11-26-1985

Technical Bulletins: IRS Regulations Clarifying Taxation of Non-Cash Fringe Benefits

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TECHNICAL BULLETIN
MUNICIPAL TECHNICAL ADVISORY SERVICE
THE UNIVERSITY OF TENNESSEE
IN COOPERATION WITH THE TENNESSEE MUNICIPAL LEAGUE
Authorization Number E14-1050-00-003-86

November 26, 1985

IRS REGULATIONS CLARIFYING TAXATION OF NON-CASH FRINGE BENEFITS

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The Internal Revenue Service finally has issued regulations clarifying the circumstances in which non-cash fringe benefits provided to employees must be treated as taxable income.

The regulations, intended to implement P. L. 99-44 passed by Congress in May 1985, establish temporary rules on record-keeping and the tax treatment of vehicles provided by cities to their employees. Except for certain narrowly defined exceptions, employers are required to withhold income and social security taxes on the income which is attributed to the employee as a fringe benefit for the use of a city-provided vehicle, effective January 1, 1985.

For the administrative convenience of employers, a special accounting rule is available as an alternative to the general withholding rule. Under the special accounting rule, the employer may treat the value of the benefits provided during the last two months of the calendar year, or any shorter period, as paid during the subsequent calendar year. Thus, the employer may treat the value of the benefits provided in the period beginning January 1, 1985, and ending October 31, 1985, as the value of the benefits provided in 1985. For years subsequent to 1985, the value of the benefits actually provided in the last two months of the previous calendar year is treated as provided in the current calendar year together with the value of the benefits provided in the first 10 months of the current calendar year.

Exempt Vehicles

Two types of vehicles are defined as exempt from taxation under the regulations. If a vehicle provided by the city qualifies as either a non-personal use vehicle or a qualified non-personal use vehicle, the city is not required to withhold any income or social security taxes for the use of the vehicle.

A non-personal use vehicle is one which the city does not permit the employee to use for any personal purpose, including commuting, and which is kept on city property. Taxes do not need to be withheld on employees who utilize these types of vehicles as long as the city has a written policy prohibiting personal use of such vehicles. This policy of prohibiting personal use need not be in writing to take advantage of the exemption in 1985. However, the city must establish a written policy prohibiting personal use of city-owned vehicles if it wishes to utilize the exemption in subsequent years.

Certain vehicles are classified as qualified non-personal use vehicles and are automatically considered to be non-taxable. The new regulations exempt public safety and other special use vehicles from taxation if certain conditions are met. In general, the vehicles covered by this exemption are those not likely to be used to any significant extent for personal purposes. These exempt vehicles include:

* Clearly marked police and fire vehicles (the police officer and fire-fighter must be on call at all times if this exemption is to be utilized, and the vehicle must be clearly marked as a police or fire vehicle).
* Ambulances and hearses.
* Cherry pickers.
* Dump trucks and garbage trucks.
* Utility trucks (the employee must be required to drive the truck home for the purpose of responding to emergencies involving electricity, gas, telephone, water, sewer, or a steam utility).
* School buses.
* Other types of buses which have the capacity to hold 20 or more passengers.
* Unmarked law enforcement vehicles (the exemption will be lost if any personal use occurs other than uses which are incidental to law enforcement responsibilities, e.g., going to and from home to a stake out site. To qualify as a law enforcement officer under this provision, for unmarked vehicles, the employee must have the power of arrest and carry a firearm).

<u>Nonexempt Vehicles</u>

The withholding obligations of the IRS Code apply to all other vehicles provided to city employees. The new regulations establish rules for substantiating non-taxable uses which occur in 1986. While written evidence is accorded greater weight, the employee may substantiate non-taxable uses by oral evidence. Non-taxable uses may be substantiated in a number of ways, including account books, diaries, logs, receipts, bills, trip sheets, and expense forms. Sampling techniques may also be used (e.g., the employee may extrapolate his or her non-personal uses for the year from records of non-personal use in an average week). Records should substantiate the time, date, place, purpose, and cost of travel.

The new regulations do not establish clear rules for the substantiation of non-taxable uses in 1985. Generally, however, the rules for 1986 should be used as guidelines to determine whether the employee's information is sufficient to classify the use (or portion of the use) of a city-provided vehicle as non-taxable. The city should retain any information provided by the employee to substantiate his or her claim that the vehicle is non-taxable to the extent of its use for non-personal purposes.

Special Rule For Commuting-Use-Only Vehicles

The employee may elect to use the simplified $3.00 per round trip rule or the annual lease value rule. The employee may use the $3.00 per day rule only if the vehicle is used solely for commuting purposes. The city must either withhold taxes on the basis of $3.00 for each day of commuting use or receive reimbursement from the employee for that amount. The city should obtain from the employee information as to the frequency of commuting use. The employer may rely on a time sheet if the vehicle is used for commuting every work day. If the vehicle is not used every work day (e.g., only twice a week), then the employee must provide the employer with information which supports the employee's claim that the vehicle was used for commuting purposes only on a sporadic or limited basis. This special rule may be used for 1985 if the city has a policy (which need not be written) of prohibiting personal use of city-owned vehicles for any reason other than commuting. This policy must be in writing in order for the $3.00 rule to work in 1986.

As outlined in existing regulations and as amended by the new regulations, the special $3.00 per day rule may not be used to value commuting use of a city-owned vehicle by a "control," or "key," employee. This type of employee means an elected official or an employee who is appointed by the chief executive officer (Mayor, City Manager, or City Commissioners), such as department heads or assistants to the chief executive officer. These control employees must use the annual lease value method for determining what should be included in income as a taxable non-cash fringe benefit.

Annual Lease Value

For cases in which the $3.00 special rule is not used for commuting-use-only vehicles and for all other nonexempt vehicles, the annual lease value (ALV) rules apply. It should be pointed out that in cases where an employee's commute is short, the ALV rule is likely to be more beneficial for the employee than the $3.00 rule. Under the ALV method, the taxable value of the fringe benefit to the employee is determined by subtracting the cost of the business use from the ALV. To calculate the taxable value of a city-owned vehicle under the ALV rule, the following four step process must be followed:

(1) The fair market value (FMV) of the vehicle is determined. The FMV is defined as the equivalent of the cost to the employee of purchasing a vehicle similar to the vehicle provided by the employer. A possible source for this information is the NADA Blue Book used by banks and car dealers to value vehicles. The value determined cannot be reduced by taking into account possible cost savings from group, or fleet purchase, discounts. Once the FMV is determined, a table (see below) is used to determine the vehicle's ALV.

(2) A mileage fraction, representing the percentage of business of the vehicle, is calculated. To determine this mileage fraction, business use miles are determined by subtracting the number of personal use miles driven by the employee from the total number of miles. The number of business use miles must then be divided by the total number of miles driven by the employee.

(3) The business use of the vehicle is determined by multiplying the appropriate ALV for the vehicle by the mileage fraction.

(4) The value of the fringe benefit attributable to the personal use of the vehicle which must be treated as taxable income for the employee is determined by subtracting the vehicle's business use from the ALV.

The ALV established by the IRS chart includes maintenance and insurance, but does not include gasoline. If the city pays for gasoline, an additional 5.5 cents per personal mile also must be included in the employee's gross income.

The IRS has asked city officials specifically to comment as to what types of employees should be prohibited from using the special $3.00 per day commuting rule as "control" employees. If city officials wish to comment on any part of the temporary regulations issued November 6, 1985, they must submit the comments to the IRS by January 5, 1986.

If you have questions or need assistance regarding this matter, contact the Municipal Management Consultant for your city, or call the MTAS office in Knoxville at (615) 974-5301.

Annual lease value table

(1) Automobile Fair Market Value	(2) Annual Lease Value	(1) Automobile Fair Market Value	(2) Annual Lease Value
$ 0 - 999	$ 660	22,000 - 22,999	6,100
1,000 - 1,999	850	23,000 - 23,999	6,350
2,000 - 2,999	1,110	24,000 - 24,999	6,600
3,000 - 3,999	1,350	25,000 - 25,999	6,850
4,000 - 4,999	1,600	26,000 - 27,999	7,250
5,000 - 5,999	1,850	28,000 - 29,999	7,750
6,000 - 6,999	2,100	30,000 - 31,999	8,250
7,000 - 7,999	2,350	32,000 - 33,999	8,750
8,000 - 8,999	2,600	34,000 - 35,999	9,250
9,000 - 9,999	2,850	36,000 - 37,999	9,750
10,000 - 10,999	3,100	38,000 - 39,999	10,250
11,000 - 11,999	3,350	40,000 - 41,999	10,750
12,000 - 12,999	3,600	42,000 - 43,999	11,250
13,000 - 13,999	3,850	44,000 - 45,999	11,750
14,000 - 14,999	4,100	46,000 - 47,999	12,250
15,000 - 15,999	4,350	48,000 - 49,999	12,750
16,000 - 16,999	4,600	50,000 - 51,999	13,250
17,000 - 17,999	4,850	52,000 - 53,999	13,750
18,000 - 18,999	5,100	54,000 - 55,999	14,250
19,000 - 19,999	5,350	56,000 - 57,999	14,750
20,000 - 20,999	5,600	58,000 - 60,000	15,250
21,000 - 21,999	5,850		