

## 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 cannot 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).

## Dividends and Capital Gains

The table below reflects the depreciation limits (based on 100 percent business use) for passenger vehicles from 1998 through 2003. If business use is less than 100 percent, 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.

Year Placed in Service	1st Year	2nd Year	3rd Year	Later Years
<b>1998</b>	\$3,160	\$5,000	\$2,950	\$1,775
<b>1999</b>	\$3,060	\$5,000	\$2,950	\$1,775
<b>2000</b>	\$3,060	\$4,900	\$2,950	\$1,775
<b>2001-2002</b> basic)	\$3,060	\$4,900	\$2,950	\$1,775
<b>2001-2002</b> with 30% bonus beginning 9/11/2001	\$7,660	\$4,900	\$2,950	\$1,775
<b>2003</b> basic for cars	\$3,060	\$4,900	\$2,950	\$1,775
<b>2003</b> basic for pickups and vans	\$3,360	\$5,400	\$3,250	\$1,975
<b>2003</b> additional for 30% bonus	\$4,600	N/A	N/A	N/A
<b>2003</b> 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 percent 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

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*The Job Creation and Worker Assistance Act of 2002 created a 30 percent additional first-year depreciation allowance for qualifying property.*

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 12 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 employee. 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. Be eligible property (tangible personal property).
2. Be acquired for business use (more than 50 percent business if used both for business and non-business purposes).

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

---Debbie P. Pipp, CPA

*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 CPAs at several locations in Western Pennsylvania. The seminars were sponsored by Penn State University.*



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# The Ethics of Tax Preparation

The tax practitioner has an obligation to minimize a client's tax liability. The professionals of McGill, Power, Bell & Associates consider themselves to be highly knowledgeable advocates for their clients. But there are serious ethical issues associated with the preparation of tax returns. We feel that our clients should be aware of these ethical issues --- issues such as can the practitioner advise a client to take a position on his or her return, when the practitioner expects the IRS to take a contrary position? What are the distinctions between tax avoidance and tax evasion? What are the limitations, if any, on tax avoidance?

## **Tax Evasion**

One ethical issue is clear. The practitioner cannot knowingly participate in a client's tax evasion. Tax evasion is characterized by fraud and illegal activity. Advising a client to provide fraudulent information on a return implicates the practitioner in illegal activity. If the tax practitioner learns that a client is engaging in a fraudulent activity, the practitioner has a responsibility to withdraw from the engagement.

## **Tax Avoidance**

The ethics of tax avoidance are much less clear cut. There is a segment of the accounting community that perceives tax avoidance as raising no ethical issues. This view is partially supported by a ruling of Federal Court Judge Leonard Hand that there is no duty or responsibility for a filer to increase their taxes.

The profession takes the position that the practitioner's primary obligation is to the client. What if any obligation does the practitioner have to ensure that the system is operating fairly and honestly?

## **The Economic Model**

With audits by the IRS declining, the "economic model" postulates the economic benefit of tax avoidance versus the probability of detection and the size of the penalty if detected. This approach proposes that if the tax savings exceed the potential penalty times the percentage of risk of detection, the tax avoidance is justified. The economic model has not effected compliance rates when the sources of income are regularly reported such as wage and salary income. Accurate reporting on tax returns for this type of income is estimated at 98 percent. In contrast, it is estimated that accurate reporting of partnership income is only 42 percent.

The ethical practitioner must reject this "lottery" philosophy for tax avoidance. The practitioner has a clear responsibility to facilitate compliance with accurate reporting when the law is clear.

However, when the law is complex or ambiguous, practitioners may advise their clients to take an aggressive approach. Care must be taken not to use an approach based on a legitimate position and push it to the point that it is no longer defensible and clearly becomes an avoidance technique.

## **Professional Standards**

There are several bases for defining the ethical issues associated with tax minimization and avoidance. These include:

- The rules of the American Bar Association
- The AICPA's Statement on Standards for Tax Services
- The Treasury Department's Circular 230

## **The ABA Model**

The American Bar Association issued Opinion 314 in 1965. It stated that an attorney may urge the statement of positions most beneficial to the client as long as there is a reasonable basis for those positions.

The tax practitioner can take this favorable position without disclosing on the return that he or she has done so.

The standard states that the attorney represents the taxpayer in what is essentially an adversarial relationship between the taxpayer and the IRS. It further states that the IRS does not represent a true tribunal or even quasi-judicial institution. Attorneys may not mislead the IRS, but are not required to disclose weaknesses in the client's case.

Later, in 1985, the ABA released formal opinion 85352. This opinion states that the attorney may advise a position most favorable to the client if the attorney has a "good faith" belief that the position is warranted under existing law. The attorney can have a good faith belief in the position if the attorney thinks that the position has at least a one third probability of prevailing, if challenged.

### **AICPA's Statement on Standards for Tax Returns**

The AICPA's standards are similar to the ABA in that they state that a CPA may only recommend a position that the CPA feels has a realistic possibility of being sustained. However, the CPA cannot prepare or sign a return that takes a position that the CPA would not recommend. The CPA has a responsibility to advise the client of potential penalty consequences and the opportunity to avoid these consequences through disclosure.

Under no circumstances can a CPA recommend a position that:

1. Exploits the low risk of audit.
2. Serves as a mere arguing position advanced solely to obtain leverage in the bargaining process of a settlement with the taxing authority.

The CPA's advocacy of the taxpayer is limited only by the requirement to satisfy the conditions of the AICPA's Standards for Tax Returns.

### **Circular 230**

Tax professionals practicing before the IRS must also comply with the rules and regulations in Circular 230. A violation could result in the practitioner being disbarred from practice before the IRS, being suspended from practice, or being censured.



Like the ABA criteria, Circular 230 states that a practitioner cannot advise a client to take a position on a tax return unless the practitioner determines that the position satisfies the "realistic possibility of success standard." This standard is defined as being satisfied if a well-informed analysis of the law and the facts by a person knowledgeable in the tax law would lead the person to conclude that the position has a one in three or better chance of being sustained on the merits.

Persons having their tax returns professionally prepared must understand that while the CPA is their advocate and has a responsibility to take positions that minimize their tax liability, they must do so under ethical and legal constraints. A CPA may not sign a return that takes a position that the CPA does not believe to have a reasonable chance of being sustained. The "audit lottery" or "leveraging negotiations for a settlement" strategies are deemed to be unethical by the profession.

---Diana L. Schaney, CPA, CSEP, CSMC

*Editor's Note --- Diana is the partner in charge of the firm's Erie office. This article is derived from a section of a seminar that she recently presented to other CPAs at seminars sponsored by Penn State University and presented in various locations in Western Pennsylvania.*

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