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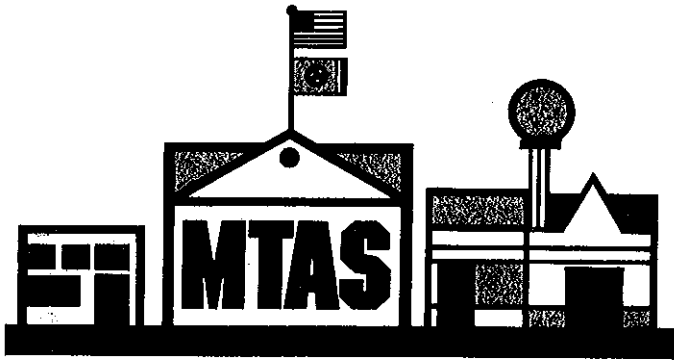
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TECHNICAL BULLETIN

MUNICIPAL TECHNICAL ADVISORY SERVICE
THE UNIVERSITY OF TENNESSEE
IN COOPERATION WITH THE TENNESSEE MUNICIPAL LEAGUE

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IRS REGULATIONS RELATING TO TAXATION OF CITY EMPLOYEES UTILIZING CITY-OWNED VEHICLES

By: Richard M. Ellis, MTAS Municipal Management Consultant

This Technical Bulletin is a more comprehensive review of the regulations issued as a result of the passage of P.L. 99-44, and supercedes all previous Technical Bulletins published which related to the taxation of employees utilizing city-owned vehicles. Special thanks goes to Marie Allen Murphy, Legal Specialist with the County Technical Assistance Service of the University of Tennessee, who prepared their technical bulletin and whose research efforts expedited the preparation of this technical bulletin.

The new regulations appear in Volume 50, No. 215 of the Federal Register (November 6, 1985) at pages 46004 through 46041. Page references contained herein are to the Federal Register. The new regulations summarize the present laws and clarify some questions which have been asked, particularly in the area of taxability of commuting in unmarked police cars and application of the three dollar (\$3.00) per day rule for those whose only personal use of an employer-provided vehicle is commuting.

If copies of the IRS regulations or further information is needed, please feel free to contact Richard Ellis at the MTAS Knoxville office (615) 974-5301. Each city employee or official affected by these provisions should become familiar with these new requirements and city attorneys and tax advisors should be consulted.

The law requiring the value of an employee's personal use of a city-owned vehicle being reported as a fringe benefit for federal income tax, social security and unemployment tax purposes has not been repealed. Employers have great flexibility in the reporting method used and may treat the value of fringe benefits provided during a calendar year as paid on a pay period, quarterly, semi-annual, annual or other basis (but no less frequently than annually.) There is a special rule that allows employers to treat the last two months of 1985 as earned during 1986. Employers also may elect not to withhold income tax if exercised by January 1 (however, FICA must be withheld) or may withhold at a flat rate of 20% (FICA is extra).

RECORDKEEPING

Valuation, or what amount to include as income, and how to substantiate the chosen value is still a very important issue. The contemporaneous log requirement has been repealed. However, substantiation in some form is required and what is required could depend on what method of valuation is being used. ("A taxpayer must substantiate each element of an expenditure or use...by adequate records or by sufficient evidence corroborating his own statement." (Page 46017) Application of exemptions must also be substantiated. The IRS takes the position that the uncorroborated statement of the taxpayer is not enough and, while no specific type of records is required, the taxpayer should keep evidence made at or near the time of use to justify the amount of the deduction, the dates of departure and return for each business trip or each personal trip, or both, the destination and purpose. Tax forms in 1985 will require the following information:

- (1) The total miles driven during the year,
- (2) The percentage of personal use,
- (3) Whether the vehicles was used for commuting, and the number of miles for a normal commute,
- (4) Whether the vehicle was available for personal use, and
- (5) Whether the taxpayer has records or written evidence to justify the deductions claimed. (Page 46025)

Employers must require periodic statements from employees showing information, such as total miles, total personal miles, or number of commutes to justify the amount used by the employer for withholding purposes. (Page 46025) The employer may rely on the employee's records and statements (and must keep a copy) unless the employer knows or has reason to know they are inaccurate. (Page 46027) As you can see, based on these requirements, some substantiation of total miles and number of personal miles, should be maintained.

EXCEPTIONS TO SUBSTANTIATION REQUIREMENTS

Specific exemptions. Vehicles specifically exempted, where commuting may be excluded from income if there is a bona fide business reason that the employee take the vehicle home, include:

- (A) Clearly marked police and fire vehicles,
- (B) Ambulances used as such or hearses used as such,
- (C) Any vehicle designed to carry cargo with a loaded gross vehicle weight over 14,000 pounds,
- (D) Bucket trucks ("cherry pickers"),
- (F) Combines,
- (G) Cranes and derricks,
- (H) Delivery trucks with seating only for the driver, or only for the driver plus a folding jump seat,
- (I) Dump trucks (including garbage trucks),
- (J) Flatbed trucks,
- (K) Forklifts,

- (L) Passenger buses used as such with a capacity of at least 20 passengers,
- (M) Qualified moving vans,
- (N) Qualified specialized utility repair trucks.
- (O) Refrigerated trucks,
- (P) School buses,
- (Q) Tractors and other special purpose farm vehicles,
- (R) Unmarked vehicles used by law enforcement officers if the use is officially authorized, and
- (S) Such other vehicles as the Commissioner may designate. (Page 46033)

Clearly marked police or fire vehicles. A police or fire vehicle is a vehicle, owned or leased by a governmental unit, or any agency or instrumentality thereof, that is required to be used for commuting by a police officer or firefighter who, when not on a regular shift, is on call at all times, provided that any personal use (other than commuting) of the vehicle outside the limit of the police officer's arrest powers of the firefighter's obligation to respond to an emergency is prohibited by such governmental unit. (Cities should have a written policy prohibiting such unauthorized use and stating such employees are on call at all times.) A police or fire vehicle is clearly marked if, through painted insignia or words, it is readily apparent that the vehicle is a police or fire vehicle. A marking on a license plate is not a clear marking.

Qualified specialized utility repair truck. The term "qualified specialized utility repair truck" means any truck (not including a van or pickup truck) specifically designed and used to carry heavy tools, testing equipment, or parts if--

- (i) The shelves, racks, or other permanent interior construction which has been installed to carry and store such heavy items is such that it is unlikely that the truck will be used more than a de minimis amount for personal purposes, AND
- (ii) The employer requires the employee to drive the truck home in order to be able to respond in emergency situations for purposes of restoring or maintaining electricity, gas, telephone, water, sewer, or steam utility services.

Unmarked law enforcement vehicles. To qualify for this exception, any personal use must be:

- (i) Authorized by the city, AND
- (ii) Incident to law-enforcement functions, such as being able to report directly from home to a stakeout or surveillance site, or to an emergency situation.

Use of an unmarked vehicle for vacation or recreation trips cannot qualify as an authorized use. (Page 46034)

Law enforcement officer. The term "law enforcement officer" means an individual who is employed on a full-time basis by a governmental unit that is responsible for the prevention or investigation of crime involving injury to persons or property (including apprehension or detention of persons for such crimes), who is authorized by law to carry firearms, execute search warrants, and to make arrests (other than merely a citizen's arrest), and who regularly carries firearms (except when it is not possible to do so because of the requirements of undercover work.) The term "law enforcement officer" may include an arson investigator if the investigator otherwise meets the requirements. (Page 46035)

Vehicle Kept On-Premises With No Personal Use

Mileage records are not required for a vehicle which is used only for business and which is kept at the employer's business during off hours. However, the employer must have a written policy prohibiting any personal use of such vehicles, which must be followed by employees. (De minimis personal use, such as a lunch-time stop between job sites, will not disqualify this exemption.) Also, the employer must keep records which would substantiate to the IRS that these five (5) requirements (the exemption) are met:

- (i) The vehicle is owned or leased by the city and made available for use by one or more city employees in connection with city business,
- (ii) The vehicle is kept on city premises when not used for city business (except temporary maintenance),
- (iii) The employee does not reside on the premises where the vehicle is kept,
- (iv) The employer (city), has a written policy that no employee, nor any individual whose use would be taxable to the employee, is allowed to use the vehicle for personal use (except a de minimis use), AND
- (v) The employer (city) reasonably believes that, except for a de minimis use, no employee nor individual whose use would be taxable to the employee, uses the vehicle for personal purposes. (Page 46037)

Under this exception, no amount is included in any employee's gross income.

Commuting As Only Personal Use

The so-called \$3.00 per day rule may be used if:

- (i) For a bona fide noncompensatory business reason, the employer requires the employee to commute in the vehicle,
- (ii) Commuting is the only allowed personal use (except de minimis uses), and the employer has a written policy so stating,
- (iii) The employee (or any individual whose use would be taxable to the employee) does not use the vehicle for any personal use other than commuting (except a de minimis use),
- (iv) The employee is not a control employee, beginning in 1986,
- (v) The vehicle is used in the employer's business, AND
- (vi) Three dollars (\$3.00) per commuting (\$1.50 one way) is reported in the employee's income for the value of such commuting. (Page 46037)

Evidence must be available to prove these six items. Gas, maintenance and similar expenses do not have to be considered. If there is more than one employee who commutes in the vehicle, the amount includable in the income of each is one dollar fifty cents (\$1.50) per one way commute (three dollars (\$3.00) per round trip per employee.) (Page 46012)

Beginning in 1986, "control employees" in automobiles ("any four-wheeled vehicle which is manufactured primarily for use on public streets, roads, and highways," Fed. Reg. p. 750, Vol. 50, No. 4, January 7, 1985 may not use this commuting rule. Control employees are defined to include elected officials and state and local executive officers comparable to an elected official.

Vehicles Used Most Of Day To Visit Job Sites

Another exception to the substantiation provisions may be used for "sales and services" vehicles, for an employee who spends most of a normal business day using the vehicle to call on customers or clients, or make deliveries, visit job sites, or similar activities. Records must be kept to show the exception applies. If the vehicle is designed primarily for personal use (an automobile or regular truck), such an employee may maintain no mileage records and treat seventy percent (70%) as business use and thirty percent (30%) as personal use (utilizing the annual lease

values set out in the IRS table or fair market value based on availability of the vehicle). Alternatively, if the vehicle is primarily designed for business use, the percentages may be changed to eighty percent (80%) business, twenty percent (20%) personal and reported accordingly. The appropriate percentage is then applied to the value and the amount included in the employee's gross income. If the vehicle is used by more than one employee, the personal use percentage must be allocated in a reasonable manner or based on actual mileage to reflect actual use by the employees; however, the value of the availability of the vehicle (or optional annual lease value) may be calculated as if the vehicle is only available to one employee.

VALUATION METHODS

A recipient of such a fringe benefit may still utilize the fair market value of availability approach to reporting, which the IRS regulations require to be determined without regard to volume leases or discounts; however, taxes, insurance, maintenance, gasoline and other similar costs must then be included. Special equipment installed strictly for the employer's benefit does not have to be counted toward value.

Special Rule For Employer-Provided Vehicles

Under the special rule for valuing employer-provided automobiles, Annual Lease Values and Daily Lease Values are utilized. The Annual Lease Value is based on an estimate of the annual cost of leasing the automobile on a four-year lease, using the fair market value of the automobile.

The Daily Lease Value is based on the Annual Lease Value and is supposed to represent the daily cost of renting an automobile based on day-to-day rental, computed by multiplying the Annual Lease Value by a fraction the numerator of which is four (4) time the number of days of availability of the automobile and the denominator of which is 365. This computation is as follows:

$$\text{Annual Lease Value} \quad \times \quad \frac{4 \times \text{number of day}}{365}$$

Whether to use the Annual Lease Value or the Daily Lease Value in reporting involves complicated rules based on continuous availability of use of the vehicle and an election may be made to treat all periods of availability as at least thirty (30) days (required to use Annual Lease Value). The regulations also deal with how to treat periods of unavailability (which is treated differently based on whether the unavailability is attributable to a bona fide business reason of the employer). The amount of the Annual Lease Value or the Daily Lease Value that is actually included as income depends on how much of the value is subject to the working condition fringe exculsion, defined and discussed below and in the regulations.

The special rules may be used by both cities and city employees and in most cases neither is bound by the other's use of the special rules. (The exception relates to calculation of the Annual Lease Value when both an employer and employee are using the special rule. If used by both, consistent use is required.) Basically, these rules detail a pro rata rule for personal use of a city-owned vehicle. While the Internal Revenue Service defines the includable income as that not qualifying as a working condition fringe, or that which would be deductible by the employee if the employee paid for such use, it seems easier to understand the concept as simply having to include the value of personal use by figuring a percentage of the Annual Lease Value of the use of the vehicle.

The example used by the Internal Revenue Service in the regulations is this:

Assume the value of the availability of an employer provided automobile is \$2,000, without regard to any working condition fringe (assuming all non-business use) and that the employee drives the automobile 6,000 miles for business and 2,000 miles for non-business. The value of the working condition fringe is \$1,500 and the amount includable in the gross income of the employee on account of the use of the automobile is \$500. To determine business and personal mileage, only mileage driven by that employee is counted.

In this example, the percentage of personal use would be determined by dividing 2000 by 8000, the total number of miles driven by the employee. That percentage (25%) is then applied to the Annual Lease Value of \$2,000 to obtain the \$500 amount includable in gross income. Of course, fuel costs of 5.5¢ per mile (2000 x 5.5¢) must be added (\$110).

When the Daily Lease Value must be used, the above illustrated computation, while using the same principles, is more complicated.

ANNUAL LEASE VALUE TABLE

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

The table is based on a four (4) year lease, so if elected should be used for four (4) years. The optional annual lease values of the table include taxes, maintenance and insurance, but do not include fuel, which again may be valued at 5.5¢ per mile or actual cost. If the vehicle is used by more than one employee, a determination of value to each is made by separately using miles driven divided by total miles times the annual lease value, with a similar computation for the other.

Dealers' blue books may be helpful in making the determination as to value, whether using the optional valuation method using annual lease values or the fair market value of availability method. Vehicles purchased prior to January 1, 1985, should be valued as of January 1, 1985.

Employers May Treat All Employee Use as Personal Use

An employer can treat the entire value of an employer-provided vehicle as income to an employee. The employer may then reimburse the employee for business use of the vehicle, or the employee may deduct the business-use part.

By imputing the full value of the vehicle to the employee, the employer will reduce its administrative work. However, unless the employee's other compensation will exceed the FICA wage base, election of this option will result in a higher FICA tax for employee and employer.

BULLETIN: Important Changes to Regulations

New temporary regulations were received just as we were preparing to publish this Technical Bulletin that slightly change some of the fringe benefit regulations relating to employer-provided vehicles. These new "proposed and temporary" regulations, effective January 1, 1986, have been issued in temporary rather than final form to allow city officials an opportunity to respond before the regulations become final. There will be a 60-day comment period followed by a public hearing. The sections presented below summarize the provisions of the new regulations which alter previously issued regulations. This new information adds to the information presented above.

Annual Lease Value Method of Valuing Employer-Provided Vehicles

To assist those cities who utilize the Annual Lease Value (ALV) valuation method, which is determined by reference to the fair market value of the employer-provided vehicle, the new regulations provide fair market value safe harbors. For an auto owned by a city, the city's cost of buying the auto will be treated as the fair market value. If the auto is leased, the retail value will be considered the fair market value. Also, the new regulations provide that the fair market value will not be increased by any special equipment added to the vehicle solely for business purposes and does not include equipment installed for any personal purposes.

First-Average Method of Valuing Employer-Provided Vehicles

Under the previous regulations cities utilized the ALV method for valuing each vehicle in city-owned fleets. The new regulations provide a rule whereby the "fleet average value" may be utilized if the fleet includes more than 20 vehicles. This method may not be utilized for any vehicle with a fair market value of more than \$16,500. The value is determined by averaging the value of all vehicles in the fleet and applying that value to each vehicle when determining the ALV. When utilizing this method of valuation, the employee must utilize the ALV method also.

Special Cents-Per-Mile Rule

The new temporary regulations provide that the standard mileage rate, which was 21 cents-per-mile in 1985, may be used to determine the value of personal use of a city-owned vehicle, if that vehicle is used regularly for official purposes or is driven at least 10,000 miles per year primarily in the service of the municipality. Since the 21 cents-per-mile rate includes consideration for gas, if a vehicle is provided by the employer and gas is not, the 21 cents-per-mile rate may be reduced up to 5.5 cents-per-mile. This special rule is only applicable for vehicles with an original fair market value of less than \$12,800.

Special Rule for Commuting Use

The new temporary regulations attempt to clarify the definition of a "control employee". Previous regulations indicated that an "officer" (now control employee) in a local government could not utilize the commuting use method of valuing the use of a city-owned vehicle, but there was no clear definition of an "officer". The new regulations are not much better. They attempt to define a "control employee" as an elected official or a "state or local executive officer". There is no information as to what constitutes a "state or local executive officer". It is assumed that new temporary regulations will be issued in 1986 which will more clearly define which employees will fall into this category.