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Understanding novated leases, FBT and claims for work-related car expenses

A novated lease is a popular way for employers to reward and incentivise their staff. Through a salary sacrifice arrangement that includes a novated lease, employees are provided with a vehicle and can also reduce their personal tax liability. However, employees should understand how fringe benefits tax (FBT) might apply to their arrangement and what they can do to minimise an FBT liability.

How does a novated lease work?

Under a novated lease arrangement, the employer takes over all or part of the employee's rights and obligations under the lease of a vehicle provided to that employee by a finance company. This transfer of rights and obligations is agreed to in an arrangement between the employer, the finance company and the employee. (The lease obligation typically reverts to the employee should employment cease.)

In return, the employee agrees to the lease payments being deducted from their pre-tax salary. This arrangement therefore allows the employee to reduce their taxable income and pay less tax.

How does FBT potentially apply?

As well as paying for the car lease repayments, an employer will sometimes pay for the car's running costs, such as fuel, maintenance, registration and car insurance. This means that a car fringe benefit arises to the employer.

Under most arrangements reached between employers and employees, FBT is ultimately borne by the employee through adjustments made in the resulting salary package. However, this FBT liability can be reduced by the employee making after-tax contributions towards the vehicle's running costs. Therefore, a question commonly asked is whether such vehicle running costs incurred by an employee and paid from after-tax income are deductible in their personal tax return.

This is a common scenario for many taxpayers, and the answer to the deductibility question is best explained using the following scenario.

Example

Susan is a senior executive at XYZ Pty Ltd (XYZ). She is occasionally required to travel to regional areas to perform her duties. Susan received a vehicle under a full novated lease as part of her total remuneration package.

Like many businesses, XYZ's policy is that any FBT liability from the provision of a car fringe benefit is to be borne by the employee through an adjustment to the salary package. In order to reduce the FBT liability, an employee contributions method is adopted by Susan's employer, such that the taxable value of the benefit is reduced by way of after-tax employee contributions.

Under this method, Susan pays for some of her car expenses, such as fuel and servicing, from her after-tax income (which reduces the FBT) while the rest of the costs are borne by XYZ from Susan's pre-tax income. Because Susan pays some of these costs from her own pocket, she now wonders whether she is entitled to claim a deduction for some of the car expenses.

Unfortunately for Susan, the short answer is no.

Broadly, "car expenses" incurred by an employee in respect of a car provided by an employer, especially one provided for that employee's "exclusive and private use", are specifically denied as a deduction within the tax legislation. Note also that this applies to relatives of an employee, such as a spouse, parent or child.

Notwithstanding the above, Susan will still benefit from the arrangement. Not only does she get the car, but her after-tax contributions towards the car's running costs reduce the amount of FBT that she would have been required to salary sacrifice as a component of her total remuneration.

The above rule would also be relevant where a company or fleet car is provided by an employer to an employee (or their relative) for their exclusive and private use. In such instances, running costs incurred by the employee, such as fuel, would not be deductible.