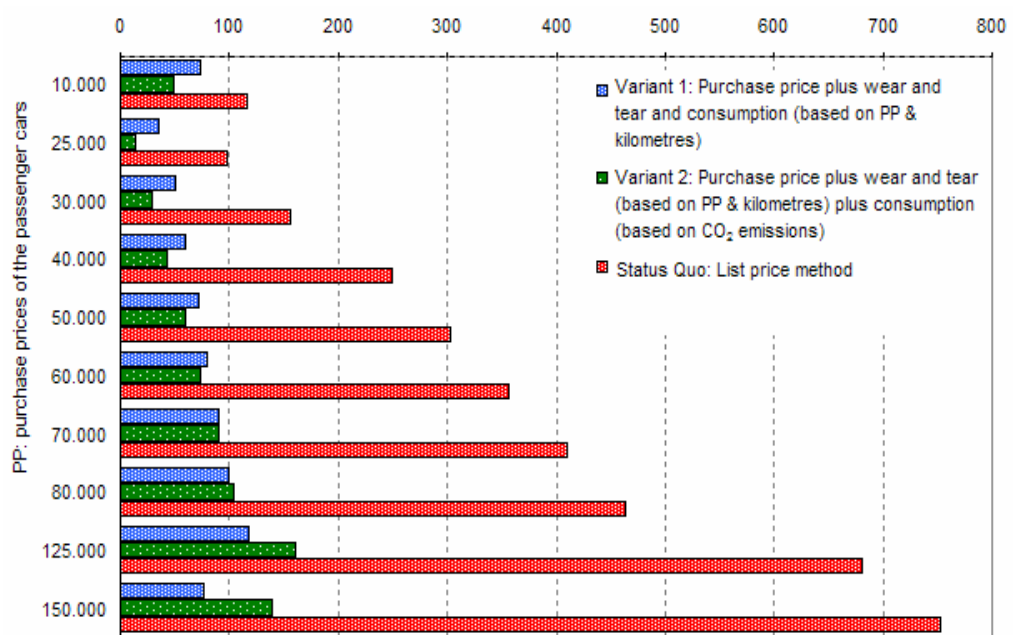
Fuel Consumption: Actual fuel consumption will not be recorded. The standard fuel consumption of each car on the road is known, as it relates to the specific CO₂ emissions in the vehicle registration document. With slight variation between diesel and petrol, these rapidly accessible and verifiable

² The option of recording all journeys in a log book would remain. If the share of private distance driven is significantly lower than the 75% used for calculations, then this option can prevent an excessive burden on the taxpayer.

emissions values allow for a simplified estimate of fuel costs per kilometre. In any case, the *explicit* inclusion of the fuel consumption in the calculation occurs only in the second of the two options for reform proposed for the component related to private use.

Option 1 (shown in blue in Figure 1, below) oversimplifies calculations more does not take into account fuel consumption based on CO₂ emissions. Though slightly easier to implement in a broad sense, this option requires special rules for those passenger cars which are disproportionately expensive to purchase due to their fuel-efficient design (e.g. electric vehicles). *Option 2* (shown green in Figure 1, below) explicitly includes CO₂ emissions, as well as a component related to wear and tear. The greater administrative effort in this second case pays off, inasmuch as no special regulations for electric or other vehicles would be necessary.

Figure 1 - Deviation from tax neutrality in Euro / Month



Both options were tested in extensive computer simulations and calibrated so that they clearly and accurately approximate a neutral and fair taxation of benefit in kind, as shown in Figure 1.³ The bars show how Option 1 (in blue)

and Option 2 (shown in green) deviate from tax neutrality between private use of a company and official use of a private car. The red bar shows deviation from neutrality in the system of company car taxation currently in place in Germany. Complete neutrality is impossible to achieve using methods based on estimates.

This approach to company car taxation could be a pragmatic way of reforming the existing system: The taxation of benefits in kind comes much closer to reality than the previous regulation, existing perverse incentives and subsidies are largely eliminated. The necessary method of calculation is un-

³ The X axis records deviation from tax neutrality in Euros / month. The Y axis records the vehicle purchase price.

complicated and the administrative burden is not significantly greater than before. As existing tax treatment is very damaging to the climate, the approximate provision of tax neutrality will already make a clear contribution to climate protection.

B.2. Taxation of the cost of purchase and fuel on part of companies: climate factor

The second point of taxation is the purchase of a vehicle by the company. The purchase price appears in the income and expenditure accounts as an item of expenditure, and thus reduces the company's taxable profits. How high the profit-reducing effect will be depends on the tax rate applicable to income or corporation tax. Sales tax benefits may also be taken into account. The current tax law for cars allows for the depreciation of company cars over a period of six years. From an ecological point of view, the main problem with the current system is that the relative advantages are particularly large when purchasing expensive vehicles which normally have above-average fuel consumption. This creates substantial incentives for buying precisely those vehicles which are highly detrimental to the environment – especially when they are also used for private purposes.

The proposal sets out to create a gentle but effective incentive to purchase company cars that produce lower greenhouse gas emissions. The incentive element therefore only comes into play at the time when a decision is made to use a particular vehicle model - i.e. at the time when the company makes a decision about which car to purchase. Thus, the specific climate protection target will be influenced (solely) on the basis of the deductibility of the purchase price and fuel costs.

Regarding the tax treatment of the purchase of passenger vehicles as company cars, a CO₂ element ("climate factor") will be introduced, as in the British model, which is oriented towards the European Regulation for the reduction of CO₂ emissions from light-duty vehicles. Either a bonus-malus system, or a penalty-based system, are possible options. The increments are related to emission values and time. The range of deduction extends from 50% (very poor emission values) to 150% (very good emission values) of the purchase cost. The CO₂ component also relates to the deductibility of the cost of fuel.

C Impacts of the reform

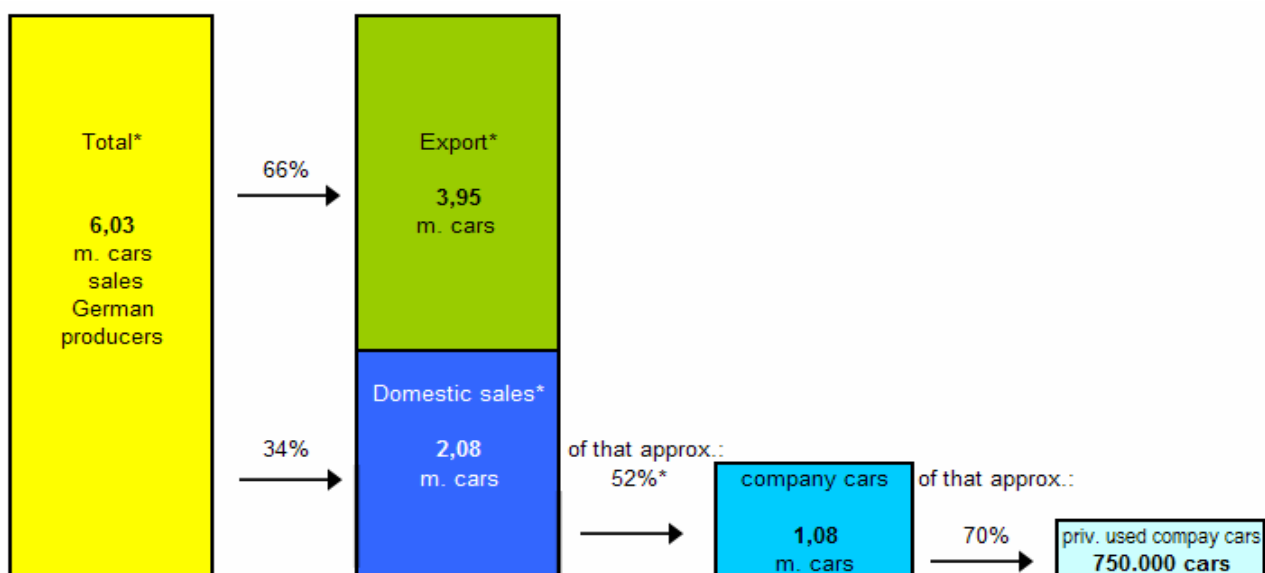
Such a reform of the tax treatment of privately used company cars works in both fiscal and environmental terms. But would the German car industry be affected by the changes?

In fiscal terms, expected additional revenues represent a reduction of current revenue losses. The reform proposal does not suggest an increase in taxation, but the reduction of tax privileges. Bearing this in mind, we estimate that the implementation of both elements of reform can generate additional tax revenues of between €2.9 and €4.6 billion annually. Additional revenues from social se-

curity contributions are also to be expected. However, as our calculations are based on unsatisfactory data, we can give only a rough estimate of between €0.4 - €0.9 billion in additional revenues.

It is not easy either to estimate the environmental effects. The reduction of tax privileges and thus increased incentives to buy a car privately and to receive income only in monetary terms will have no immediate environmental impact. However, since after the reform additional kilometres driven in company cars will not be free, distortions in terms of mobility behaviour will be reduced, which should result in a decrease in road traffic. Because there will no longer be higher tax privileges for particularly fuel-inefficient vehicles, certain changes in demand may be expected as well. Overall, we estimate that between 2012-2020 savings of 2.9 - 5.7 million tons of CO₂ could be achieved compared to a business as usual scenario with unchanged company car taxation.

Figure 2 - The German car market: Average sales 2007-2009



* Average 2007-09. Because of the scrappage scheme (the so called "Abwrackprämie"), the year 2009 is distorted and not representative.
Sources: VDA, Dataforce, own calculations

The German car industry sells approximately 750,000 vehicles a year to the German company car market (see figure 2, average sales from 2007-2009). This represents a significant proportion of the German car industry's total production of 6 million passenger cars per year. Nevertheless, relatively little impact on the car industry is expected, as most corrections to perverse incentives are expected to effect the behaviour of individuals in relation to their mobility. Individuals will drive less, but the majority of company car users will scarcely be able to do without their company car. Instead, models with efficient engines will become more popular - i.e. demand will steer the German car industry towards producing the low-emissions, highly efficient vehicle technology needed in the future.