



# VEHICLE EXPENSES

## 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, they represent a significant business expense that, in turn, can yield significant tax deductions.

This guide highlights those 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 those tax incentives being offered to environmentally-friendly vehicles for businesses and personal consumer use. Finally, this guide covers the special limited-time only federal tax deduction for state sales tax on new vehicle purchases.

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. However, 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, ask yourself:

- Should I use the standard mileage method or actual costs?
- If your business vehicle is also used for personal, non-business transportation, what additional tax rules are involved?
- Should I buy or lease?
- What are the records that I need to keep 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 (except in excess of a “luxury” auto limit);
- Parking fees and tolls;
- Licenses;
- Loan interest; and
- Garage rent.

These expenses generally can be deducted either using the “actual cost” method or using the “standard mileage rate” in combination with certain actual costs.

**Caution.** You can deduct only the portion of the cost that is attributable to business. To the extent you use your business vehicle for personal purposes, you need to exclude those 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 your business is audited, this is a favorite place for the IRS to deny deductions, or at least negotiate them downward, if you don’t 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 a reimbursement plan that qualifies as an “accountable plan,” you don’t need to report anything on your tax return and your employer gets a business expense deduction for those expenses directly. 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 also subject to personal use.

**Standard mileage rate.** Under the standard mileage method, you determine the amount of the 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 for certain current consumer price index factors.

The 2010 standard mileage rate is 50 cents-per-mile for business miles driven (down from 55 cents-per-mile for 2009).

The 2010 standard mileage rate for medical and moving purposes is 16.5 cents-per-mile (down from 24 cents-per-mile for 2009).

Finally, the 2010 standard mileage rate for charitable purposes remains at 14 cents-per-mile, the same as it was for 2009 as the amount is fixed by statute.

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



**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 start keeping contemporaneous mileage logs from day 1.

Since depreciation is already built into the standard mileage allowance, taking any depreciation (including “Section 179 expensing” or “bonus depreciation,” if applicable) forecloses using the standard mileage for that vehicle for the duration of ownership. The standard mileage rate also cannot be taken if your business operates five or more vehicles at the same time (that puts them into the “fleet” category).

## DEPRECIATION

The *Economic Stimulus Act of 2008* (2008 Stimulus Act) allowed taxpayers to claim “bonus depreciation” for tangible

personal property (including vehicles) put into use in a trade or business or for the production of income during 2008. The benefit was subsequently extended in the *American Recovery and Reinvestment Act of 2009 (2009 Recovery Act)* for 2009 purchases, but has not been extended for 2010 purchases. The benefit provided that, in addition to regular depreciation, you could claim a depreciation deduction equal to 50 percent of the cost of a vehicle purchased and put into business use after December 31, 2008 and until December 31, 2009. One requirement, however, was that the employee meet the 50 percent business purpose rule. Another was that the vehicle must be new. Still, another was the “luxury vehicle” limitation.

Both bonus depreciation and Section 179 expensing allowances, which have not been extended to 2010, but could be through retroactive legislation by Congress, are restricted by the limits on “luxury vehicle” deductions. For example, the *2008 Stimulus Act* provided an \$8,000 addition to the first-year cap on luxury vehicle depreciation for vehicles purchased after December 31, 2007 and placed into service before January 1, 2010. For 2009 purchases, that added up to allowable first-year depreciation of \$10,960. Such a benefit could be extended through 2010 if Congress acts to retroactively extend a similar incentive for the 2010 year.

### **“Luxury” vehicles**

Whether you buy or lease your automobile, your business deduction is subject to the so-called luxury auto limits when you use the actual costs method, rather than the standard mileage rate.

**Comment.** The Section 179 expense deduction is treated as a deduction for purposes of the depreciation caps imposed by the luxury car rules. As a result, the sum of the regular first-year depreciation deduction, including bonus depreciation, and the Section 179 expense allowance may not exceed the applicable first-year luxury depreciation cap.

The *2008 Stimulus Act* and the *2009 Recovery Act* generously raised the Code Sec. 280F limit on “luxury” first-year auto depreciation by \$8,000 to a \$10,960 maximum, if bonus depreciation was claimed for a qualifying vehicle. If the vehicle is not predominantly used for business in a subsequent year, however, then bonus depreciation must be recaptured.

**Comment.** Congress may reinstate bonus depreciation for 2010 retroactively to January 1, 2010 at any time during the year, so continue to check with your tax advisor on the availability of this benefit.

A “luxury” automobile for tax purposes in 2010 is defined as passenger automobile with a fair market value of over \$15,300 (\$16,000 for light trucks or vans/SUVs with truck chassis). For 2009, the values were \$15,000 and \$15,200, respectively.

The depreciation portion of your deduction for the vehicle's first five years of business use is based on the assumption that your car or light truck costs no more than the maximum amounts. This assumption limits the amount of depreciation that you may take each year over the assumed five-year "useful life" of the vehicle. If you keep your vehicle more than five years, you can continue to annually depreciate it in the amount allowed in year four and five until recovery of the purchase price is reached. If you sell your vehicle, however, you will recognize gain or loss measured by the selling price less basis (adjusted for claimed depreciation).

The IRS usually releases the luxury vehicle depreciation limits for any given year by the Spring of that year. Nevertheless, consumer price data upon which these numbers are based are now available for 2010 and, from them, the following depreciation "caps" can be projected:

For regular automobiles placed in service during 2010, the depreciation limits are estimated to be<sup>1</sup>:

Year 1 (2010)	\$3,060
Year 2 (2011)	\$4,900
Year 3 (2012)	\$2,950
Year 4 (2013 and thereafter)	\$1,775

<sup>1</sup> The IRS is expected to release the actual depreciation caps on automobiles and trucks/vans in May 2010. These figures are estimated calculations based on the previous year's depreciation limits.

For trucks and vans placed in service during 2010, the depreciation limits are estimated to be:

Year 1 (2010)	\$3,160
Year 2 (2011)	\$5,100
Year 3 (2012)	\$3,050
Year 4 (and thereafter)	\$1,875

Depreciation for a vehicle in its first year is less than that allowed for its second year because of a depreciation rule called "the half-year convention," which assumes your vehicle was purchased on July 1st of the year of purchase, no matter when it was actually bought.

**Qualified use vehicles.** The IRS now exempts from the dollar limits altogether any light truck or van that is specially designed or modified for business to preclude the likelihood of personal use; referred to as qualified use vehicles. This includes, for example, clearly marked police and fire vehicles, ambulances, bucket trucks ("cherry pickers"), and forklifts.

**Comment.** While motorcycles are not considered qualified use vehicles, they are also not subject to the luxury depreciation limits applicable to passenger automobiles. However, since motorcycles are classified as "any other property used as a means of transportation," they are still subject to the 50 percent business use test and depreciation recapture rules.

### **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 fully deductible to the extent used for business, but they are subject to a special income add-back rule to accommodate the luxury auto rules. If a leased business automobile, light truck, or light van first placed in service in 2010 has a fair market value of \$18,500 or more, for example, the lessee must add-back to income the amount determined by a table published by the IRS, continuing every year for the remainder of the lease in which the taxpayer uses the leased vehicle for personal reasons.

**Example.** An employee of American, Inc. leases a sports car with a fair market value of \$30,000 for the purposes of making sales calls. The employee claims business expense deductions in the amount of lease payments made for use of the vehicle. During 2009, his third year of leasing the vehicle, he drives 75 percent of the time for a qualified business purpose and 25 percent of the time for personal reasons and commuting to the office. Under the IRS's inclusion amounts

chart, the employee is required to include back \$177 (75 percent of \$236) into his income to reduce the deduction he ordinarily claims for the lease payments.

### **PERSONAL USE**

Use of a company vehicle for commuting or personal reasons will limit a business's taxable benefits and even create tax liabilities for employees. Vehicle costs incurred for personal use are self-explanatory, although separating business and personal use for tax purposes can sometimes be challenging.

Commuting expenses, which are personal expenses, generally include those incurred while traveling from the taxpayer's residence to the main place of business or employment. 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 main place of employment. As a result, vehicle costs incurred while driving from

your residence to a secondary place of business or employment as a result of a temporary assignment usually are not considered commuting costs.

Passenger vehicles are subject to the IRS's special modified accelerated cost recovery system (MACRS) if primarily used for a business purpose. They are classified as "five-year property" and subject to certain depreciation limits. However, if a company-owned vehicle is used for a business purpose less than 100 percent of the time, the employer must further reduce these limits by the percentage of personal use incurred during the year.

If an employee does not use the vehicle for a valid business purpose for more than 50 percent of the time, employers must even go a step further and alter their entire depreciation method for the vehicle, using the alternative form of MACRS (ADS). ADS adheres to the straight-line depreciation method. This switch 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. Assuming the employee takes the vehicle home, availability in the driveway will not be counted since mileage, rather than time used, controls.

### **Cents-per-mile valuation**

One of the permissible methods of valuation an employer can use to value the personal use of an employer-provided automobile is the mileage allowance rate, which for 2010 is 50 cents-per-mile. The maximum fair market values (FMVs) for use of the vehicle cents-per-mile valuation rule in 2010 are:

- \$15,300 for a passenger automobile; and
- \$16,000 for a truck or van, including automobiles built on a truck chassis, such as minivans and SUVs built on a truck chassis.

An employer who maintains a fleet of at least 20 automobiles can value the FMV of each automobile as equal to the average value of the entire fleet. The fleet-average value is the average of the FMVs of all automobiles in the fleet. The maximum FMVs for use of the fleet-average valuation rule in 2010 are:

- \$20,300 for a passenger automobile; and
- \$21,000 for a truck or van.



### **Employee income**

Personal use of a vehicle does not only impact the size of the write-off that a business can take. It also impacts the employee since it is considered a taxable fringe benefit to the employee to the extent of personal use. The income 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.

Figuring what income an employee must report may be done by any one of three methods selected by the employer to determine the fair market value of the vehicle's personal use:

- (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;
- (3) The cents-per-mile rule using the IRS standard mileage rate; or
- (4) The commuting valuation method (\$1.50 per one way commute).

Certain qualifications are required for some of these options. For example, the commuting valuation method is only allowed because the transportation is



provided solely because of unsafe conditions if walking or public transportation were used.

**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 to be 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."

**Tax-free parking.** The Tax Code draws a distinction between an employer's provision of a vehicle for employee personal use and certain payments to employees for parking costs for commuting in their own vehicles. For 2010, this annually inflation-adjusted exclusion is \$230 per month for qualified parking expenses. Employers can directly distribute this payment to employees as a fringe benefit or establish a pre-tax benefit paid by employees.

**Tax-free bike-to-work.** Employees may exclude up to \$20 a month from their wages from tax as reimbursement for the costs of commuting by bicycle! It includes costs for the purchase, accessories, repair, and storage of a bicycle regularly used to ride to and from work. Employees are not allowed to receive this benefit, however, in the form of a pre-tax salary reduction.

### SUVs

Not too long ago, businesses were able to take advantage of a quirk in the tax laws originally intended for construction vehicles. Individuals who purchased a truck with a gross vehicle weight of 6,000 pounds or more could write-off the entire cost of the purchase under Code Sec. 179. Many SUVs built on truck chassis weigh more than 6,000 pounds.

An SUV built on a truck chassis and with a gross (loaded) vehicle weight of over

6,000 pounds continues to be allowed favorable treatment, but it is not substantial. It continues to be exempt from the depreciation caps on luxury vehicles, so that accelerated depreciation can be taken, starting in year 1, based upon the full purchase price of the vehicle.

**Caution.** Congress may soon close this loophole, however, and might do it retroactively to January 1<sup>st</sup> of the year in which such legislation would pass.

## 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 properly keep 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.*** An employee's car expenses will be deemed substantiated if the employer reimburses the employee's expenses with a mileage allowance using a flat rate or a stated schedule that combines periodic fixed and variable payments. At least five employees must be covered by such an arrangement at all times during the calendar year, but at no time can the majority of covered employees be management employees.

For 2010, the standard automobile cost used to compute a FAVR allowance can not exceed \$27,300 (up from \$27,200 for 2009).

## 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, decreasing U.S. dependence on foreign oil, and reducing greenhouse gas emissions keeps Congress active in making these technologies more economical and accessible to the average consumer.



Congress changed the deduction to a credit in 2005, and the credit can now exceed \$3,000 for certain models. Not only limited to individuals, the credit is also available for businesses and corporations, depending upon the make and model of the vehicle and when it was purchased.

On the plus side, a tax credit is worth more than a deduction. On the negative side, the new credit is more complex to calculate than the old deduction. The credit is made up of two other credits: (1) a fuel economy credit that varies with the vehicle's rated fuel economy, and (2) a conservation credit based on the vehicle's estimated lifetime fuel savings.

**Caution.** The credit is temporary. For most cars and trucks, it expires in 2011. For many of the more popular models, they have already expired or are being phased out. In addition to the January 1, 2011 deadline, taxpayers could only claim the full amount of the credit until the first quarter after the quarter in which the manufacturer recorded 60,000

sales of the vehicle. During the second and third quarters after this milestone, taxpayers could only claim a 50 percent credit. During the fourth and fifth quarters, it was reduced to 25 percent. After the fifth quarter, no credit was allowed.

**Alternative fuel vehicles.** Vehicles that run on natural gas, hydrogen and other alternative fuels are eligible for a special tax credit. Fuel cell and electric vehicles also get special treatment, as do advanced lean-burn-technology diesel-powered vehicles, some of which are now in production.

### **Plug-in vehicle purchases**

The *Emergency Economic Stabilization Act of 2008* created a temporary credit against tax for taxpayers who purchase and place into service certain qualifying plug-in electric drive motor vehicles between 2010 and 2014. The maximum credit amount is \$7,500 (depending on the vehicle's weight) for qualifying vehicles purchased after December 31, 2009. The credit applies to the first 200,000 qualifying vehicles sold by a particular manufacturer. The credit begins to phase out by 50 percent during the second and third quarters, 25 percent during the third and fourth quarters, and then zero during the fifth quarter after the sales milestone has been reached. These limitations were made permanent by the *2009 Recovery Act*.

**Business use.** While businesses may not benefit from the plug-in electric drive motor vehicle tax credit in name, they nonetheless may still reap the financial rewards. The plug-in electric motor vehicle credit cannot be directly claimed if the vehicle is used for a business purpose. However, businesses may still claim the amount that would otherwise qualify for the credit (if the vehicle had been used for personal purposes) as part of the business's general business credit.

### **The American Recovery and Reinvestment Act of 2009**

Important provisions in the *2009 Recovery Act* have made significant additional benefits available to those acquiring or retrofitting green-vehicles.

**AMT relief.** The *2009 Recovery Act* adds new relief against the infamous alternative minimum income tax (AMT) if you claim the alternative motor vehicle credit. Individuals are allowed to treat the fuel economy credit as a non-refundable personal credit against the AMT. Before January 1, 2011, buying an environmentally-friendly automobile can reduce your enhanced tax liability under the AMT, dollar for dollar, no matter how much you earn.

**Plug-in electric motor vehicle conversion.** The *2009 Recovery Act* created a new credit against tax for those who convert their existing car or truck into

a “qualified plug-in electric motor vehicle.” Meeting this definition involves treating your vehicle as if it were an appliance more so than a land-cruiser. You have to convert the light truck or car from running on gasoline to running on a battery. When this battery has lost its power, you must be able to recharge it in some way that is outside of the car.

**Comment.** This involves a different science from that used by hybrid vehicles, which recharge themselves as you apply the break pedal.

Once you have met the technical requirements, you must convert the vehicle before December 31, 2012 to claim this new credit. It reduces your income tax by an amount equal to 10 percent of the cost of converting the vehicle, up to a maximum of \$4,000 in tax savings. Additionally, you can only employ this vehicle for your personal use. Your business cannot take advantage of the plug-in electric motor vehicle conversion credit.

**Low-speed, two and three-wheeled vehicles.** The *2009 Recovery Act* also carved out a special version of the new plug-in credit for low-speed and two or three-wheeled vehicles that were purchased between February 17, 2009 and January 1, 2010 that run on electric batteries. The credit was worth 10 percent

of the purchase price, up to a maximum of \$2,500. It is not certain whether Congress will retroactively extend this benefit for 2010.

## NEW VEHICLE PURCHASE SALES TAX DEDUCTION

Finally, as an incentive for consumers to buy any new vehicle, green or not, and to get the economy moving, the *2009 Recovery Act* allowed taxpayers to deduct from their taxable income the state sales and excise taxes paid on new motor vehicles purchased after February 17, 2009 and before January 1, 2010. This incentive has not been extended through 2010. If Congress passes legislation extending the tax break for the year, it can make the deduction retroactive to January 1, 2010.

The amount of the deduction allowed was limited to the state sales or excise tax due on the first \$49,500 of the purchase price of the vehicle. The amount was phased-out for modified adjusted gross income (AGI) exceeding \$125,000 (or \$250,000 for joint filers) and was reduced to zero for individuals with 2009 modified AGI exceeding \$135,000 (or \$260,000 for joint filers).

There were several caveats to this benefit. Each deduction was treated as either an increase in the standard deduction *or* included in the state and local general

sales tax itemized deduction. As a result, if you were claiming the itemized deduction for state and local general sales taxes in lieu of the deduction for state and local income taxes, you could also claim the new motor vehicle state and local sales tax deduction as part of the standard deduction. The law prohibited taxpayers from claiming the same amount as a deduction in two places.

## 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.