About the Author

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By Bob Trinz, Senior Tax Analyst for Thomson Reuters

Why the Company Car Is Still a Valued Fringe Benefit

A company car has long been an extremely popular "perk" or fringe benefit for company owners and key employees of medium-sized or small enterprises. As this article demonstrates, this benefit yields substantial nontax as well as tax benefits for the owner or employee, as well as tax deductions for the employer.

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To illustrate the benefits of the company auto, let us assume that Mr. Smith, the owner-employee of Widget, Inc., expects to drive an auto 8,500 miles a year for business (e.g., to visit customers, check on local suppliers and distributors), and 7,000 miles per year for personal driving (e.g., commuting and weekend trips; his family owns other cars used for other personal mileage). That mileage represents roughly fifty-five percent business and forty-five percent personal usage. Let's further assume Widget's having a good year and Smith wants to project a successful image to his business contacts, so Widget buys or leases a new $50,000 auto for his business/personal use.

The unique benefits that flow from the arrangement are as follows:

• Smith's cost for his personal use of the vehicle will be equal to the tax he pays on the fringe-benefit value of his forty-five percent personal mileage. By contrast, if Smith bought or leased the auto himself to be able to drive those personal miles, he would have to use after-tax dollars to fund the entire purchase or lease cost of the car.

• Assuming Smith's personal use is properly treated as fringe benefit income, Widget treats the car for tax purposes much the same way it would any other business asset, subject to severe depreciation deduction restrictions if the auto is purchased (somewhat mitigated by a bonus first-year write-off if the auto is bought new and placed in service this year), and relatively mild deduction restrictions if the auto is leased. Out-of-pocket expenses associated with the car (insurance, oil and gas, maintenance, etc.) are completely deductible, including the portion that relates to Smith's personal use. If Widget finances the car, all the interest it pays on the loan would be deductible as a business expense. By contrast, if Smith bought or leased the auto himself, he could only claim deductions for the business-use portion of the allowable depreciation amount (or lease expense) and out-of-pocket expenses of running the car. And if he financed the car, the interest payments would be nondeductible personal interest under IRC Sec. 163(h)(1)(A) (unless he used a home equity line of credit).

• As a final benefit to Smith, the purchase or lease of the vehicle by Widget will have no effect on his credit rating.

Observation. It is important to note that providing an auto for an owner's or employee's personal and business use (or solely personal use) will not be free of complications and paperwork. Personal use will have to be tracked and valued under the fringe benefit rules and treated as compensation income.

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Tax Consequences of Personal Use

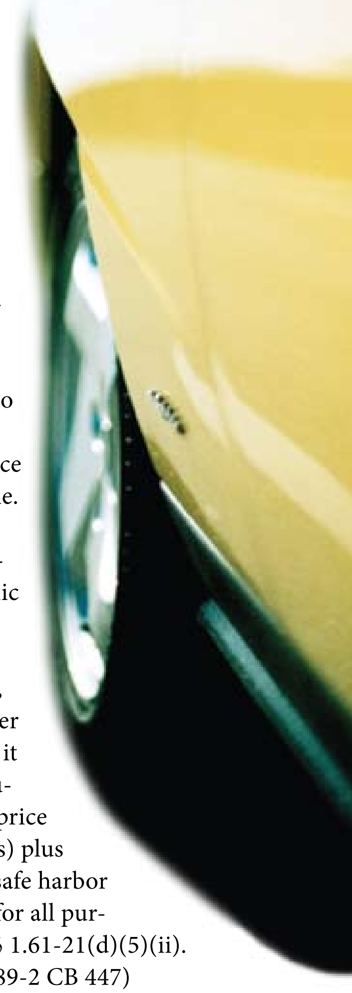
The value of an employee's personal use of a company auto is a taxable fringe benefit treated as noncash compensation paid to the employee (references to the employee are references to both an employee-owner and a regular employee). That value is included in his or her income unless excluded under the Code. (Treasury Regulation Sec.1.61-21(a))

Such personal driving has the following tax consequences:

• *For the employer:* Although it furnishes a noncash fringe benefit to an employee that must be treated as compensation, the employer may deduct only the costs it incurs in providing the auto to its employee, not the auto's value to the employee. It may claim a depreciation deduction if it owns the auto or a deduction for leasing costs if it rents the auto. (Reg § 1.162-25T(a)) Because the value of personal use of an auto is treated as compensation income, the employer must pay FICA taxes [i.e., for old age, survivors, and disability insurance (OASDI), and hospital insurance (HI)] on that value. However, the OASDI component of FICA taxes is payable on the value of personal use only to the extent the employee's other compensation does not exceed the OASDI wage base ($102,000 for 2008). The value also is subject to federal income tax withholding unless the employer elects not to withhold federal income tax. (IRC Sec. 3402(s)(1); Announcement 85-113, 1985-31 IRB 31, Sec. 4)

• *For the employee:* The personal use value appears on the employee's W-2 and is treated as salary on his Form 1040. FICA taxes will be withheld from the employee's pay on the value (but only on the HI part of the FICA taxes if he is already over the OASDI wage base).

As a general rule, the personal use of any vehicle results in compensation income. (Reg § 1.61-21(a), Reg § 1.61-21(b)(1)) However, mileage on an employer-provided auto is a nontaxable working condition fringe benefit to the extent that it is (1) employment-related business mileage, and (2) substantiated to the employer. The exclusion applies whether the employee is equipped with an upscale auto or an economy model. (Reg § 1.132-5(a)(1), Reg § 1.132-5(b)(1), Reg § 1.132-5(c)(1))



Valuing Personal Use with the FMV Method

The value of any fringe benefit supplied to an employee generally is its FMV. In the auto context, the FMV is the amount an individual would have to pay—in an arm's length transaction—to lease an auto comparable to the one supplied by the employer for a comparable period of time. (Reg § 1.61-21(b)(4)) If the employer leases the auto supplied to the employee, it cannot use its lease cost as FMV. (Reg § 1.61-21(b)(2))

Observation. The dealer that sold or leased the auto to the employer should be able to supply a statement of the auto's FMV leasing cost.

Once FMV has been established, the employer then multiplies it by the ratio of the employee's personal mileage on the car to total mileage. The result is charged to the employee as noncash compensation due to personal use of the auto. (Reg § 1.61-21(b)(1), Reg § 1.132-5(b)(1)(i)) The employer also must charge the employee with compensation income equal to the FMV of other employer-paid costs for goods or services relating to personal use (e.g., gas, maintenance, insurance).

Illustration. Continuing with our example of Widget, Inc., and Mr. Smith, an owner-employee, we will assume Widget buys or leases a new $50,000 auto for him in January of 2008. The lease runs for three years. Widget also insures the auto and pays for maintenance. We will assume the lease would cost Smith $7,500 a year and the insurance and maintenance would cost $3,000. For 2008, Smith's employment-related business use of the auto is fifty-five percent, and his personal use is forty-five percent.

Result. Under the general FMV personal use valuation method, Smith would be charged with $4,725 of compensation income in 2008 due to his personal use [($7,500 + $3,000) x 0.45)]. At a thirty-five percent effective tax rate, that ends up costing Smith only $1,654 ($4,725 x 0.35). If Smith also charges all gas costs on a company credit card and does not reimburse the employer for fuel consumed during personal driving, he would also have compensation income equal to forty-five percent of total gas costs for 2008.

Valuing Personal Use with the Table Value Method

Instead of using the general FMV method, employers have the choice of using one of three optional methods: the table value method (also know as the annual lease value method), the cents-per-mile method, or the commuting value method. (Reg § 1.61-21(b)(1)). However, as a practical matter, because of the many restrictions placed on the cents-per-mile and commuting value methods, the table value method is the only optional method that is effectively available for owners or key employees.

To apply the table value method, the first step is to determine the FMV of the auto as of the first date on which the auto is made available for the personal use of any employee of the employer. (Reg § 1.61-21(d)(2)(i)(A))

As a general rule, an auto's FMV for purposes of determining annual lease value is the amount an individual would pay locally to purchase a comparably equipped auto. (Reg § 1.61-21(d)(5)(i)) However, the employer can avail itself of the following safe-harbor valuation methods:

- For an auto owned by the employer, the safe harbor value (for non-auto manufacturers) is the employer's cost of buying it (including sales tax, title, and other expenses attributable to the purchase), provided the purchase is made at arm's length. (Reg § 1.61-21(d)(5)(ii)(A)
- The safe harbor value of an auto *leased* by the employer is either: (1) the manufacturer's suggested retail price less eight percent (including sales tax, title, and other purchase expenses) (Reg § 1.61-21(d)(5)(ii)(C)), or (2) the retail value of the auto as reported in a nationally recognized publication which regularly reports new or used auto retail values, whichever is applicable (reported retail price). For the auto in question, the reported retail price must be reasonable. Pricing sources consist of publications and electronic databases. (Reg § 1.61-21(d)(5)(ii)(C)) Alternatively, where the employer leases the vehicle, it may use the manufacturer's invoice price (including options) plus four percent as a safe harbor estimate of FMV for all purposes under Reg § 1.61-21(d)(5)(ii). (Notice 89-110, 989-2 CB 447)

Once FMV is found, locate the dollar range in Column 1 of the table that includes that FMV. The corresponding amount in Column 2 is the annual lease value. (Reg § 1.61-21(d)(2)(i)(B)) Finally, multiply the annual lease value by the ratio of the employee's annual personal mileage to total annual mileage (employment-connected business driving plus personal driving). (Reg § 1.132-5(b)(1)(i); Reg § 31.3501(a)-1T, Q&A-7)

For automobiles with a FMV greater than $59,999, the annual lease value is equal to: (0.25 x FMV) + $500. (Reg § 1.61-21(d)(2)(iii))

The annual lease value method takes into account the FMV of insuring and maintaining the auto. The amount shown in the table cannot be reduced by the FMV of any service included in the lease value but not supplied by the employer. (Reg § 1.61-21(d)(3)) For example, there is no reduction if the employee must pay his or her own insurance costs. The FMV of any other service supplied with the auto—such as a driver or chauffeur—must be added to the table lease value. (Reg § 1.61-21(b)(5), Reg § 1.61-21(d)(3)(i))

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Illustration. Continuing with our example of Widget, Inc., suppose it supplied Mr. Smith, its owner-employee, with a new $50,000 auto on January 1 of this year, and he uses it fifty-five percent for business driving and forty-five percent for personal driving.

Under the table-value method, Smith would have $5,963 of noncash compensation for the year due to his personal use of the auto ($13,250 annual lease value per table times forty-five percent).

Observation. Special table value rules apply if the lease starts in the middle of the year or if the auto is only made available for part of the year. Additionally, the table values are based on a four-year term.

The table value method does not take into account the FMV of fuel provided to the employee by the employer, whether in kind, via a reimbursement arrangement, or via direct charging of the cost of fuel to the employer. Therefore, where an employer provides fuel to an employee, its FMV is an additional fringe benefit to the employee and must be included in gross income (except for the gas used for employment-connected business driving). (Reg § 1.61-21(d)(3)(ii)(A)) The FMV of fuel provided in kind by an employer may be determined based on all the facts and circumstances. Alternatively, but only for fuel provided *in kind* for miles driven within the U.S., Canada, or Mexico, fuel may be valued at 5.5 cents per mile for all miles driven by the employee. (Reg § 1.61-21(d)(3)(ii)(B))

Observation. With gas hovering at $4 a gallon in many areas, having fuel valued at 5.5 cents per mile is an incredible bargain. As a practical matter, however, for personal mileage this rule is usable only if the employer maintains a gas pump on the premises (e.g., it has a fleet of cars or trucks).

Where an employer provides an employee with fuel by means of a reimbursement arrangement, or by allowing the cost of the fuel to be charged directly to it, the FMV of the fuel is the amount of the actual reimbursement or the amount charged, if the fuel is bought at arm's length. (Reg § 1.61-21(d)(3)(ii)(C))

Pros and Cons of Valuation Methods

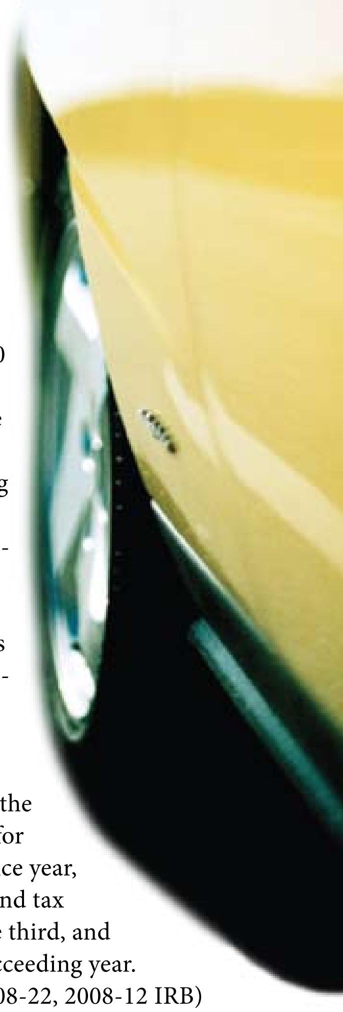
The chief virtue of the general FMV valuation method is that the current arm's length cost of leasing a car (and insuring it) may be less than the valuation produced by the annual lease value method, which is based on a table that has not changed since it was first issued in temporary regs in 1985. (TD 8063, 1986-1 CB 10) On the minus side, however, the FMV method may mean more "legwork" for the employer (i.e., in establishing the arm's length value of the auto's use) and can be a cumbersome method for an employer that maintains more than a few cars. The method also may be costly for the employee if he is given the use of an auto for a relatively short period of time (e.g., he is given the use of an auto the company leases for only two years).

Employees must keep a diary or similar record with detailed entries for employment-connected business usage of the auto.

The chief virtue of the annual lease value method is simplicity. An employer using this method can find the value of any employee's personal mileage on any auto by using a universal table that includes insurance and maintenance costs. On the minus side, however, the annual lease value method may bear little if any resemblance to actual lease values. Thus, this method may produce more

ANNUAL LEASE VALUE TABLE FOR AUTOS

Automobile FMV	Annual Lease Value
$ 0–999	$ 600
$ 1,000–1,999	$ 850
$ 2,000–2,999	$ 1,100
$ 3,000–3,999	$ 1,350
$ 4,000–4,999	$ 1,600
$ 5,000–5,999	$ 1,850
$ 6,000–6,999	$ 2,100
$ 7,000–7,999	$ 2,350
$ 8,000–8,999	$ 2,600
$ 9,000–9,999	$ 2,850
$ 10,000–10,999	$ 3,100
$ 11,000–11,999	$ 3,350
$ 12,000–12,999	$ 3,600
$ 13,000–13,999	$ 3,850
$ 14,000–14,999	$ 4,100
$ 15,000–15,999	$ 4,350
$ 16,000–16,999	$ 4,600
$ 17,000–17,999	$ 4,850
$ 18,000–18,999	$ 5,100
$ 19,000–19,999	$ 5,350
$ 20,000–20,999	$ 5,600
$ 21,000–21,999	$ 5,850
$ 22,000–22,999	$ 6,100
$ 23,000–23,999	$ 6,350
$ 24,000–24,999	$ 6,600
$ 25,000–25,999	$ 6,850
$ 26,000–26,999	$ 7,250
$ 28,000–29,999	$ 7,750
$ 30,000–31,999	$ 8,250
$ 32,000–33,999	$ 8,750
$ 34,000–35,999	$ 9,250
$ 36,000–37,999	$ 9,750
$ 38,000–39,999	$10,250
$ 40,000–41,999	$10,750
$ 42,000–43,999	$11,250
$ 44,000–45,999	$11,750
$ 46,000–47,999	$12,250
$ 48,000–49,999	$12,750
$ 50,000–51,999	$13,250
$ 52,000–53,999	$13,750
$ 54,000–55,999	$14,250
$ 56,000–57,999	$14,750
$ 58,000–59,999	$15,250



taxable compensation income for employees than the FMV method.

Consistency Rules for Personal Use Valuation Methods

An employer is not required to use the same valuation method for all its autos. For example, it may use the FMV method for one auto and the annual lease value method for another. (Reg § 1.61-21(c)(2)(ii)) However, once an employer chooses a valuation method for a particular auto, it is generally locked into that method for that auto. In other words, the election is binding for all later periods the auto is made available to *any* employee. (Reg § 1.61-21(d)(7)(ii), Reg § 1.61-21(e)(5)(ii))

An employer is treated as having made the choice to use a particular valuation method when it values personal use with that method for income, employment tax, and reporting purposes. (Reg § 1.61-21(c)(3)(i)) In general, the election to use the annual lease value or mileage rate method must be made for the first day on which the auto is made available to an employee. (Reg § 1.61-21(d)(7)(i), Reg § 1.61-21(e)(5)(i))

For income tax purposes, a company owner or employee may always use the general fair market valuation method to value an employer-provided benefit, even if the employer uses the table value method. (Reg § 1.61-21(c)(2)(ii))

Caution. An employee tempted to use the general FMV method because it produces a lower valuation than the employer's use of the table value method should keep in mind that he will have to attach a statement to his return reconciling the amount included in income with the amount reported on his W-2.

In general, in the context of our discussion geared to a small or medium-sized firm, an owner or employee will use the annual lease value method to value his personal use of an employer-provided auto only if the employer uses that method. (Reg § 1.61-21(c)(2)(ii))

Recordkeeping Requirements

Whether the general FMV or table value method is chosen, the only way to distinguish between employment-related business driving (which is excluded as a nontaxable working fringe benefit if properly substantiated) and personal driving (which is a taxable fringe benefit) is on the basis of mileage. (Reg § 1.132-5(b))

Recommendation. Employees must keep a diary or similar record with detailed entries for employment-connected business usage of the auto (time, place, mileage, business purpose). These entries are needed to establish the non-taxable working condition fringe benefit portion of employees' usage. Employees also should enter beginning and ending odometer readings for the period of time involved. Total mileage less employment-connected business mileage will yield personal mileage, the value of which must be treated as taxable fringe benefit compensation income.

Business Auto Deductions for the Employer

If all personal use of the auto by an owner or employee (or a member of his or her family) is properly treated as fringe benefit compensation income, the auto will be treated as if it were 100 percent used for business. That means the employer may deduct all of its operating expenses (e.g., oil, gas, maintenance, and repairs) and also may claim all of the allowable depreciation deductions or lease deductions. Rationale: Where personal use is treated as fringe benefit compensation income, the employer may deduct all of the allowable costs incurred in supplying that benefit. (Reg § 1.162-25T; Reg § 1.274-5T(e)(2))

Because of the so-called "luxury auto" deduction limits of IRC Sec. 280F, however, employers will have to grapple with severe restrictions on depreciation and expensing deductions if the company auto is purchased (unless the vehicle is a heavy SUV, defined below) and relatively mild restrictions if it is leased (and no restrictions at all if the vehicle is a heavy SUV).

Purchased autos: The otherwise-allowable depreciation and IRC Sec. 179 expensing deductions for a new business auto bought and placed in service in 2008 are limited to $10,960 for the placed-in-service year, $4,800 for the second tax year, $2,850 for the third, and $1,775 for each succeeding year. For new light trucks or vans [passenger autos built on a truck chassis, including minivans and sport utility vehicles (SUVs) built on a truck chassis] bought and placed in service in 2008, the limits are $11,160 for the placed-in-service year, $5,100 for the second tax year, $3,050 for the third, and $1,875 for each succeeding year. (Revenue Proc. 2008-22, 2008-12 IRB)

Caution. If the vehicle is used by a more-than-five percent company owner, the above first-year limits—which are substantially more generous under the Economic Stimulus Act of 2008 than the normal first-year limits—apply only if business use exceeds fifty percent of total use. If it does not (or if the auto is bought used or the employer elects not to use bonus first-year depreciation for autos and other 5-year assets), first-year depreciation will be limited to only $2,960 if the vehicle is an auto, and $3,160 if it is a light truck or van. (IRC Sec. 168(k)(2)(D))

These rules are relaxed considerably if the company-owned vehicle is a heavy SUV, one with a gross vehicle weight rating (GVWR) of over 6,000 lbs. Because such vehicles fall outside of the IRC Sec. 280F(d)(5) definition of a passenger auto, the strict annual depreciation deduction limits do not apply. As a result, the employer may:

• Expense up to $25,000 of the cost of the heavy SUV under IRC Sec. 179(b)(6);

• Claim bonus first-year depreciation under the Economic Stimulus Act of 2008 of its cost as reduced by any expensing claimed (this is available only if the vehicle is bought new and placed in service in 2008); and

• Write off what is left of the cost of the vehicle after subtracting the expensed amount and the bonus first-year depreciation amount under the normal depreciation rules applicable to 5-year property.

Caution. If the heavy SUV is used by a more-than-five percent company owner, the above generous rules apply only if business use exceeds fifty percent of total use. If it does not, the vehicle is not eligible for expensing, bonus first-year depreciation will not be available, and a slower (straight line) form of depreciation must be used to recover the cost of the vehicle. (IRC Sec. 168(k)(2)(D), IRC Sec. 280F(b)(1), IRC Sec. 280F(d)(1))

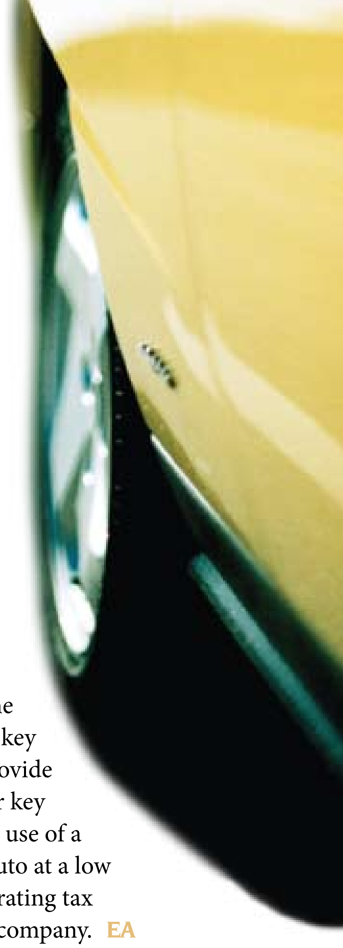
Leased autos: A business which leases an auto for its owner or key employee may deduct the full lease payment, assuming personal use is properly treated as compensation income. However, unless the auto is modestly priced (e.g., for leases signed in 2008, it has a FMV under $18,500 if an auto, or under $19,000 if a light truck or van), the business must include a certain amount in income during each year of the lease. (IRC Sec. 280F(c)) This income inclusion amount varies with the initial FMV of the leased auto, the lease term and the year of the lease, and is adjusted for inflation each year.

Tables 5 and 6 of Rev. Proc. 2008-22, 2008-12 IRC, Sec. 4.03, carry the income inclusion tables for passenger autos, light trucks, and vans with a lease term beginning in 2008.

Observation. These addback amounts are relatively modest, even for higher-priced autos. For example, if a $50,000 auto is leased on January 1, 2008 for a three-year term, the income inclusion amount would be $177 for 2008, $388 for 2009, and $575 for 2010.

Mileage Rate Method of Deducting Auto Expenses

For the sake of completeness, it should be noted that instead of deducting actual business-related out-of-pocket expenses plus depreciation, an eligible business may deduct business-connected expenses of leased or purchased autos (including vans, pickups, and panel trucks) by way of the standard mileage rate. This method yields a fixed deduction for each business mile trav-



eled regardless of actual expenses, cost of the auto, or its age. Assuming personal use is properly valued and treated as compensation income, even personal mileage would count as business mileage. The mileage rate, which is adjusted for inflation annually, is equal to 50.5 cents for each business mile traveled during the first half of 2008 and 58.5 cents for each mile traveled during the second half of 2008. The mileage rate deduction method is available only if a number of restrictions are met. For example, it is not available if the auto was written off in a previous year using accelerated depreciation or if the business owns or leases five or more autos and uses them simultaneously. (Revenue Procedure 2007-70, 2007-50 IRB 1162)

A deduction computed under the standard mileage rate is in lieu of all operating and fixed costs of the automobile allocable to business purposes. Such items as depreciation (or lease costs), maintenance and repairs, tires, gasoline (including all taxes on the gasoline), oil, insurance, and registration fees are included in operating and fixed costs. (Revenue Procedure 2007-70, 2007-50 IRB 1162, Sec. 5.03) However, the taxpayer may separately deduct parking fees and tolls attributable to business use of the auto. (Revenue Procedure 2007-70, 2007-50 IRB 1162, Sec. 5.04)

Observation. As a practical matter, the mileage rate method is not an attractive write-off for the company auto used by the owner or a key employee, because it is likely to be much smaller than the deductions that can be claimed by writing off actual out-of-pocket expenses and depreciation or lease costs.

Conclusion

The company auto still weighs in as a champion fringe benefit for the company owner or key employee. It can provide company owners or key employees with the use of a status-enhancing auto at a low tax cost while generating tax deductions for the company. EA