

Newsletter Winter 2004

TAX LAWS APPLYING TO VEHICLES

Standard Mileage Rate and Actual Costs

One of the most common tax deductions is for the business use of vehicles. The deduction can be based on the “standard mileage rate” or “actual costs”. Depreciation, interest, maintenance and repairs, tires, gasoline and oil, license and registration fees and insurance are inclusive in actual costs. Only the business use percentage of actual costs will be allowable tax deductions unless the personal use benefit is reported as taxable income to the taxpayer. In this case, all of the actual costs may be deducted.

The standard mileage rate in 2003 was 36 cents; the rate increases to 37.5 cents for 2004.

In order to maintain the option to select between actual costs or using the standard mileage rate, the user must:

1. Use the standard mileage rate in the vehicle’s first year of service.
2. Have only depreciated the vehicle using the straight line method (the depreciation calculation is subject to luxury auto limitation amounts).

Standard Mileage Rate Disallowed

The taxpayer is *not allowed to use the standard mileage rate* if:

1. The vehicle is used for hire (such as a taxi).
2. Five or more vehicles are used simultaneously (such as in a fleet).
3. A depreciation method other than straight line has been used (such as the Section 179 additional depreciation allowance, or the additional first-year bonus depreciation allowance).
4. The vehicle is leased and actual expenses for it were deducted after 1997.
5. The taxpayer is a rural mail carrier who received a qualified reimbursement.

Allowable Additional Expenses when using the Standard Mileage Rate

Taxpayers can deduct personal property taxes applicable to vehicles as an itemized deduction (Schedule A) even if the taxpayer uses the standard mileage rate or does not use the vehicle for business purposes. The taxpayer can also deduct business related parking fees and tolls, but cannot deduct fines or penalties for traffic violations. A self-employed taxpayer can deduct the business portion of interest paid on loans for the vehicle. An employee using his vehicle for business use for his employer can not deduct interest on the vehicle loan; it is considered personal interest.

Depreciation and Deduction Limitations

Vehicles defined as passenger vehicles have limits on the allowable annual depreciation. A passenger automobile is defined as a four wheel vehicle that is both:

1. Manufactured primarily for use on public roads, streets and highways.
2. Rated at 6,000 pounds or less unloaded gross vehicle weight (GVW).

A passenger vehicle does not include:

1. An ambulance or hearse used as such.
2. A vehicle used to transport persons or property for hire.
3. A qualified non-personal-use vehicle (a vehicle, by reason of its nature, that is not likely to be used more than a de minimis amount for personal purposes)

The table below reflects the depreciation limits (based on 100% business use) for passenger vehicles from 1998 through 2003. If business use is less than 100%, the limits must be reduced to reflect the actual business use percentage. Basic amounts and additional amounts allowed for bonus depreciation are represented. Beginning in 2003, trucks and vans that are subject to the limitation amounts are provided an increased basic depreciation limit.

| <u>Year placed in service</u> | <u>First Year</u> | <u>Second Year</u> | <u>Third Year</u> | <u>Later years</u> |
|--|-------------------|--------------------|-------------------|--------------------|
| 1998 | \$3,160 | \$5,000 | \$2,950 | \$1,775 |
| 1999 | \$3,060 | \$5,000 | \$2,950 | \$1,775 |
| 2000 | \$3,060 | \$4,900 | \$2,950 | \$1,775 |
| 2001-2002(basic) | \$3,060 | \$4,900 | \$2,950 | \$1,775 |
| 2001-2002 (with 30% bonus beginning 9/11/2001) | \$7,660 | \$4,900 | \$2,950 | \$1,775 |
| 2003 basic for cars | \$3,060 | \$4,900 | \$2,950 | \$1,775 |
| 2003 basic for pickups and vans | \$3,360 | \$5,400 | \$3,250 | \$1,975 |
| 2003 additional for 30% bonus | \$4,600 | N/A | N/A | N/A |
| 2003 additional for 50% bonus, beginning 5/6/2003 | \$7,650 | N/A | N/A | N/A |

Keep in mind, the above depreciation limits do not apply to trucks and vans that have a loaded gross vehicle weight greater than 6,000 pounds.

Bonus Depreciation

The Job Creation and Worker Assistance Act of 2002 created a 30 percent additional first-year depreciation allowance for qualifying property. The Jobs and Growth Tax Relief Reconciliation Act of 2003 increased the additional first-year depreciation allowance percentage to 50 percent. Only *new* property (original use beginning with the taxpayer) qualifies for bonus depreciation. Currently, Pennsylvania does not recognize bonus depreciation as an allowable method.

Section 179 Deduction

Section 179 permits the taxpayer to elect to depreciate all or part of the cost of certain property in the tax year that it is "*placed in service*". To be eligible the property must:

1. Be eligible property (tangible personal property)
2. Be acquired for business use (more than 50% business if used both for business and non-business purposes)
3. Be acquired by purchase (not inherited, not from a related party)
4. Not be excepted property (air conditioning or heating units, property leased to others, property used predominantly in lodging, property outside of the U.S., and property used by tax-exempt organizations, governmental units or foreign persons or entities)

The dollar limits for the Section 179 deduction are presented in the table below.

| Taxable Year | Dollar Limit |
|---------------------|---------------------|
| 1999 | \$19,000 |
| 2000 | \$20,000 |
| 2001 | \$24,000 |
| 2002 | \$24,000 |
| 2003 | \$100,000* |
| 2004 | \$100,000* |
| 2005 | \$100,000* |
| 2006 | \$25,000* |

*Increased by the Jobs and Growth Tax Relief Reconciliation Act of 2003. The dollar limits for 2004 and 2005 will indexed for inflation. Without further legislation, the limit will revert to \$25,000 in 2006.

The section 179 available deduction limit is reduced if the cost of total annual qualifying property acquired is greater than \$400,000. The amount was previously \$200,000. The \$400,000 will also be adjusted for inflation in years 2004 and 2005. The reduction of the allowed deduction limit is dollar for dollar for the amount greater than \$400,000.

The allowable maximum Section 179 deduction can also be limited by the taxpayer's taxable income. Section 179 amounts elected, but not utilized because of income limitations, are carried forward. Section 179 allowable deduction for vehicles is limited to the depreciation basic limits (i.e., \$3,060 for cars and \$3,360 for pickups and vans for 2003).

Disposition of Partial Business Use Vehicle

Proceeds of the sale of a vehicle used partially for business must be allocated between the business and personal portions to determine separate gains and losses on the sale. A gain on the personal portion of the asset is a long term capital gain reported on Schedule D, whereas a loss on the personal portion is a nondeductible personal loss.

Trade-in versus Sale of a Vehicle

The Internal Revenue Code provides for the non-recognition of gain or loss on the exchange (trade-in) of a vehicle for another vehicle. Any realized gain or loss is deferred until the taxpayer "disposes of the vehicle through a sale". Taxpayers should review tax consequences when

choosing between trading in or selling a vehicle that has been subjected to depreciation limits to ensure timely expense deductions.

Leasing an Automobile

A taxpayer who leases a vehicle for more than 30 days may have to reduce the lease payments deduction by an "inclusion amount" for each tax year of the lease. The inclusion amount is calculated using an IRS table, which shows the inclusion amount for each year of the lease, based on the Fair Market Value of the vehicle. This amount should be prorated in a year where the lease does not extend for the full twelve months. After four full years of lease, the Fair Market Value may be adjusted. The inclusion amount does not apply to leased vehicles with GVW greater than 6,000 pounds.

Employer Provided Vehicles

If an employer provides a vehicle to an employee, the business use is excluded from the employee's income, but the personal use must be valued and included in the employee's wages or must be reimbursed by the employer. There are three special valuation methods available to employers for determining fair market value of the personal use of an employer-provided vehicle.

Employers who do not provide vehicles to their employees often reimburse them for expenses associated with the business use of the employee's personal vehicle. These reimbursements are not included in an employee's income if they are made under an accountable plan. To qualify as an accountable plan:

1. The employee incurs deductible expenses, while performing services as an employee.
2. The employee accounts for these expenses to the employer within a reasonable time period (usually within 60 days).
3. The employee returns excess reimbursement within a reasonable time (usually 120 days).

For most business owners an understanding of the IRS rules governing the deduction or reimbursement of automobile related expenses is essential.

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Editor's Note---Debbie is a Manager in the Firm's Meadville Office. This article is based upon a presentation that she made as a section of a tax seminar offered to other CPA's at several locations in Western Pennsylvania. The seminars were sponsored by Penn State University.