When the car stalls

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John Messore and Peter Moroz consider the potential pitfalls of leasing company cars to employees, as demonstrated by the case of Smallman & Sons

Key Points

What is the issue?

Smallman & Sons v HMRC is one of a long line of tax cases on company cars. Instead of employees leasing their own personal cars directly, those cars were leased by the company which onward leased them or recharged them to employees at full value.

What does it mean to me?

The case serves to illustrate the draconian nature of ITEPA 2003 s 114 and the risks present if there is any commercial arrangement, arm's length or not, involving the employer.

What can I take away?

The main takeout in this case is to obtain up to date expert advice. There are many instances where arrangements could have been bett er constructed, even when advice was sought.

On 24 August 2021, the First-Tier Tribunal released the decision in Smallman & Sons Ltd v HMRC [2021] UKFTT 300 (TC) (see bit.ly/ 3C4PvBH). This is one of a long line of tax cases on company cars and follows on from recent cases such as Apollo Fuels v HMRC [2016] EWCA Civ 157 and Harrison Solway Logistics Ltd v HMRC [2019] UKFTT 72.
The basic facts in these cases are very similar. Instead of employees leasing their own personal cars directly, those cars were leased by the company which onward leased them or recharged them to drivers at the same amount paid to the leasing company.

The cars in Smallman were all second hand, and no VAT was charged on their sale or claimed as input tax by Smallman. They were roughly three to five years old when acquired. The two directors, BG and LG, chose the cars they wanted and then those cars were financed by lease purchase agreements entered into between Smallman and Lombard. All costs in relation to the cars (including the cash deposits paid to Lombard, the servicing costs, the finance charges under the agreements with Lombard and the purchase option payments) were debited to the joint directors' loan account of BG and LG, which they maintained at all times with a credit balance. There was no marginal cost to the employer in the arrangement.

The judgment notes: 'The reason for doing things this way was to take advantage of the good finance rates offered by Lombard to SSL (presumably by reason of its financial standing and the established relationship with Lombard), which would not have been available to …private individuals. There was no evidence before us as to the actual amount of costs saved as a result of these arrangements (obviously the underlying purchase price of the cars was unaffected) but it was allegedly referred to by the appellants' accountants in correspondence as being "much cheaper".'

As there was no cost to the company, then you might be forgiven for thinking that there was no benefit in kind. Indeed, that is what was held in both Apollo and Harrison Solway Logisti cs. However, in Smallman the opposite was held. This is unpleasant for the directors/owners of Smallman, who now face a large potential tax bill; and also very unhelpful for the many other taxpayers who might inadvertently be doing something similar.

The law

Let us remind ourselves of some of the relevant legislati on to be found in Income Tax (Earnings and Pensions) Act 2003 (ITEPA 2003). The general rule is that the cash equivalent of an employment-related benefit is the cost of the benefit less any part of that cost made good by the employee. However, there are special rules for cars.

The car benefit in kind rules are set out in ss 114 to 148 and commence:

Section 114: Cars, vans and related benefits

1. This Chapter applies to a car or a van in relation to a particular tax year if in that year the car or van—(a) is made available (without any transfer of the property in it) to an employee or a member of the employee's family or household…

In all the above tax cases, because the car was made available via the company, HMRC contended that the asset was within the punitive car benefit in kind rules. This thereby led to a significantly higher tax charge, as well as extra Class 1A and VAT recovery implications.

Other leading cases

In Apollo Fuels, the Court of Appeal agreed with the Upper and First-tier Tribunals that 'a charge to income tax arises under Chapter 6 only if the terms on which a car is leased to an employee confer a benefit on the employee in the ordinary sense of that word. The employees in this case received no such benefit'. Since the leases between the group and the employees were at arm's length, there was no benefit here.

A similar argument succeeded in Harrison Solway Logistics.

Following HMRC's loss at the Court of Appeal in Apollo Fuels, Parliament moved the goalposts in 2016 to ensure that bargains at arm's length would now be caught.

Legal change

Finance Act 2016 s 7(4) stipulated that the following text should be inserted in s 114 (cars, vans and related benefits to which Chapter 6 applies), after sub-s (1):

'(1A): Where this Chapter applies to a car or van, the car or van is a benefit for the purposes of this Chapter (and accordingly it is immaterial whether the terms on which it is made available to the employee or member constitute a fair bargain).'

This change takes effect for the 2016/17 tax year onwards.

There is also no mention of grandfathering but if a fair bargain had already been struck before the 2016/17 tax year, then one should have sympathy for any taxpayer that had entered into an arrangement before the law changed.

The only exception to this new rule is where one has a leasing business and the car is provided to the employee on the same basis as a member of the public; otherwise any employee of Hertz or Europcar going on holiday to Spain for a week and hiring a car from their employer would be deemed to have a car benefit in kind for a week.

The 2016 changes also covered vans or living accommodation provided on an arm's length basis, such that those facilities would also be caught by the traditional benefit in kind rules, notwithstanding that there was a bargain at arm's length.

The *Smallman* case

The Smallman appeal covered 2011/12 to 2016/17 inclusive. Only one of those years is potentially affected by the new rules.

Smallman argued that if anything the cars were made available not by the employer but at the request and cost of the employees (who were also directors) themselves. The employer played no role other than administratively. Also, it might have been argued that the car was not made available by reason of employment.

Unfortunately, if any vehicle is made available to employees then under s 117(1) it is almost always automatically deemed to be made available by reason of employment. The judge also concluded that as the lease was in the name of the employer then, absent any other evidence, it had to be the employer that was making the car available.

Smallman’s advocate argued that the employer was merely acting as agents of the directors, who were also shareholders. However, there was no evidence of this verbal agency agreement. Further, the judge confirmed that his view would have been the same even if there had been a formal agency agreement (i.e. that the company was acting only as agent for the individual directors). The car would still be regarded as being available by reason of employment.

Was there actually a benefit? This is the question that was addressed in the Apollo case. For periods after 2016/17, s 114(1A) renders the question irrelevant.

In Smallman, the period in question straddled the old and new rules.

When considering the rules before 2016/17, the tribunal decided that there was some ‘benefit’ to the employees because HMRC argued that the taxpayers were able to get a better finance deal on the cars via the company than if they had leased the vehicle directly. The tribunal upheld the assessments for car benefit and associated Class 1A NICs. The tribunal did, however, rule that there was no carelessness on the part of the employer or employees. This meant that penalties were abated and the period of assessment was reduced from six years down to four years.

There was no discussion on whether the quantum of benefit was reduced by the amounts the employees had themselves paid in lease costs but one presumes that relief might be allowed as being a contribution for private use.

The case serves to illustrate the draconian nature of s 114 and the risks present if there is any arrangement, arm’s length or not, involving the employer.

Obtain expert advice

The main takeout in this case is to obtain up to date advice from specialists – and not to assume that reimbursing costs eliminates the benefit in kind.

In some circumstances, there may be advantages in involving the employer in the commercial arrangement, namely where businesses implement salary sacrifice arrangements for cars with below 75g/km CO2 emissions, so that the employee can avail themselves of preferential benefits in kind rates, particularly in relation to electric vehicles.