BUSINESS USE OF A VEHICLE

This is perhaps one of the most prevalent write-off issues a business owner faces. Nearly every business uses a vehicle at one time or another for a business purpose. (See definition below)

Thus, a business may be able to deduct various expenses associated with this use of a vehicle. Normally there are two major methods used: a standard mileage rate or actual expenses method. Both of these methods involve calculating the business portion of the allowable expenses which are then deducted against business revenues. From a tax-savings standpoint, the allowable deduction saves an amount in taxes relative to the marginal tax rate for the business. For example, if your tax bracket is 33%, you will save one-third in taxes for every dollar of deductible vehicle expense you paid out.

In addition to the methodology to be used, other issues that you, the business owner, must face include recordkeeping and substantiation requirements, and calculating the business use percentage.

First, an overview of the two main methods for deducting these business vehicle expenses is in order.

The Actual Expense Method

This method is basically what it sounds like. You deduct the business portion of the various expenses associated with operating a vehicle. These costs may include the following:

fuel, insurance, repairs, maintenance, tires, registrations, garage rental, parking fees, tolls, lease fees, property tax loan interest expense, washing & waxing, depreciation, etc.

While most of these ordinary expenses are self-explanatory, a couple of them merit further detail, specifically depreciation and leasing expenses which are at opposite ends of the deduction spectrum.
Basically, a vehicle can be either owned or leased for business purposes. Depending on which option you select determines whether you will be taking a depreciation expense for a portion of the cost of the vehicle, or taking a leasing cost write-off instead. You can't do both at the same time.

Depreciation Write-off: The business cost basis of a vehicle can be written-off over an allowable time frame as opposed to all at once. This is a form of depreciation expense. For most passenger type and non-exempt vehicles, the depreciation amount and method is governed by the IRS, and generally involves the use of MACRS rules. This is a hybrid depreciation calculation combining a declining balance and straight line methodology. You are not always required to use this method, however. Under certain instances you can also elect a straight line method, or a different declining balance method instead.

In effect, though, all of these depreciation methods and rules set the time frame and dollar amount of depreciation that can be taken for the vehicle each year. There are certain limitations/differences in the actual amount of the cost of the vehicle that can be written off under each of these rules for any given year.

This means that the cost of the vehicle does not necessarily impact the amount of depreciation that can be taken in a particular year once a certain price range is involved. So if you buy a $15,000 car vs. a $40,000 car, the amount of depreciation taken(at least for the first 5 years) may not be different between the two vehicles.

Leasing Expenses: If you lease a car instead of buy it, you are not allowed to depreciate it. Rather, you can take the business portion of the lease payments as a deduction–subject to certain limitations. These limitations parallel the depreciation deduction limitation in that a portion of the lease payments may not be allowable as a net deduction if the value of the car exceeds certain government amounts. This falls into the so-called "luxury vehicle" use rules and/or "lease inclusion amount" calculations. It's a way for the IRS to limit the business write-off of vehicles that exceed certain dollar values. Thus, if you lease a Cadillac vs a Ford Escort, the amount of the lease payment deduction may be limited as set forth in IRS tables associated with "luxury vehicles."

Standard Mileage Rate

This method uses an IRS mileage rate allowance instead of using actual expenses. Note, however, that this method is not available to all. It is not an allowable method for the following situations:

Vehicle is used "for hire."

Two or more vehicles are being operated at the same time.
You do not own the car(except for leasing).
Most corporations and partnerships where more than one vehicle is being used.
The vehicle has been previously depreciated using MACRS or ACRS methods in an earlier year.
The vehicle was converted from personal use to business under certain controlled or related-party transactions.

For those who qualify, however, the most recent standard mileage rate allowance is 65.5 cents per business mile. By choosing this method, you do not take actual operating expenses. Instead, you get a business use deduction of cents per business mile.

There are a few expenses that can be added to the standard mileage deduction, however. You can also write-off the business portion of parking fees, tolls, business loan interest, and personal property taxes on the vehicle.

Note that this election to use the standard mileage method should generally be chosen in the first year you place the vehicle in service for business purposes to preserve this option.

From a substantiation viewpoint, the standard mileage allowance method is easier to use. However, it may not provide the bigger deduction. Some of the major variables that can affect the choice of standard mileage vs actual expense methods include: cost of vehicle for depreciation purposes, repair expenses, insurance coverage amounts, type of gas mileage, business use percentages, total miles driven, and lease payments. In other words, whenever possible you should try to project out the actual costs of the vehicle to compare to the standard mileage method and pick the option best suited to you.

Calculating The Business Use Percentage

For situations where the vehicle is not being used 100% for business, the calculation for the deductible portion of the business expenses allowed for tax purposes is based on a ratio between personal and business use. For example, if you drive the vehicle a total of 10,000 miles for the year and 6,000 of those miles were for allowable business purposes, the business use percentage is 60%. That means you could claim 60% of the total operating expenses of the vehicle for business purposes.

If business use percentage is less than 50%: A special "wrinkle" develops in the situation where the business use is below 50% and you are using the actual expense method where depreciation is being taken. In this case, the IRS requires a different depreciation calculation than MACRS. An alternate MACRS system is used. The net result is that you are allowed a smaller depreciation deduction– everything else being equal–for the year in which the business use is less than 50%.

Recordkeeping & Substantiation Requirements

The IRS has various requirements you should follow for validating the business use of a vehicle. IRS not withstanding, if you have employees who will be using company vehicles, you would want them to provide you with adequate substantiation–both for your piece of mind, and for IRS purposes.

With that in mind, the record keeping recommendations are designed to be able to prove the following:

1) When you placed the vehicle into use
2) Adjusted cost basis of vehicle
3) Operating expenses(such as gas, insurance, etc.)
4) Total mileage verification and business mileage verification
5) Business purpose of business miles claimed

Record keeping should be done in a timely fashion; that is, the verification should be done at or near the time of the actual occurrence/expense. For the actual expenses that is fairly easy if you are paying by check, credit card, or cash where a receipt is given to you. For other situations, or for verification of mileage, the suggestion is to use a diary or business log to track the other expenses and miles driven. While this is not always required to survive an IRS audit(ref. the "Cohen" case in which reconstructive testimony was allowed as verification), it is certainly the best way.

The verification of mileage driven is usually handled by the use of a travel log in which the total miles are recorded periodically, and the business miles are identified within this framework. While using exact odometer readings is the ideal, it is not always done this way. A listing on a daily basis of the total miles driven can suffice for one part; a notation of the round trip miles driven that day for business purposes will suffice as well.

Some exemptions: There are certain types of vehicles that may be exempt from some(or all) of the substantiation/recordkeeping rules, most notably:

Busses, moving vans, heavy specialty trucks, cranes, bucket trucks, fork-lifts, dump trucks, cement mixers, certain delivery vehicles, ambulances, hearses, garbage trucks, certain vehicles for hire where no personal use is possible, various farm vehicles, and so forth.

Basically, the major criteria on the bulk of the substantiation rules requirements is whether or not the vehicle is likely to be used for any personal purposes, and the nature of the vehicle. A "passenger-type" vehicle where the major burden falls as to substantiation is considered one that weighs less than 6000 pounds, is four-wheeled, and is designed for use on public roads. The exempted vehicles usually differ from this definition, and are used directly in a trade or business for the purpose of carrying property or persons for hire.

How long to keep records: For IRS purposes, it is usually necessary to keep substantiation records for at least three years from the date you last filed the tax return in question.

Employee

If an employee used his/her vehicle for their employers purpose, they are entitled to similar deductions as stated above. The only difference, in deductions, is that an employee cannot deduct interest on vehicle loans.

In order to secure a deduction the employee must be in "travel status". This rule applies to business use also.

Business use

Business use and *travel status* are synonymous. Commuting to and from work is not deductible, **regardless** of the distance or method used (car, plane, bus, train) to get to your regular work location.
If you have a qualified home office, under code section 280(A), you do not have to account for commuting miles. Self-employed individuals, who do not have a qualified home office, cannot deduct their mileage to/from their customer location (work site) if they got to only one site per day.
If they have multiple work sites in a single day they cannot deduct the mileage to/from the first and last stop of the day. They are considered commuting miles.

Temporary work location miles are fully deductible. If you have a regular place of business (work location) and you go to a temporary site (customer, vendor, bank, etc.) those miles are deductible.
Also, if you see multiple customers, vendors, etc., in one day, all but the first and last stop of the day are deductible. Your temporary work location can be local or "out of town".

Conclusion

Using a vehicle for business purposes is a commonplace event. The odds are you will be dealing with this issue one time or another whether it be for yourself, or for an employee situation. In the situation where you have a choice between the two different methodologies, it sometimes requires a bit of detailed thinking. This is especially true if you are considering the actual expense method, and if the business use percentage may be low.

Since the business deduction increases as the business mileage increases, some pre-planning here could make a difference if you have more than one vehicle available for business use. The higher the business use ratio, the higher the business deduction.

Record keeping is not terribly onerous. While contemporary record keeping is always the best, it is not an absolute requirement for IRS purposes. So you don't have to write down the particulars as soon as you stop the car! However, the proof of the actual expenses being claimed is required. Canceled checks, and paid invoices will suffice. There may be certain expenses where this type of substantiation is nearly impossible(gas, washing & waxing, etc.) at times . In this case, the use of an expense log or other consistent record keeping may serve as adequate proof instead.