The Tax Informant

"Father, forgive them, for they do not know what they are doing"

The Department of Finance Canada and its civil servants in complete disarray (Part 2) – Section G

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G. Automobile supplied by an employer and a personal use of 150%!

Everyone knows that "hockey players are able to give 110%", an expression that we also often hear in professional environments. Astonishingly, this kind of impossible math seems to be the case for some individuals with cars provided by an employer … cars used for personal reasons apparently 150% of the time! This is all due to the cars purchased by an employer being "overtaxed" on a disproportionate tax benefit. A "Good job, guys" goes out once again to the civil servants at the Department of Finance Canada, specifically those in charge of this tax policy. What's more, this situation has been brought to their attention nearly 15 years ago! Another tale of pure carelessness…

Two employees, same kind of car, 2.3 times more tax

To illustrate the problem, here's an example:

> Two employees work at ABC Inc. Both employees have been provided the exact same car by their employer: a 2016 Mazda CX-5 (see below for examples with 12 different models, all taken from real contracts). Both employees use their car 30% of the time for business and 70% of the time for personal reasons. In the first case, the car provided to the employee was purchased with a 36-month lease (no cash) standard contract between the employer and Mazda. In the second case, the employer decided to take advantage of a limited-time promotional offer from the manufacturer and purchased the car. The difference in how the car was purchased is supposed to have absolutely no bearing on the employee and everything else about the car is the same, right down to the colour and annual mileage. And yet … there are major differences for the employee. A taxable benefit will have to be added every year to the employee's income for their right to use the car for personal reasons (70% of the time). A second taxable benefit will apply to the operating costs paid by the employer for the car. **However**, in our example, the employee who is driving the purchased vehicle will have to deal with the first taxable benefit that will be 2.3 times the taxable benefit of the employee driving the vehicle leased by the employer (called the "standby charge benefit").

Obviously, the initial reaction would be to believe that the taxable standby charge benefit on the leased vehicle is too low. But our example shows otherwise. In fact, in the case of the leased vehicle, the taxable standby charge benefit is equal to 2/3 of the leasing cost, as per the *Canadian Income Tax Act*. In other words, a taxable standby charge benefit in the case of the leased vehicle is the same, in this example, as assuming the employee uses the vehicle 66.6% of the time for personal reasons (2/3 = 66.6%). In our example, this more or less corresponds to reality (the vehicle is used for personal reasons 70% of the time). In short, in the case of a vehicle provided to an employee and leased by the employer, when it is used for personal reasons between 50% and 100% of the time, it will be taxed more or less appropriately, maybe slightly overtaxed or undertaxed but nothing too dramatic. Keep in mind different rules apply when the vehicle is used for personal reasons less than 50% of the time.

However, when the vehicle provided to an employee has been purchased by their employer, the annual taxable benefit for a standby charge equals 24% of the cost of the vehicle (including taxes), or 2% per month (12 x 2% = 24%). In our example, based on a real contract, the taxable standby charge benefit for a 2016 Mazda CX-5 will be $9,319 per year (vs. $4,080 in the case of the leased vehicle). That means that the employee who drives a purchased vehicle will be taxed a standby charge benefit that is $15,717 higher than in the case of the other employee over the latter's three-year lease contract ($9,319 - $4,080 = $5,239 x 3 = $15,717)! With a marginal tax rate of 40%, that means the employee who drives the car purchased by their employer must pay $6,300 more in taxes and is therefore $6,300 poorer.

As we've explained above, the $4,080 taxable standby charge benefit (in our example) in the case of the leased vehicle corresponds to a personal use of 66.6%. Using the simple math rule of three, the $9,319 taxable standby charge benefit for the vehicle purchased by the employer means that the vehicle is used for personal reasons 152% of the time (if $4,080 = 0.6667, $9,013 = 1.523)!! That is just ridiculous. How can you use a vehicle 152% of the time? Think this is an unrealistic example? Check out the following link for 12 examples (Toyota, Audi, Subaru, Ford, BMW, Mazda, Nissan), all based on real contracts signed in the past few years (**http://www.cqff.com/informateur/automobile_employer.pdf**). The figures speak for themselves. The taxable standby charge benefit for an automobile leased by an employer for an employee is generally between 40% and 50% of the standby charge for the same vehicle that would have been purchased by the employer. It's such a ridiculous situation that it has become unthinkable for an employer to purchase a vehicle for their employee when the latter uses it for personal reasons for 50% or more of the time (the disparity isn't as catastrophic and progressively decreases when the vehicle is used for personal reasons less than 50% of the time because of the different formula used to calculate taxable benefits).

In our opinion, the tax system should be "more or less" neutral (without necessarily being perfect) when it comes to a company's financial decision to purchase or lease a vehicle for their employee. We are so far from this being the case. So where does the problem come from? Tax legislation regarding cars provided by an employer has not changed since 1981 (except for a 2003 modification in the case when a vehicle is used more than 50% of the time for business reasons)! Those of an older generation (including this author) remember that a lease contract for a new vehicle in 1981 was a rare thing and included an interest rate that varied between 27% and 35% (compare that with current rates that vary between 2% and 5%). Because the costs of leasing a vehicle include the estimated cost of depreciation for the duration of the contract and interest fees (in short, the real ownership costs—not operating costs—of the vehicle for the duration of the contract), is it really necessary to explain that what resulted in low disparities in 1981 now makes no sense whatsoever? How is it logical that when a vehicle is purchased, the taxable benefit over four years represents 96% of the vehicle's initial cost in this climate of low interest rates? Logic is nowhere to be seen in this situation. It has left the building!

Well aware for the past 15 years!

If you think that this absurdity (which is easily fixable, as we will demonstrate below) has not been brought to the attention of the civil servants at the Department of Finance Canada, you're very wrong. Even though this author has been aware of this issue for about 25 years, it is only in 2003 that our organization contacted representatives of the Department of Finance Canada in Ottawa to notify them of this obvious and unfair problem. After having described it in detail, concrete proof in hand, the individual responsible for these rules at the time strongly suggested we write to the Minister of Finance Canada to make him aware of the situation. We were happy to write to the Honourable Ralph Goodale (who is still a Minister with the current federal government) in order to get the problem fixed through the appropriate legislative modifications. Not only did we send a first polite and detailed letter on July 20, 2004, we also sent a second (as polite and as detailed) one on December 15, 2004. On May 6, 2005 (!) we finally received a very brief response from his cabinet stating our request would be included in the government's review of tax policies. There it is again, that meaningless sentence. It's used again and again by the staff at the Department of Finance Canada to make everyone believe they'll actually do something about the problem.

We then set out to make tax experts throughout the country aware of the problem (few of them knew about the issue). We submitted a detailed question with several concrete examples to the Department of Finance Canada for a federal roundtable during the *Congrès de l'APFF* (*Association de planification fiscale et financière*) in October 2005. Once again, a representative of the Department of Finance Canada told us they'd take it into account during their upcoming assessment of measures on vehicles. See where this is going? Nothing happened. Nothing. We once again questioned the Department of Finance Canada during the *Congrès de l'APFF* in October 2009 to get an update on what their stance was regarding their answer in 2005. Once again, they replied with a meaningless response: "The Department of Finance is continuously finding ways to improve the tax system while taking into account the government's priorities and available budget." Let's remain polite: this is pure bull dung. First, the tax cost associated with a legislative change of this kind is relatively low (in practice, most employers in this situation have no other choice but to lease a vehicle … as long as they're aware of the immense disparity that exists). Second, current tax rules for an automobile purchased for an employee basically amount to a rip off. Is there anyone competent working on tax legislations at the Department of Finance Canada? Does no one care about fair and balanced rules for taxpayers? Finally, it must be said that Quebec's *Ministère des Finances* listened to our concerns several years ago and agreed that the current rules are completely bonkers. We even came up with potential solutions they could discuss with their federal counterparts… Which they tried to do, without success.

A simple solution

As in the case of every point discussed in our newsletters, we will outline a potential solution that is both simple and fair.

For vehicles provided by an employer to their employee, the annual taxable standby charge benefit should simply be based on the following formula for a leased vehicle:

$$\text{costs of leasing (including taxes)} \quad \times \quad \frac{\text{kilometres driven for personal use}}{\text{total kilometres driven}}$$

This specific formula should apply in every situation where the vehicle is being used for personal reasons (even if it is less or more than 50% of the time). It truly reflects the personal use related to the standby charge, to which would be added the taxable benefit associated with the operating costs. Keep in mind that lease payments normally reflect the estimated depreciation of the vehicle for the duration of the contract as well as financing costs.

In the case of a vehicle purchased by the employer, the formula should seek to sensibly emulate the results obtained with the costs of a lease. For the past <u>several</u> years, such a result would easily be obtained by lowering the standby charge benefit to about 16% or 17% of the cost (1.4% per month) instead of 24% of the cost (2% per month), multiplied by the ratio between the kilometres driven for personal use and the total kilometres driven. It's not a difficult solution… All we need is for the civil servants at the Department of Finance Canada to show a bit of willingness.

Electric cars and tax policies

When it comes to electric cars, the current tax policy is a pathetic mess. In terms of operating fees (fuel, maintenance, etc.) for a car provided by the employer, the taxable benefit for the fees paid by the employer for the personal use of the vehicle is calculated exactly the same way for an electric vehicle as it is for a gas-powered car: $0.26/kilometre in 2018. Even though the operating fees of an electric vehicle are much lower than a gas-powered car. However, the other taxable benefit associated with a vehicle provided by the employer (the standby charge explained above) is significantly higher for an electric vehicle because it costs much more for the employer (lease included), all other things being equal. Furthermore, the $8,000 grant offered by the government of Quebec does not, according to the CRA, reduce the "cost" of the vehicle in terms of the standby charge benefit, but it reduces the depreciable cost of the vehicle for the employer! In other words, it is much too costly for an employer to provide their employee with an eco-friendlier vehicle. How does this make any inkling of sense? When will these rules be reviewed? "*Father, forgive them, for they do not know what they are doing*"