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## Technical Bulletins: Changes in IRS Rules Regarding Employee Fringe Benefits

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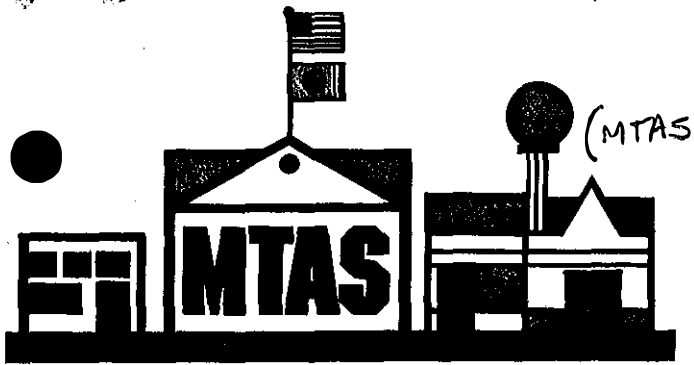
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# TECHNICAL BULLETIN

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## CHANGES IN IRS RULES REGARDING EMPLOYEE FRINGE BENEFITS By Richard M. Ellis, Municipal Programs Consultant

The Internal Revenue Service has issued temporary regulations, retroactively effective to Jan. 1, 1985, which will affect certain fringe benefits provided to city employees. The major impact on city employees will involve their use of city-owned vehicles. It should be assumed that these regulations will become permanent, although there has been debate in Congress regarding the elimination of some of the provisions of the new regulations, especially those that would involve public safety personnel. Many questions regarding exactly how these regulations will be applied have not been answered, but it is anticipated that most of the provisions will be adopted, and they will have an impact on cities, as employers, and the city employees who have access to city-owned vehicles on a regular basis.

The basis of the new regulations (Section 61[a][1] of the Internal Revenue Code) provides that unless specifically excluded by some other section of the Internal Revenue Code, gross revenue includes certain non-cash fringe benefits. The recipient of a non-cash fringe benefit must include in his or her gross income the amount of the fair market value of the benefit, reduced by the amount, if any, paid by the recipient for the benefit and further reduced by the amount, if any, specifically excluded by the Internal Revenue Code. Below is a brief explanation of the new regulations, how they are applied, and the reporting requirements for the city.

### DETERMINATION OF VALUE

The primary impact on cities will be employee use of city-owned vehicles. Other benefits which will have an impact in some cities are city-paid memberships in social or civic clubs, and city employees receiving free tickets to entertainment events. Each of these are fringe benefits which are subject to the new regulations, and the value of them must be included in an employee's gross income for purposes of taxation. Below are methods to be utilized in determining the value of these fringe benefits.

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In the case of a fringe benefit such as a club membership or free tickets, the value of those memberships or tickets represent the amount that must be included as gross income for the employee. For the use of a city-owned vehicle, there are two special rules for valuing city-provided vehicles, Annual Lease Value and Daily Lease Value.

### **ANNUAL LEASE VALUE (ALV)**

If a city provides a vehicle to an employee for an entire calendar year, the Annual Lease Value (ALV) is the value of the benefit provided. To calculate the ALV, determine the fair market value of the vehicle as of the date the vehicle is provided to the employee, or Jan. 1, 1985, whichever comes first. One method for establishing fair market value is the information utilized by banks to determine the value of vehicles for loan value. Whatever method is used, once fair market value has been established, the proposed rules include a table which determines the ALV ( see attachment). It should be noted that the ALV includes an allowance for insurance and maintenance. IT DOES NOT ALLOW FOR FUEL. A fair market value of the fuel provided by the employer must be established, or the fuel could be valued at 5.5 cents per mile. This amount for fuel would be included as gross income to the employee, along with the ALV, and be subject to taxation.

If a vehicle is provided to an employee for a period less than a calendar year, but more than 30 successive days, the value of the employer-provided vehicle is determined by pro-rating the ALV, which is computed by multiplying the ALV by a fraction, the numerator of which is the number of days of continuous availability and the denominator is 365. As an example, assume that a vehicle is utilized for 40 continuous days and the ALV is determined to be \$2,000. The computation would be:  $\$2,000 \times 40/365 = \$220$ .

### **DAILY LEASE VALUE (DLV)**

Availability of a vehicle for a period of less than 30 days requires the use of the Daily Lease Value (DLV) rule in determining the value of the benefit to the employee. The DLV equals the ALV multiplied by a fraction, the numerator of which is four times the number of days of availability and the denominator is 365. Utilizing an ALV of \$2,000 and use of the vehicle for 15 days, the computation would be:  $\$2,000 \times (4 \times 15)/365 = \$320$ .

As can be seen, the value of the DLV is somewhat higher than utilizing the ALV method. The rules permit proration based upon a full 30 days, even though the employee does not utilize the vehicle for the full 30 days. This will allow for a lower value in most cases.

Once an employee has determined the method of valuation, it cannot be changed as long as that employee is assigned any vehicle; and, a vehicle cannot be transferred from an employee for the purpose of lowering federal taxes.

### **COMMUTING VALUE**

Recognizing that some vehicles are provided for commuting only, a special rule has been proposed that would establish a benefit value for such a situation. In order to use the special rule to compute the commuting value, all of these criteria must be met:

1. For bona fide, non-compensatory business reasons, the employer requires the employee to commute in the vehicle provided.

2. The employer has a strict policy that the vehicle is not to be utilized for personal purposes other than commuting, except that certain exceptions are made for stopping at a grocery, laundry, etc., when going to and from the work place and the home.

3. The vehicle is utilized solely in the employer's business.

4. Except in the case of police, fire, and emergency medical vehicles, a substantial amount of the use of the vehicle is by employees other than the employee required to use the vehicle for commuting.

5. The employee required to use the vehicle is not a "key employee." For city government, a "key employee" may mean a city manager, a department head, and/or a supervisor. It is unclear who would be considered a "key employee" in city government; this is a matter which should be resolved by the IRS.

If an employee satisfies all of the above criteria, the commuting value is computed at \$3 per day for each day a vehicle is utilized for commuting, whether the commute is one-way or round-trip. This provision relating to commuting would appear to indicate that police officers (other than the chief and other administrative officers), fire personnel (other than the chief and other administrative personnel), and certain emergency response personnel in public works, would fall into this category if they are taking vehicles home as required by their jobs.

#### WORKING CONDITION FRINGE

Recognizing that if an employee was utilizing his or her own vehicle for business purposes operating expenses would be allowable deductions, provisions have been made in these rules to allow for reduction of the value of the benefit to be applied to gross income. This is called a working condition fringe, and is the amount that would be allowable as a deduction if the employee paid for the availability of the vehicle. Assume the ALV of an employer-provided vehicle is \$2,000 and the employee drives 6,000 miles for the employer and 2,000 miles for non-business reasons. The value of the working condition fringe is \$2,000 multiplied by the fraction, the numerator of which is the business-use mileage (6,000 miles) and the denominator the total use mileage (8,000 miles). The computation:  $\$2,000 \times 6,000/8,000 = \$1,500$ .

Thus, the value of the working condition fringe is \$1,500, and the total amount included in gross income by the employee is \$500. This provision requires that the employee maintain thorough records on all mileage driven, especially mileage related to city business. An example of the type of record that should be kept is attached. These records must be provided to the official designated to collect such data in the city in order to determine the amount of working fringe benefit the employee is entitled to.

## REPORTING

The city has some flexibility as to when it considers the benefits presented in this bulletin have been paid to the employee, as long as it is paid on or before the last day of the calendar quarter in which the benefit is provided. Benefits provided during the first calendar quarter of 1985 may be deemed paid on or before the last day of the second calendar quarter. This is a one-time provision due to the late publication of rules. It will be the responsibility of the city to report, at least quarterly, the benefit employees derive from the use of city-owned vehicles. Such benefits are considered to be supplemental income, which is subject to a flat 20% withholding from the employee's wages and is subject to social security taxes.

Until such time as final rules are issued regarding this matter, MTAS recommends that all cities which provide city-owned vehicles to city employees begin to keep contemporaneous records as discussed above (see attached suggested form). The exception to the necessity for record-keeping relates to those employees who are required to commute in city-owned vehicles. As long as the \$3 per day value as discussed above is included in the employee's income, no record-keeping is required. All city officials should consult with their city attorney, their auditors, accountants, and other officials responsible in any way for the administration of federal employment taxes. Contact any MTAS office for additional assistance.



(b) Annual Lease Value. Select the dollar range in column 1 of the table set forth below, corresponding to the fair market value determined in (a). Except as otherwise provided in this O/A-13, the Annual Lease Value for each year of availability is the corresponding amount in column 2 of the table.

Annual Lease Value Table

(1)	(2)
<u>Automobile Fair Market Value</u>	<u>Annual Lease Value</u>
\$ 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 - 27,999	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

<u>Automobile Fair Market Value</u>	<u>Annual Lease Value</u>
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 - 60,000	15,250

For vehicles having a fair market value in excess of \$60,000, the Annual Lease Value is equal to: (.25 x automobile fair market value) + \$500.

(c) Determination of Annual Lease Value after fourth year. Except as otherwise provided in (d), the figures in the Table are the Annual Lease Values for the period starting on the first date on which the special rule is applied by the employer or the employee to the automobile, and ending on December 31 of the fourth full year following that date. The Annual Lease Value for each of the subsequent calendar years is determined by taking the fair market value of the automobile on the January 1 following the period described in the previous sentence and selecting the amount in column 2 of the Table corresponding to the appropriate dollar range in column 1 of the Table.



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