Woman C.P.A.

Volume 48 | Issue 1 Article 5

1-1986

Auto Expense Deduction of Employees: Under the Deficit Reduction Act of 1984

Cherie J. O'Neil

Ramesh Narasimhan

The Auto Expense Deduction of Employees

Under the Deficit Reduction Act of 1984

by Cherie J. O'Neil and Ramesh Narasimhan

This research was funded by a grant from the Peat, Marwick, and Mitchell Education Foundation.

The new auto expense limitation rules of Sec. 280F are having a profound effect on the employee who uses his or her auto for business. In most cases, the annual depreciation charge for autos purchased or placed in service after June 18, 1984 has been significantly reduced during the first three years of the accelerated cost recovery system (ACRS) recovery period. Furthermore, unless the employee can substantiate a business use of more than 50 percent, no investment tax credit (ITC) will be allowed. The new law also limits the election to expense and imposes new record keeping requirements effective with the 1986 tax year. Employees, who in the past, relied on reasonable estimates to calculate their auto expense deductions will now be required to meet the substantiation requirements of Sec. 274(d).

Under the new law, many different auto expense calculations are possible. In some cases these alternatives result in significantly different annual tax savings, which make selecting the best method a difficult, if not impossible, choice. This article explains the technical provisions of the new law and points out where further clarification is needed.

Record Keeping Requirements

The Tax Reform Act of 1984 (TRA) replaced the "adequate records" requirement of Sec. 274(d) with a new stricter "adequate contemporaneous records" requirement. In response to the public outcry over the need to make daily entries in a log, the contemporaneous recordkeeping requirement was repealed.[1] For 1985, a written log of auto mileage is not necessary. Accurate records are needed, however, to calculate the qualifying business use percentage used in determining the allowble auto expense. While the new law prohibits the Treasury Department from requiring taxpayers to keep a daily contemporaneous log, this is a wise alternative. The Conference Report indicates that oral evidence has considerably less value than written evidence; and that contemporaneous evidence has a greater weight than evidence created at a later time.[2] Furthermore, for tax years after December 31, 1985, the substantiation rules for Sec. 274(d) will apply to transportation expenses (e.g. local travel). Thus, the taxpayer must be able to substantiate: (1) the amount, (2) the time, (3) the destination, (4) the business purpose of the travel expenditure.[3] Such documentation will require written records, but these records will not have to be contemporaneous.

For those employees, who have autos furnished to them by their employer, the substantiation requirements still apply. To obtain a full deduction for the auto, the employer must have a *written* policy forbidding any personal use of the company auto (de minimus use, such as a lunch stop is allowed).[4] If the employee is permitted to use the company auto for commuting to and from work, some appropriate amount[5] must be included in the employee's gross income at year end,[6] unless such commuting is for a bona fide business reason (e.g. for security reasons the employer requires the employee to drive the auto home). The substantiation requirements will not be applied to vehicles which, by their nature, would not be used more than a de minimus amount for personal use (e.g. police and fire vehicles, buses, ambulances, delivery trucks). If the employee is a 1 percent or more shareholder, or an officer, personal use of the company auto constitutes a constructive dividend, taxable to the employee and not deductible by the employer.

Complying With the New Law

Sec. 280F requires the computation of a qualified business use (QBU) percentage for each tax year. For the employee, QBU occurs only when the

Employees, who use their personal auto to carry out their job related duties, will find that the new law requires complex annual calculations of the auto expense deduction.

employee's auto is used "for the convenience of the employer" or as a "condition of employment."[7] This is a significant change from the old law and requires the employee to justify the use of his or her auto in the employer's business. When the auto is used for the convenience of the employee, no deduction is allowed.

For example, if the employer has motor pool with company autos available for employee use, but the employee prefers to use his or her own auto (it is more convenient, or a newer model, or has air conditioning), that use is for the convenience of the employee and no depreciation deduction is allowed. Temporary Reg. 1.280F-6T(a) (4) gave an example of an employee who chooses to use her own auto and receive reimbursement from her employer even though a company auto is available. The use of her own auto is not for the convenience of her employer and is not required as a condition of employment. Therefore, no depreciation deduction is allowed, and the reimbursement is includable in the employee's income. The only offsetting deduction permitted against the reimbursement is for out of pocket costs, such as gas. Assuming that this example will be included in the forthcoming regulations, an employee with access to a company auto may not claim use of his or her personal auto has QBU. There has not been any indication of what kind of substantiation is required to prove that no company auto was available. Perhaps a letter from the head of the motor pool will be needed, or perhaps a notation in the employee's records that no company auto was available will suffice. The Treasury needs to clarify the kind of documenttion that will be required in these cases.

Limits on the Depreciation Deduction

After the employee has calculated the QBU percentage for the year, the next step is to compute the auto expense deduction. At this point, the limitations of Sec. 280F are applied to the depreciation deduction and the investment tax credit. Out of pocket costs for gas, repairs, etc. and the standard mileage deduction are still calculated in the regular way. If the auto is used 60 percent for business, 60 percent of the operating expenses are deductible. If the standard mileage rate is used, it is still based upon the .205 and .11 cents per mile rates.

Sec. 280F affects: 1) the method of depreciation which can be used, either Accelerated Cost Recovery (ACRS), or straight line (SL) based upon the earnings and profits (E&P) life of five years, and 2) the dollar amount of depreciation which may be claimed each year. The allowable depreciation method depends upon QBU. If it is more than 50 percent, the ACRS method may be used. If it is 50 percent or less, the SL method must be used.[8] The depreciable basis is limited to the auto's cost times the QBU percentage times either the ACRS percentage or the SL percentage, whichever applies. Once the depreciation expense is calculated, it is limited to either $4,000 times the QBU percentage in year 1, if the auto was purchased between June 18, 1984 and April 2, 1985, or $3,200 times the QBU percentage in year 1, if the auto was purchased after April 2, 1985. In the second and subsequent years, the QBU percentage is multiplied by $6,000 if the auto was purchased between June 18, 1984 and April 2, 1985, or by $4,800, if the auto was purchased after April 2, 1985.[9] These limits do not eliminate the depreciation deduction, they simply limit the annual deduction and defer some tax benefits to future years. For a $20,000 auto with a QBU of 90 percent, see Table 1 for the allowable annual depreciation deductions.

In both cases, the depreciation deduction goes beyond the three year ACRS life. In the first case, at the end of year three, the Sec. 280F limits have restricted the allowable depreciation deductions to either $14,400, or $11,520, depending upon the date the auto was purchased. Since the total

TABLE 1

ACRS Depreciation on a $20,000 Auto with 90 Percent Business Use

IF AUTO PURCHASED:		(6/18/84-4/2/85)		(4/2/85 OR LATER)	
YEAR	ACRS DEDUCTION	LIMIT	DEDUCTION	LIMIT	DEDUCTION
1	$4,500	$3,600	$3,600	$2,880	$2,880
2	6,840	5,400	5,400	4,320	4,320
3	6,660	5,400	5,400	4,320	4,320
4	0	5,400	3,600	4,320	4,320
5	0	5,400	0	4,320	2,160
TOTAL	$18,000		$18,000		$18,000

TABLE 2

SL Depreciation on a $20,000 Auto with 40 Percent Business Use

IF AUTO PURCHASED:		(6/18/84-4/2/85)		(4/2/85 OR LATER)	
YEAR	SL	LIMIT	DEDUCTION	LIMIT	DEDUCTION
1	$ 800	$1,600	$ 800	$1,280	$ 800
2	1,600	2,400	1,600	1,920	1,600
3	1,600	2,400	1,600	1,920	1,600
4	1,600	2,400	1,600	1,920	1,600
5	1,600	2,400	1,600	1,920	1,600
6	800	2,400	800	1,920	800
TOTAL	$8,000		$8,000		$8,000

TABLE 3

Auto Purchased Jan. 1, 1985 with Varying Business Usage

COST OF AUTO:	$20,000
DATE OF PURCHASE:	JANUARY 1, 1985
MARGINAL TAX RATE:	45%
DISCOUNT RATE:	12%

DEPRECIATION DEDUCTIONS

		ELECTION TO EXPENSE		NO ELECTION TO EXPENSE	
YEAR	QUALIFIED BUSINESS USE	4% ITC	6% ITC	4% ITC	6% ITC
1	70%	$ 2,800	$ 2,800	$ 2,800	$ 2,800
2	60	3,600	3,582	3,600	3,600
3	60	3,552	3,488	3,600	3,600
4	40	1,280	1,260	1,600	1,579
5	40	1,280	1,260	1,600	1,579
6	40	640	630	800	789
7	40	360	340	0	0
TOTAL		$13,512	$13,360	$14,000	$13,947
RECAPTURE:					
EXCESS DEPRECIATION					
YEAR:	4	3,312	3,300	3,800	3,893
NET DEPRECIATION EXPENSE:		$10,200	$10,060	$10,200	$10,054

INVESTMENT TAX CREDIT

		ELECTION TO EXPENSE		NO ELECTION TO EXPENSE	
		4% ITC	6% ITC	4% ITC	6% ITC
YEAR:	1	$448	$672	$467	$700
RECAPTURE:					
EXCESS ITC					
YEAR:	2	64	96	67	100
YEAR:	4	43	64	44	67
NET INVESTMENT TAX CREDIT:		$341	$512	$356	$533
PV OF TAX SAVINGS:		$3,888	$4,033	$3,916	$4,068

allowable depreciation deduction over the life of the auto is $18,000, the balance may be expensed in subsequent years. The only limit on the deduction in years four and beyond, is $6,000 ($4,800) times the QBU percentage. A very expensive auto may require seven or more years to fully write-off.

The SL method requires a six year write-off based upon 10 percent in years one and six, and 20 percent in years two through five. If the same auto has a QBU of only 40 percent, the SL, five year E&P mid-year convention method must be used. Table 2 shows the allowable annual depreciation deductions.

For autos purchased between June 18, 1984, and April 2, 1985, which cost more than $28,000, the ACRS limits will defer part of the auto expense deduction into the seventh and subsequent years. For autos purchased after April 2, 1985, which cost more than $22,400, the ACRS limits will defer part of the auto expense deduction into the seventh and subsequent years. The more expensive the auto, the longer the depreciation deducton period. For autos purchased between June 18, 1984 and April 2, 1985 which cost less than $16,500, the allowable depreciation will always be less than the Sec. 280F limits. For autos purchased after April 2, 1985, which cost less than $13,200, the allowable depreciation will always be less than the Sec. 280F limits. No matter what the auto costs, the depreciation deduction is first limited by the QBU percentage, then by the annual dollar limit times the QBU percentage.

The auto price inflation adjustment scheduled to become effective for autos purchased after January 1, 1985, has been deferred to 1989. For autos purchased after December 31, 1988, the $2,400/$4,800 limits will be adjusted for increases in the consumer price index auto component for October of the previous year.[10]

Limits on the Investment Tax Credit

The previous illustrations did not consider the investment tax credit (ITC), which is also limited by Sec. 280F(a)(1). The ITC is the lesser of the cost of the auto times the QBU percentage times the ITC percentage, or $1,000 times the QBU percentage if the 6 percent ITC is elected, or $667 times the QBU percentage if the 4 percent ITC is elected, for autos purchased betwteen June 18, 1984, and April 2, 1985. For autos purchased after April 2, 1985, the ITC limits are $675 times the QBU percentage if the 6 percent ITC is elected, or $450 times the QBU percentage if the 4 percent ITC is elected. However, if QBU is less than or equal to 50 percent, no ITC is allowed.[11] This is a true *elimination* rather than a *limitation* as was observed in the calculation of the depreciation deduction. Thus, the employees must carefully establish the QBU percentage of more than 50 percent in the year of purchase. This points to the need to keep accurate detailed records of auto use, so that the maximum allowable ITC can be taken. If QBU is greater than 50 percent, then the Sec. 212 production or maintenance of income use (e.g. investor use) may be included in the QBU percentage. But, if QBU is less than or equal to 50 percent, then the Sec. 212 use does not qualify for the ITC. For example, an auto with business use of 60 percent and investor use of 20 percent qualifies for an ITC based upon 80 percent of the cost of the auto. But, an auto with 20 percent business and 60 percent investor use will not qualify for any ITC. Recall, that for depreciation purposes, a QBU percentage of 50 percent or less requires the use of straight line depreciation. For an auto used 20 percent for business and 60 percent for investment, 80 percent of the auto may be depreciated, but the SL method must be used, and no ITC is permitted.

If the employee has QBU of more than 50 percent, then either the full ITC-reduced basis method, or the reduced ITC-full basis method may be used. When the full ITC of 6 percent is taken, he basis must be reduced by one half of the allowable ITC. Thus, this method will effect the depreciation calculations. While one might assume that the correct basis for the depreciation deduction for a $20,000 auto purchased on February 1, 1985 with a QBU of 80 percent is $15,600 [(20,000 x .8) - (800 x .5)], it is not. The correct procedure is to deduct one half of the ITC before multiplying by the QBU percentage.[12] Thus, the depreciable basis is $15,680 [(20,000 - (800 x .5)) x .8].

When the election to expense is considered, the ITC may be less. Referring to the previous example, when the election to expense is taken, the ITC is $768 [(20,000 - 4,000) x .8 x .06], which is $32 less than the no election to expense method. The basis for depreciation, in this example, when the election to expense is used is $12,493 [(20,000 - 4,000 - (768 x .5)) x .8] which is $3,187 less than the full ITC, reduced basis, no election to expense method. Furthermore, no immediate additional tax benefit is obtained by making the election to expense, since the first year deduction for both the depreciation deduction and the election to expense is limited to $4,000 times the QBU percentage.[13] Thus, no additional deduction is obtained in the first year by making the election to expense, and some of the ITC is lost.

TABLE 4

Auto Purchased May 1, 1985 with Varying Business Usage

COST OF AUTO:	$20,000
DATE OF PURCHASE:	MAY 1, 1985
MARGINAL TAX RATE:	45%
DISCOUNT RATE:	12%

DEPRECIATION DEDUCTIONS

YEAR	QUALIFIED BUSINESS USE	ELECTION TO EXPENSE 4% ITC	ELECTION TO EXPENSE 6% ITC	NO ELECTION TO EXPENSE 4% ITC	NO ELECTION TO EXPENSE 6% ITC
1	70%	$ 2,240	$ 2,240	$ 2,240	$ 2,240
2	60	2,880	2,880	2,880	2,880
3	60	2,880	2,880	2,880	2,880
4	40	1,344	1,330	1,600	1,586
5	40	344	1,330	1,600	1,586
6	40	672	665	800	793
7	40	568	554	0	0
TOTAL		$10,928	$11,879	$12,000	$11,965
RECAPTURE:					
EXCESS DEPRECIATION					
YEAR:	4	1,728	1,777	1,800	1,862
NET DEPRECIATION EXPENSE:		$9,200	$10,102	$10,200	$10,103

INVESTMENT TAX CREDIT

		ELECTION TO EXPENSE 4% ITC	ELECTION TO EXPENSE 6% ITC	NO ELECTION TO EXPENSE 4% ITC	NO ELECTION TO EXPENSE 6% ITC
YEAR:	1	$315	$473	$315	$473
RECAPTURE:					
EXCESS ITC					
YEAR:	2	45	68	45	68
YEAR:	4	30	45	30	45
NET INVESTMENT TAX CREDIT:		$240	$360	$240	$360
PV OF TAX SAVINGS:		$3,362	$3,721	$3,649	$3,752

Changes in the Annual QBU Percentage

When the QBU percentage varies from year to year, the employee's annual depreciation deduction also changes. As long as the QBU percentage remains above 50 percent, the ACRS method may be used. But should the QBU percentage decline to 50 percent or less, three things occur. First, the employee may be subject to depreciation recapture. Second, the employee may be subject to ITC recapture. Third, the ACRS method of depreciation is no longer allowed and the straight line method must be used, even if QBU subsequently rises to more than 50 percent. The above order must be followed in making the calculations. Recapture the excess depreciation first, then recapture the ITC, then recompute the basis, if the full ITC is elected and then compute the allowable straight line depreciation.

The depreciation recapture rule of Sec. 280F requires that the prior years depreciation be recomputed using the straight line E&P life method. Any excess depreciation must be recaptured.[14] Refer to the earlier example of the $20,000 auto with a QBU of 80 percent. Suppose that in year two, the QBU declines to 40 percent. The year one depreciation is recomputed using the SL method and is now only $1,600 [20,000 x .8 x .1]. Since the depreciation for year one is $3,600, there is a $2,000 depreciation recapture. The year two depreciation deduction is $1,600 [20,000 x .4 x .2], subject to the limit of $2,400 [6,000 x .4]. Since the actual is less than the limit, the year two deduction is $1,600.

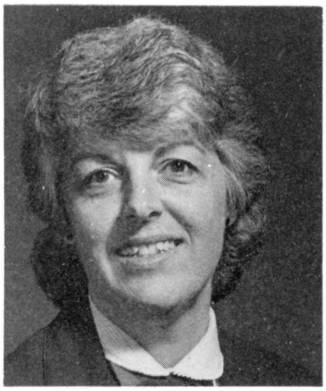
Any decline in QBU triggers ITC recapture. The recapture of the ITC follows the rules of Reg. 1.47-2(e). Thus, a decline in QBU from 80 percent to 40 percent will require an ITC recapture of $400 [(1,000 x .8) - (1,000 x .4)]. If the auto costs $16,500 or less, the ITC recapture would be based on the cost of the auto, rather than the $1,000 limit. When computing the ITC recapture, it is important to know how to count the number of years the auto was held, because of the varying recapture percentages. If, for example, the auto was purchased on Feb. 1, 1985, and sold on Dec. 1, 1986, the entire ITC must be recaptured since the auto was not owned one full tax year, even though it was owned more than 365 days. Any disposition or decline in QBU is assumed to occur on the first day of the tax year. Thus, in the example, the holding period is counted from Feb. 1, 1985, to Jan. 1, 1986 which is not one full year. If the disposition of the auto or decline in QBU occurs in 1987, the holding period is counted from Feb. 1, 1984 to Jan. 1, 1987, which is more than one full year. In that case the ITC recapture would be 2/3 of the ITC. A change in QBU in 1988 would require a 1/3 recapture and a change in QBU in 1989 would not require any recapture. Thus, to avoid any ITC recapture, the QBU percentage will have to be substantially the same during the first four tax years.

While depreciation recapture is triggered only in the year in which the QBU percentage declines to 50 percent or less, the ITC recapture occurs in any year in which the QBU is less than the QBU of the previous year. There is a de minimus rule mentioned in the committee report,[15] which presumably would not require ITC recapture when there is a small decline in QBU, from 80 percent to 79 percent, for example.

The ITC recapture rule offers some tax planning opportunities for the employee who purchases an auto during the last few months of the tax year. Assume, for example, that an employee purchased a $20,000 auto on December 1, 1985, took one business trip, and then parked the auto in the garage for the rest of the month. Since QBU for the year is 100 percent, the full $675 ITC may be claimed. If the QBU in 1986 is 40 percent, $405 of the ITC must be recaptured. As long as QBU equals or exceeds 40 percent, the remaining $270 need not be recaptured. Thus, the employee receives a net ITC of $270, even though the business use of the auto averaged approximately 40 percent over its useful life. In year two, $1,200 excess depreciation will have to be recaptured. (The ACRS deduction of $3,200 exceeds the straight line deduction of $2,000). Once the ITC and/or ACRS deductions are recaptured, a subsequent increase in the QBU percentage will not reinstate the previously disallowed deduction. Thus, the employee must carefully monitor his or her use of the auto to maintain an acceptable QBU percentage and minimize the recapture potential.

Examples

Tables 3 and 4 illustrate the annual depreciation expense for a $20,000 auto purchased on either January 1, 1985 (Table 3) or on May 1, 1985 (Table 4) with varying annual QBU percentages. In the fourth year the QBU percentage is less than 50 percent. For this year and all subsequent years the depreciation deduction is computed using the straight line method. The depreciation expense for the first three years is recomputed and

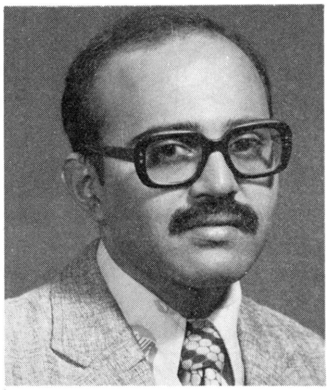


Cherie J. O'Neil, DBA, CPA, *is associate professor of accounting at Virginia Polytechnic Institute and State University. She is a member of AWSCPA, AAA, and the Virginia Society of CPAs. She is a member of the editorial board of THE WOMAN CPA.*

the excess of the depreciation expense over the straight line method is subject to depreciation recapture in year four. In years two through four there is ITC recapture since the QBU in each year is less than the previous year. The examples also illustrate the four methods by which the depreciation expense and ITC can be computed. At the bottom of each column, the present value of the tax savings is computed using a 12 percent discount rate and a 45 percent marginal tax rate. The full ITC method yields the greatest tax savings in present value terms. This holds true when the tax rate is varied from 15 percent to 55 percent and the discount rate is varied from 6 percent to 18 percent. Even if the employee chooses the election to expense method, the full ITC method is still preferable to the reduced ITC method.

Conclusion

The new auto expense rules of Sec. 280F and the substantiation requirements of Sec. 274(d) require the employee who uses his or her auto for business to make complex annual calculations to determine the auto expense deduction. These calculations must be substantiated by the employee by adequate records or by sufficient evidence corroborating the taxpayer's own statement. These new rules make tax planning for the auto expense deduction difficult. The employee must decide whether or not to make the election to expense, whether or not to elect the full ITC or the reduced ITC, and strive to maintain a constant annual QBU to avoid depreciation and/or ITC recapture. As the Department of the Treasury issues new regulations in this area, hopefully the employee's task will be made easier. Once the employee establishes that QBU is more than 50 percent, then perhaps the IRS will let the employee use a constant annual business use percentage in making the subsequent years calculations. By permitting the employee to use the QBU percentage established in year one for all subsequent years, as long as the percentage did not vary significantly, the complex recapture calculations and subsequent recomputation of the annual depreciation expense will not have to be made. This would help employees comply with the law and reduce the possibility of error when making the annual depreciation expense calculations.Ω



Ramesh Narasimhan, MBA, CMA, *is a Ph.D. candidate at Virginia Polytechnic Institute and State University. He has a MBA from West Georgia College and is a member of NAA and the Institute of Management Accountants.*

NOTES

[1] U.S. Congress, H.R. 1869, Repeal of Contemporaneous Recordkeeping Requirements Act of 1985, approved by Congress, May 16, 1985, signed by the President, May 24, 1985.

[2] Ibid., House Report 99-67, May 7, 1985.

[3] Ibid., Act Section 1.

[4] Ibid., House Report 99-67, Conference version, May 8, 1985.

[5] Ibid., Act Section 5 directs the treasury to issue regulations by October 1, 1985 to carry out provisions of the act. The temporary regulations, which were withdrawn, indicated a $3 daily amount to be included in income for personal commuting expense.

[6] IRC Sec. 3402 (s) (2)

[7] IRC Sec. 280F (d) (3)

[8] IRC Sec. 280F (b) (2)

[9] IRC Sec. 280F (a) (2) (A)

[10] IRC Sec. 280F (d) (7)

[11] IRC Sec. 280F (b) (1)

[12] IRC Sec. 280F (a) (3)

[13] IRC Sec. 280F (d) (1)

[14] IRC Sec. 280F (b) (3)

[15] U.S. Congress, Tax Reform Act of 1984, Act Sec. 179, Conference Committee Report, July 18, 1984.