DEDUCTING VEHICLE EXPENSES

Is it time to finally get rid of your old clunker for a spanking new vehicle? If so, it's appropriate to consider the tax deductions that are available when you use your vehicle in connection with your business.

Business or Personal? Most small business owners use their vehicles for both business and personal reasons. The amount of the deduction that you can take for vehicular travel will depend on whether your mileage is deemed to be for business or personal purposes. If you commute to your workplace, your commuting mileage is considered personal. Travel from your home or workplace to other locations to transact business is deemed to be business travel. If you drive for a business purpose from your home-based office, your mileage is considered business.

A Vehicle That You Have Purchased. If you use a vehicle that you own personally (rather than a vehicle that is titled in the name of your business), there are two methods under which you may take a tax deduction, the mileage rate method or the percentage method. (For purposes of the vehicle expense deductions, a vehicle that is titled in the name of your sole proprietorship is treated as a vehicle that you own personally.) Once you use the percentage method, you cannot switch to the mileage method. However, you can switch from the mileage method to the percentage method.

The *mileage rate method* allows you to take a deduction in the amount allowed by the Internal Revenue Service (IRS), which is a specified rate for each business mile traveled during the year. (The amount of the mileage rate usually changes a bit each year.) This amount applies regardless of the age, model, or condition of your vehicle and regardless of the amount of your actual expenses for maintenance, repairs, gas, oil, etc.

The *percentage method* requires that you determine the percentages of business and personal use of your vehicle. You are allowed to take a deduction based on the business-related percentage of the operating expenses (gas, oil, maintenance, tires, registration fees, repairs, insurance, etc.) plus a deduction for depreciation over five years.*(Depreciation* is the amount by which the value of a business asset, including a vehicle, is reduced due to its increasing age.)

A Vehicle That You Have Leased. If you use a vehicle that you have leased personally (rather than a vehicle leased in the name of your business), you must use the percentage method discussed above. If the dealer required you to make a cash payment when you signed the lease, you may deduct the amount of that payment pro rata during the term of the lease. (Again, a vehicle leased in the name of your sole proprietorship is treated as if it was leased in your name.)

A Vehicle Owned By Your Business. The rules are a bit more complicated if you use a vehicle that is titled in the name of your business (other than your sole proprietorship). If anyone (you or your employees) uses the vehicle exclusively for business purposes, your business may take a deduction under the mileage or the percentage method. However, if anyone uses the vehicle for both business and personal purposes, they will be deemed to have received income to the extent that they use the vehicle for personal purposes. Also, your business will be responsible for payroll taxes with respect to that compensation.

Your business can select from amongst three different methods to determine the amount of compensation for someone’s personal use of a business-owned vehicle. These are the fair market value method, the annual lease value method, or the standard mileage method.

Under the *fair market value method* your business must determine the cost to lease a comparable vehicle for a time period comparable to the period that the business intends to own and permit personal use of the vehicle. Based on that cost, your business would then use the percentage method, described above, to determine the amount of compensation for personal use.

Under the *annual lease value method*, your business must follow several steps. First, your business must determine the fair market value of the vehicle. If your business uses the annual lease method, the Internal Revenue Code allows your business to assume that the fair market value is equal to the vehicle’s retail value as specified by the manufacturer (less 8 percent) or as published by a nationally recognized publication that regularly reports new or used vehicle values (such as the "Blue Book"), provided that the published value is "reasonable." Next, your business must consult a table within the United States Treasury Regulations to determine the annual lease value. Finally, your business must use the percentage method, describe above, to determine the amount of compensation for personal use, which will be based on the annual lease value.

The *standard mileage method* is the simplest. Under this method, your business determines compensation for personal use at the rate allowed by the IRS per mile of actual personal use (which, as noted above is a specified rate per mile).

Disposing of the Vehicle. The following rules apply whether you or your business own the vehicle. Generally, when you purchase a new vehicle you must decide whether to sell or trade the old vehicle. If the amount that you could receive from a sale exceeds the vehicle's basis (its original cost minus depreciation), you will incur tax on the amount by which the sales price exceeds the basis, even if you used the vehicle for business and personal purposes. In that case, you should consider trading the old vehicle to whomever is selling you the new one because you are not taxed on the value of the traded vehicle. (However, you will have to deduct the value of the traded vehicle from the cost of the new one for purposes of depreciating the new vehicle.) If the amount that you could receive from a sale is less than the vehicle's basis, you can deduct the amount of the loss only to the extent that your use of the vehicle was for business purposes, determined under the percentage method described above.

Record Keeping Requirements. Whomever is taking the deduction must maintain records detailing the date, mileage, and business purpose of each trip. The entries must be recorded at or near the time of the business travel. Whomever is taking the deduction must also maintain records proving the cost of the vehicle, the date of the purchase or lease, and the cost and dates of all maintenance, repairs, etc.

Conclusion. Owning and driving a new vehicle is an enjoyable experience. Why not increase your enjoyment by seeking the advice of a tax professional who can help you obtain the best tax deduction.