VEHICLE EXPENSES

Wolters Kluwer

VEHICLE EXPENSES: Deductions That Can Save You Money

Motor vehicles form an essential part of American business life. Each day, they transport millions to and from work and millions more use them as an integral part of their jobs. As such, vehicles represent a significant business expense that, in turn, can yield significant tax deductions.

This guide highlights tax benefits that are specific to vehicles used to transport employees or self-employed individuals to and from work locations, as well as light-duty vehicles that may also transport goods. It also covers tax incentives for environmentally-friendly vehicles for businesses and personal consumer use. You'll learn about:

- Automobile deductions;
- Standard mileage rate/actual cost;
- "Luxury" auto depreciation;
- Personal use of business vehicles; and
- The tax benefits of "green" vehicles.

AUTOMOBILE DEDUCTIONS

Deducting expenses for the business use of a car or truck frequently confuses taxpayers. Many small businesspeople and self-employed individuals are caught on audit. Mistakes aren't intentional, but the rules can be confusing. The IRS

knows that many small businesspeople are pressed for time and they don't always keep complete records of the business use of a car or truck. However, this is a fatal mistake.

If you use a car or lightweight truck for business, you should ask yourself:

- Should I use the standard mileage method or actual costs to deduct my expenses?
- What additional tax rules apply if I also use my business vehicle for personal purposes?
- Should I buy or lease?
- What records do I need to substantiate my automobile deductions?

Deductible expenses. Generally, you can deduct as a business expense the cost of:

- Gasoline;
- Oil;
- Tires;

- Repairs;
- Insurance;
- Annual depreciation (as limited by the "luxury" auto rules);
- Parking fees and tolls;
- Licenses;
- Loan interest; and
- Garage rent.

These expenses generally can be deducted using either the "actual cost" method or the "standard mileage rate" in addition to certain actual costs.

> ***CAUTION.*** You can deduct only the portion of the cost that is attributable to business. If you use your business vehicle for personal purposes, you need to exclude the personal-use costs from your deduction. Will the IRS just trust your "say so" on whether you used your business car for personal purposes? No, you must keep accurate mileage-and-purpose written logs for every trip. If you are audited, this is a favorite place for the IRS to deny deductions, or at least negotiate them downward, unless you keep meticulous records.

HOW YOU FILE

How much tax benefit you get from your automobile deduction depends on how you take the deduction:

- ***If you are operating your own business,*** your automobile expenses are deductible as a direct deduction against your business income, either on your business's separate tax return, or on Schedule C of your Form 1040.
- ***If you are an employee whose business-use automobile expenses are not reimbursed,*** you can deduct your automobile expenses only if you itemize your deductions and only as a miscellaneous itemized deduction subject to the two percent adjusted gross income floor, which usually will severely restrict the amount you can deduct.
- ***If you are an employee who is reimbursed by your employer*** under an "accountable plan," you don't need to report anything on your tax return; you don't include the reimbursement in income or deduct it as an expense. An "accountable plan" is one that meets strict IRS standards for contemporaneous mileage logs and other proof.

Standard mileage rate or actual costs?

Using the standard business mileage method is a simple way to compute deductions for car expenses in lieu of calculating the operating and fixed costs allocable to business purposes. It also simplifies computations when the vehicle is used for nobusiness purposes.

Standard mileage rate. Under the standard mileage method, you determine the amount of your allowable deduction by multiplying all the business miles driven during the year by the standard mileage rate. If your business is not

on a calendar tax year, you must keep track of mileage for each calendar year segment and multiply each by the standard mileage rate for that calendar year.

The standard mileage rate is somewhat of a moving target because it is adjusted regularly to reflect changes in the cost of operating a vehicle. The rate is adjusted at least once a year, and sometimes more often if fuel prices are especially volatile.

The 2013 standard mileage rate is 56.5 cents per mile for business miles driven. The 2014 rate is 56 cents per mile.

The standard mileage rate cannot be used to compute the deductible expenses for vehicles:

- That are used for hire, such as taxis;
- That are part of a fleet (five or more vehicles used simultaneously); or
- For which the taxpayer claimed depreciation, bonus depreciation or Section 179 deductions (because depreciation is "built in" to the standard mileage allowance).

Other rates. The standard mileage rate for medical and moving expenses is 24 cents per mile in 2013, and 23.5 cents per mile in 2014. The standard mileage rate for charitable purposes is always 14 cents per mile; unlike the other standard rates, it is not adjusted each year.

Records. The business portion of parking fees and tolls may be deducted in addition to the standard mileage rate, if you keep receipts for them.

The IRS advises that taxpayers keep records as long as they may be needed for the administration of any provision of the Internal Revenue Code. Generally, this means you must keep records that support your deduction (or an item of income) for three years from the date you file the income tax return on which the deduction is claimed. A return filed early is considered filed on the due date.

> ***CAUTION.*** Timing is important! You can use the standard mileage rate only if you use it from the beginning; that is, the first year that your vehicle is used in your business. Before you purchase a vehicle, talk to your tax advisor and decide if the standard mileage rate is best in your business situation. Using the standard mileage rate requires you to keep contemporaneous mileage logs from day one.

COST RECOVERY

If you don't use the standard business mileage rate to calculate your deductible vehicle expenses, you may be entitled to depreciate or expense the vehicle. There are three cost recovery options—Section 179 expensing, bonus depreciation, and regular depreciation—each with many special rules and exceptions. You may also have to recapture some of these benefits when you dispose of the vehicle or stop using it for business purposes.

> ***CAUTION.*** Each of these benefits is allowed only for the business use of the vehicle. For example, if only 75 percent of the vehicle's use is for business purposes, the deduction amounts and limits discussed below are reduced by 25 percent.

Code Sec. 179 expensing

Many small businesses qualify for the Section 179 expense allowance, which allows them to deduct the entire cost of depreciable property in the year it is acquired. You acquire a vehicle (new or used) when you purchase it or lease it under a capital lease (a lease with a fixed purchase option or a Purchase Upon Termination (PUT) feature).

To qualify for expensing, the property must be used at least 50 percent in your trade or business. If the vehicle's business use is less than 100 percent, your Section 179 deduction is reduced in proportion to the nonbuinsess use.

Your total Section 179 expense deductions are limited to $500,000 in 2013 ($25,000 in 2014). This limit is reduced for larger taxpayers that place $2 million in qualified property in service during 2013 ($200,000 in 2014). In addition, your Section 179 deduction cannot exceed your taxable trade and business income for the year.

> ***CAUTION.*** For larger vehicles that weight between 6,000 and 14,000 pounds, the amount that you can take into account for Section 179 expensing is limited to $25,000. This limit is intended to plug the "SUV loophole," which inadvertently encouraged the use of large, inefficient vehicles by allowing their entire cost to be expensed.

> ***COMPLIANCE TIP.*** If you're an employee, use Form 2106, Employee Business Expenses, to elect Section 179 expensing. Otherwise, use Form 4562, Depreciation and Amortization.

Bonus depreciation

On your 2013 return, you may be able to claim bonus depreciation deduction on a new vehicle that you acquired after 2007 and placed in service during 2013. The vehicle's business use percentage must be at least 50 percent. If

the vehicle's business use is less than 100 percent, your bonus depreciation deduction is reduced in proportion to the nonbuinsess use.

Bonus depreciation in 2013 is equal to 50 percent of the cost of the property, as reduced by any Section 179 expense deduction claimed. However, bonus depreciation for a vehicle is limited to $8,000. For example, if in 2013 you acquired and placed in service a $50,000 vehicle, and you elected to expense $30,000 of that amount, your bonus depreciation deduction would be $8,000 ($50,000 cost less the $30,00 expensed is $20,000; half of this amount is $10,000, so bonus depreciation is limited to $8,000).

CAUTION. Bonus depreciation is generally limited to the cost of purchasing new property. Thus, it does not apply to most used vehicles or to vehicles leased by unincorporated taxpayers

COMPLIANCE TIP. Bonus depreciation applies automatically unless you elect not to use it on Form 4562, Depreciation and Amortization.

Bonus depreciation generally expires for property placed in service after 2013, but it remains available through 2014 for certain aircraft and other property with long production periods.

Depreciation

A vehicle used in a trade or business or for the production of income can be depreciated over its useful life. Depreciation deductions basically allow you to recover a portion of the vehicle's cost each year. A car, sports utility vehicle, van, or pick-up truck is generally depreciated under Modified Accelerated Cost Recovery System (MACRS) over a five-year period. However, if the business use percentage for the vehicle is less than 50 percent, you must use the less generous Alternative Depreciation System (ADS) depreciation method.

CAUTION. An employee may not depreciate a vehicle unless its business use is for the convenience of the employer and is required as a condition of employment.

Luxury Caps. Annual depreciation deductions for leased and purchased passenger automobiles are limited under the luxury car caps, also known as the "listed property" rules. For this purpose, virtually all automobiles are considered luxury cars except for:

- a truck, van or SUV with a gross vehicle weight rating of at least 6,000 pounds,
- a vehicle used in the transportation of persons for hire (taxis and limos),
- a vehicle used to transport property for hire,

- ambulances and hearses, and
- a truck or van that is modified so that it is not likely to be used for personal purposes (a qualified nonpersonal use vehicle), such as clearly marked police cars, cherry pickers, and forklifts.

> **COMMENT.** Since motorcycles are not four-wheeled vehicles, they are not subject to the luxury car limits.

When the luxury caps apply, the MACRS deduction for each year in the recovery period is limited to an amount based on the year that the vehicle is placed in service. The limits are slightly higher for a truck, van or SUV that is built on a truck chassis.

The first-year MACRS depreciation limits for vehicles placed in service during 2013 are $3,160 for passenger automobiles in general; and $3,360 for trucks, van and SUVs on truck chassis. The maximum bonus depreciation deduction for 2013 effectively increases these limits by $8,000, to $11,160 and $11,360, respectively.

> **CAUTION.** The Section 179 expense allowance and bonus depreciation deduction are both considered first-year depreciation deductions for purposes of the luxury car limits. This means that for 2013, the sum of your regular first-year depreciation, plus your bonus depreciation, plus your Section 179 expense deduction cannot exceed $11,160 (or $11,360 for a truck or van on a truck chassis).

Depreciation deductions that are disallowed by the limit are not lost. Instead, they can be carried forward and deducted over time after the recovery period (generally five years) ends, as long as you are still using the vehicle in your business.

BUYING VERSUS LEASING

The decision to buy or lease a vehicle has important tax consequences. Some people are reluctant to lease vehicles because they ultimately will not own them. Others believe that if a business uses 20 or more vehicles, leasing is the best value for their money. Your tax advisor will help you calculate the benefits and detriments of leasing.

Automobile leases. Lease payments are deductible to the extent you use the vehicle in your trade or business or for the production of income. This means that if you use a leased vehicle for business and personal purposes, you can deduct only a portion of your lease payments,

as determined under annual tables provided by the IRS. Different tables apply to cars with a fair market value (FMV) up to $100,000; cars with a FMV over $100,000; and trucks and vans.

> ***COMMENT.*** This adjustment is commonly referred to as an "inclusion amount," but it actually reduces the amount of the lease payments that you can deduct as a business expense.

The inclusion amount adjustment applies to vehicles with a FMV of at least $19,000 if the lease started in 2013 (or $18,500 if the lease started during 2009 through 2012). The inclusion amount is a percentage of part of the FMV of the vehicle, multiplied by the percentage of business and investment use of the vehicle for the tax year, prorated for the number of days of the lease term in the tax year. It applies to each year of the lease.

Example. On January 17, 2013, Joe leases a car for three years and starts using it in his business. The car has a fair market value of $32,250 on the first day of the lease term. He uses the car 75% for business and 25% for personal purposes during each year of the lease. According to the IRS tables, Joe must reduce the lease payments he claims as deductible business expenses by the following inclusion amounts for each year of the lease:

Tax year	Dollar amount	Proration	Business use	Inclusion amount
2013	$ 9	349/365	75%	$ 6
2014	20	365/365	75%	15
2015	29	365/365	75%	22
2016	35	16/366	75%	1

PERSONAL USE

Use of a company vehicle for commuting or personal reasons can limit a business's tax benefits and even create tax liabilities for employees. Separating business and personal use for tax purposes can sometimes be challenging.

Business expense deductions for vehicle expenses are subject to the rules that govern travel expenses. For travel expenses to be deductible, you generally must spend the night away from your "tax home," which is your main business or work location. This means that daily commuting expenses to your main job site are usually nondeductible personal expenses. If you work at multiple locations, the IRS requires you to consider the time you spend, your level of business activity, and income earned at each location to determine which location is your tax home. As a result, vehicle costs incurred while driving from your home to a secondary place of business or employment or to a temporary assignment can often be deductible travel expenses.

Earlier, we discussed the deduction and depreciation rules for passenger vehicles that are used at least 50 percent for business purposes. A different set of rules applies when a business vehicle is used for personal purposes more than 50 percent of the time.

A business vehicle that is not used primarily for business purposes can still be depreciated, but the owner must use the alternative form of MACRS (ADS). While MACRS uses a five-year recovery period, ADS adheres to the less generous straight-line depreciation method. If a vehicle qualifies for MACRS in one year but not in the next, the switch to ADS impacts not only the year in which personal use predominates, but also retroactively. Any depreciation deductions recognized under the general MACRS method in previous years that exceed the depreciation deductions you would have otherwise been allowed under ADS must immediately be recognized as ordinary income under this "recapture" rule.

> ***COMMENT.*** Personal use is generally determined by keeping a mileage log of business and personal use each day. The mere availability of the vehicle in the employee's the driveway does not count as personal use since mileage, rather than time used, controls.

Cents-per-mile valuation

One method for determining the value of an employee's personal use of an employer-provided automobile is the mileage allowance rate, which is 56.5 cents per mile for 2013 (56 cents per mile for 2014). However, this method cannot be used in 2013 if the fair market value (FMV) of the vehicle is more than $16,000 for a car, or $17,000 for a truck, van or other vehicle built on a truck chassis.

An employer who maintains a fleet of at least 20 automobiles can treat the FMV of each one as the fleet-average value, which is the average of the FMVs of all automobiles in the fleet.

Employee income

Personal use of a vehicle does not impact just the size of the write-off that a business can take. It also affects the employee, because personal use of an employer's car is a taxable fringe benefit. The value of the personal use must be reported by the employer on the employee's Form W-2 for the year.

COMMENT. Self-employed individuals follow the same depreciation-allocation rules as employers but, of course, do not charge themselves additional income for personal use since it is their own vehicle, whether owned or leased.

The employer may use one of three methods to determine the fair market value of the employee's personal use of a vehicle:

(1) The cost of leasing the same or a comparable vehicle from an unrelated third party;
(2) The automobile lease valuation rule under the IRS-provided Annual Lease Value Table; or
(3) The cents-per-mile rule using the IRS standard mileage rate.

A fourth method, the commuting valuation method, is available if the employer (1) requires the employee to use the vehicle for commuting or provides it because other transportation methods are unsafe, and (2) strictly limits any other personal use. This method assigns a $1.50 value to each one-way commute.

One exception. Some personal use of a demonstrator automobile by a full-time salesperson within the sales region of employment is considered a tax-free working condition fringe benefit, as long as there are substantial restrictions on personal use.

Chauffeur services. If a chauffeur is provided to an employee, the income taxed to that employee is determined by a fraction, the numerator of which is equal to the sum of the hours spent by the chauffeur actually providing personal driving services to the employee and the hours spent by the chauffeur in "personal on-call time," and the denominator of which is equal to all hours the chauffeur spends in driving services of any kind paid for by the employer, including all hours that are "on-call."

FRINGE BENEFITS

Although an employee is taxed on the value of his or her personal use of employer's vehicle, an employer can provide several other transportation-related fringe benefits that are not included in the employee's income.

Tax-free parking. An employee can exclude up to $245 per month in 2013 ($250 in 2014) in employer-provided parking benefits. The exclusion applies to cash reimbursements, parking fees paid directly by the employer, and parking fees paid through a compensation reduction agreement. The fees can pay for parking at the employer's location or at a commuting hub (such as a train station) that the employee uses to get to work.

Van pools and public transporation. For 2013, employers can provide tax-free fringe benefits for van pools and/or public transportation that are equal to the value of the tax-free parking benefit (that is, $245 per month per employee). For 2014, this limit is schedule to drop to $130, unless Congress extends temporary rules that established parity between these benefits and parking benefits.

Bicycles. Employers can provide a tax-free fringe benefit of up to $20 per month to reimburse an employee's costs of commuting by bicycle. These include reasonable expenses for the purchase, improvement, repair, and storage of a bicycle that the employee regularly uses for travel to work. The employee must not have received any parking, van pool or public transportation fringe benefits for the month. The $20 amount is not indexed for inflation.

SUBSTANTIATING DEDUCTIONS

You must keep adequate records to substantiate your deductions. These include:

- Purchase bill-of-sale or lease contract;
- Receipts for all maintenance and repairs;
- Total mileage driven per year, broken down into personal, commuting and business miles; and

- Dates of each use of the automobile for business, with the purpose of the expense.

Daily log. Keeping a daily log is very important to maximize your deduction and substantiate the business use of your vehicle. If you keep proper records, you can quickly and accurately determine your deduction when tax time comes around. Also, in case you are audited, you'll be able to easily substantiate your deduction.

Your daily log should record:

- Odometer readings with each trip (multiple short trips, though, can be combined); and
- Gasoline, oil and other purchases.

Fixed and variable rate (FAVR) method. If you are an employee who uses your own vehicle in your employer's business, your vehicle-related business expenses are substantiated if your employer reimburses you under a

qualified fixed and variable rate (FAVR) allowance.

Under this method, your employer pays you an allowance that includes payments covering fixed and variable costs, such as a cents-per-mile rate to cover your variable operating costs (gas, oil, etc.) plus a flat amount to cover your fixed costs (depreciation or lease payments, insurance, etc.).

The amount of a FAVR allowance must be based on data that is derived from where you live and work; must reflect retail prices; and must be reasonable and statistically defensible in approximating your actual expenses.

The FAVR method includes several defaults and safe harbors that can simplify recordkeeping. For example, you can avoid tracking business and personal use mileage because the FAVR method provides a business use percentage based on the number of miles your employer reasonably projects you will drive for business purposes during the year.

> ***COMMENT:*** If your employer uses a FAVR allowance to reimburse your vehicle expenses, you can still claim a separate deduction for parking fees and tolls that you pay in your business travel.

> ***COMPLIANCE TIP:*** An employee covered by a FAVR allowance must provide the employer with information about the make, model, year, odometer reading and sales price of the automobile.

GREEN VEHICLES

The tax laws include special incentives to encourage consumers to purchase environmentally-friendly, or "green," cars and trucks. While demand for green vehicles may wax and wane, concern for air quality in urban areas, U.S. dependence on foreign oil, and greenhouse gas emissions keeps Congress active in making these technologies more economical and accessible to the average consumer.

These incentives have varied greatly over the last few years. Two credits are available for vehicles placed in service during 2013 and 2014: one for plug-in electric drive vehicles, and one for fuel cell vehicles.

> ***COMPLIANCE TIP:*** If the vehicle is used in a trade or business (and can therefore be depreciated), the credit allocable to the business use portion is part of the general business credit, rather than a separate credit. If the vehicle is personal property, the credit is a separate nonrefundable personal credit.

Plug-in electrics. The tax credit for qualified plug-in electric vehicles also applies to plug-in electric hybrids. A qualified vehicle must be new, and its original use must begin with the taxpayer. The amount of the credit ranges from $2,500 to $7,500, depending on the amount of power supplied by the battery.

This is a permanent credit; it does not expire. However, the credit for a particular make begins to phase out when the manufacturer has sold 200,000 new qualified vehicles for use in the United States.

The electric vehicle credit also allows a credit of up to $2,500 for qualified two- and three-wheeled vehicles that are acquired during 2012 and 2013.

Fuel cell vehicles. An alternative motor vehicle credit applies to qualified fuel cell vehicles placed in service before 2015. The credit ranges from $4,000 to $40,000, based on the vehicle's weight. The credit can be increased by up to $4,000 if the vehicle achieves specified efficiency improvements.

Conclusion

The tax aspects of owning and operating a vehicle have grown more complex over the years, in a way keeping pace with the more complicated nature of what was once simply a motorized box with wheels and a seat. As the cost of vehicles has grown into a major investment (the price of a 1926 Model-T was $350!), the need to maximize any tax deduction or credit associated with vehicle ownership and operation has increased proportionately.

Not only are there more than a dozen deduction and credit alternatives available for vehicles used in a business, each has its own set of rules that forces decision to be made in a taxpayer's quest to maximize tax benefits. Personal use of a vehicle, whether in connection with a business or strictly as a consumer purchase, complicate these considerations but sometimes can even provide additional tax benefits.