The Employee Contribution Method

Background

The Novated Lease has evolved to become the method of choice for many employees wishing to drive their vehicle of preference in the most cost and tax effective arrangement available.

In respect of costing in the effects of fringe benefits tax (FBT,) originally, novated lease programs were typically structured using the gross cost ‘Statutory Fraction Method’, whereby the FBT was calculated and structured as an extra pretax payroll deduction.

The FBT rate has been and still is the same as the top personal marginal tax rate. So, during a time when the top personal marginal tax rate was applied to a relatively low income level – and when the vast majority of employees with novated leases were salary sacrificing them from income levels attracting the top personal marginal tax rate - this method of FBT treatment was suitable.

However, over time, as the top personal marginal tax rate cut in at much higher income levels, the gross cost ‘Statutory Fraction’ method disadvantaged employees salary sacrificing a motor vehicle whose income was less than that taxed at the top marginal tax rate. This was because they were being charged FBT at a higher tax rate than their income was being taxed at – thus reducing the tax benefit of the novated lease.

The top marginal tax rate currently cuts in at a much higher taxable income – ie greater than $180,000.

To ensure employees were not disadvantaged by this progressive upward shifting in income bracket / tax rate threshold settings and to enable them to continue obtaining the maximum benefits from their vehicle packaging arrangements, the ***Employee Contribution Method (ECM)*** became norm and is now the primary FBT treatment option used.

The ECM ensures that all employees whose salaries are under the top marginal tax rate will have higher benefits when compared to the pre-tax Statutory Fraction Method.

Why and How?

The ECM is well established in tax law / practice and revolves around the employee making a ‘PERSONAL’ contribution towards the running costs of their benefit motor vehicle from their after tax (Nett) Salary.

For every after tax dollar that an employee contributes they reduce the FBT taxable value of the vehicle by the same amount. The FBT taxable value is calculated by the following formula –

Capital cost of vehicle for FBT purposes X applicable Statutory fraction (based on standard annual kilometre brackets) –

So, if we assume a $30,000 vehicle for example, the personal contributions required to reduce the FBT taxable value to $0, will be determined according to the statutory fraction attributable to each km bracket –

		Personal Contribution to reduce FBT taxable value to $0 for 2011-12 FBT yr
0 – 25,000 Kms	***20%***	***$6,000***
25,001 - 40,000 Kms	***14%***	***$4,200***
40,000+	***10%***	***$3,000***

Thus, as a 'substitute' for FBT, an after tax contribution may be paid by an individual Employee up to the Taxable Value of the vehicle.

An employee will thus be effectively eliminating a tax calculated at 46.5% by utilising $s taxed at their lower personal incremental tax rate.

The level of savings available to Employees via the Contribution Method can be significant and the goodwill an Employer can generate by allowing its entire Employee base to benefit from Vehicle Salary Packaging utilising ECM is obvious.