How to Maximize Your Tax Write-Offs For Car and Truck Expenses

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[For IRS Code 179A, visit www.irs.gov/publications/p946/ch02.html]

For many self-employed contractors, salespersons and other individuals who depend heavily on their vehicles, the tax deductions for car and truck expenses can be substantial. Yes, vans and sports utility vehicles (SUV's) are included in this general category.

The key to getting the biggest deduction possible is to know the **"rules of the game"** and to keep good records. This is especially important as vehicle write-offs are often one of the largest tax deductions on your income tax return. They are also one of the largest audit flags as well. Well organized and accurate vehicle expense and mileage records are your strongest protection against the long arm of the tax auditor.

What are the Rules?

If a taxpayer uses an auto or truck in a trade or business, he or she may account for vehicle business expenses by using either of the following two methods:

- Standard Mileage or Mileage Rate Method
- Actual Expense Method

The **Standard Mileage Rate Method** is by far the simplest method of calculating the car and truck expenses. The allowable tax deduction is simply the total business miles multiplied by the Standard Mileage Rate (SMR), which for 2003 is 36 cents ($.36) per mile. The rate is $.375 per mile for 2004. The SMR includes a built-in depreciation factor of

$.15 or 15 cents per mile ($.16 for 2004). This electable method may be used only by employees and self-employed persons. It may be used for only one car or truck at a time

Example: If Bob drives 20,000 business miles in year 2003, he would have an auto deduction of:
20,000 miles X $.36 = $7,200 [$7,500 for 2004 @ $.375 per mile]

The **Actual Expense Method**, on the other hand, requires the taxpayer to accumulate all of the costs of operating the vehicle during the year and multiplying this total by the "business use percentage". This method may be used by any taxpayer.

Obviously, if a vehicle is used exclusively for business (i.e., does not include any personal commuting miles), its business use percentage is 100%. Therefore, all operating expenses are deductible.

Personal and Business Use of Vehicle

Frequently, self-employed individuals use a vehicle for both personal and business purposes. Since only the business portion is deductible, the business use percentage must be calculated. This is where good recordkeeping comes into play. The business use percentage is calculated by dividing total business miles by total miles.

Example: Cheri uses her Ford pick-up truck in her contracting business. She qualifies to use a portion of her home as an office. Her total miles for the year (personal & business) are 40,000. She figures her business miles by adding up her round trip mileage between her home office and various job sites. The
total is 35,000 miles. Therefore, her business use percentage is 35,000 business miles/40,000 total miles = 88%.

Cheri's total truck expenses for the year, including depreciation, are $16,000. Her allowable tax deduction is $16,000 X 88% = $14,080.

Can the Taxpayer Switch Methods?
If the standard mileage rate for a car or truck is selected in the "first" year of business use, the taxpayer may use either method in later years (exception: leased vehicles).

If the actual expense method is used in the first year, then that method must be used for the life of the vehicle. The reason for this restriction has to do with the depreciation allowance included in the standard mileage rate. It is not expressed in terms of years as is the case with regular depreciation methods.

Tax Strategy: calculate the allowable deduction for the vehicle's first business year using both methods and claim the larger deduction. Most tax return preparation software will automatically calculate and compare both types of deductions.

What Expenses are Included?
All operating and fixed costs connected with maintaining a business car/truck are deductible, such as gas, oil, tires, repairs, maintenance, insurance, taxes, licenses, depreciation, car loan interest and garage rent. Business parking fees and tolls are additionally deductible under either method.

Little known rule: business related car loan interest and state and local property taxes (not license and registration fees) **may be added to the standard mileage rate amount** (IRS Revenue Ruling 88-92 & Revenue Procedure 97-58; Sec 5.04).

DEPRECIATION

Depreciation, simply stated, is the recovery of a business asset's cost, due to normal wear and tear, over its economic or useful life. You are getting back (recovering) over time, as a depreciation deduction, a portion of the money you invested in that asset. Cars and trucks are depreciated over a five year period (life). How much you are allowed to deduct in the first and later years of your vehicle's depreciable life is determined by the "depreciation method" and various cost recovery limitations. This is the main reason why depreciation rules are so complex. Here are some basic guidelines to help you select the best depreciation write-off option:

▪ **Listed Property**: cars or passenger autos with an "unloaded" **gross vehicle weight** (GVW) of **6,000 lbs** or less are known as "listed property" (for a truck or van, "loaded GVW is substituted for unloaded GVW). Listed property is subject to depreciation deduction limitations (IRS Code Sec 280F). Of course there are exceptions such as ambulances, hearses, taxis and specially modified vehicles which make them unsuitable for carrying passengers.

▪ **Business use is more than 50%:** if a vehicle is used more than 50% for business, it may be depreciated over 5 years using a straight line or accelerated method of depreciation known as MACRS (Modified Accelerated Cost Recovery System). Under the straight line method, the vehicle depreciation deduction remains constant over its life (1/5 or 20% per year). Under MACRS, the depreciation rates and amounts change, typically with the largest deduction in the first year.
Annual statutory dollar caps also apply depending on the type of vehicle, when it was placed in service and other depreciation elections made. A special first year expensing deduction of up to $11,010 may be elected (**IRS Code Sec**

179). What this means is that no matter how much you paid for your car, truck, van or SUV, you can't write off more than the annual limit (dollar cap) for listed property vehicles. The Section 179 write-off may only be used for a vehicle's first year of (business) service. A used vehicle qualifies.

Another little known fact: the Sec 179 deduction is **limited to the "trade or business income"** of the taxpayer which most people think applies only to their Schedule C business profit. In other words if there is no profit, there is no Section 179 deduction. The little known fact is that IRS regulations define "active trade or business income" to include the trade or business income of "being an employee" (IRS Reg 1.179-2). **What does this mean and why is it so important?** It means that the Section 179 deduction may be preserved or taken in full if an individual tax return also includes the taxpayer's or spouse's wages, ordinary income from a partnership or Subchapter S corporation and certain business related gains. It's important because it may allow you to take a much greater Section 179 deduction than you thought the IRS would allow. Knowledge is power. Here is a simple example:

In 2003, Joe has a profit from his printing business of $6,000. Mary, Joe's wife, has employee wages of $110,000. Joe buys $100,000 worth of equipment for his business. He needs the biggest tax write-off he can get. He elects to expense his equipment in 2003 under the Section 179 expensing option. Without Mary's wage income, Joe would only be able to deduct $6,000 as a Section 179 expense. With Mary's wages, however, he can claim the **full $100,000 deduction** for the machine. The courts have held that a joint return reflects the activity of a taxable unit. That is, wages of one spouse are presumably attributable to the other spouse for purposes of maximizing the Section 179 deduction. I bet that many married couples don't realize that they have become such a

powerful “taxable unit”. Most income tax software will apply this special rule, however, it’s not automatic. The taxpayer must first elect the Section 179 option.

- **New Law**: The Jobs and Growth Tax Relief Reconciliation Act of 2003 provides for a special **50%** “bonus” depreciation allowance for qualified automobiles/trucks, listed or non-listed property acquired after May 5, 2003 and before January 1, 2005. Business use must be over 50%. Before May 5, 2003, a 30% bonus depreciation allowance is in effect as a result of prior legislation: The Job Creation and Worker Assistance Act of 2002. It seems that the tax laws sometimes change before the ink is really dry. Note: the 50% special bonus depreciation (applies to certain assets other than vehicles too) is due to expire by January 1, 2005 unless Congress acts to renew or extend it. In addition to the **date placed in service** and **over 50% business** use rules, a vehicle must be purchased as **new** to qualify for bonus depreciation. You must elect to claim either the 30% or 50% bonus depreciation allowance. It’s not automatic. Also, you may still claim the 30% rate even if you qualify for the 50% rate, without losing the higher depreciation deduction caps available under the 50% allowance.

- **Luxury auto limits**: luxury auto rules apply to cars, light vans, trucks or SUV’s weighing 6,000 lbs GVW or less. The IRS generally allows depreciation on only the first $15,300 to $18,350 of a vehicle’s cost (for 2003). The threshold amount allowed depends on type of vehicle, date placed in service and whether or not the special or bonus depreciation was claimed and at what rate (30% or 50%). In other words, you can forget about trying to depreciate the full cost of your new Mercedes, unless it weighs over 6,000 lbs.

- **Business use is less than 50%:** if business use of a vehicle is less than 50%, it is **not eligible** for MACRS, Section

179 or the 50% or 30% special depreciation allowance. Straight line depreciation method is required. Tip: try for at least 51% business use.

- **Vehicles over 6,000 lbs GVW:** trucks, vans and SUV's with a GVW of over 6,000 lbs **are not subject** to the depreciation limitations under the luxury auto or Section 179 rules. This probably explains why taxpayers started buying the monster SUV's weighing over 6,000 lbs. Moreover, the maximum allowable Sec 179 deduction is **$100,000** instead of $10,710 for passenger autos and 11,010 for trucks and vans less than 6,000 lbs GVW. The maximum Section 179 allowance was previously $24,000 (2002 tax act). Note: these vehicles are still considered listed property. They are **not eligible for accelerated depreciation or a Section 179 expense when business use is 50% or less.** As stated previously, qualified nonpersonal-use vehicles, are exempt from the listed property and GVW rules.

- **Electric and clean-fuel vehicles:** electric passenger autos, Qualified Electric Vehicles (QEV) and clean fuel vehicles, generally fall under the same rules and limitations that apply to non-electric vehicles, however, the cost recovery thresholds and deduction limitations are substantially higher. The total cost that may be depreciated or expensed ranges from $45,400 to $53,383. The maximum Section 179 caps go from $9,080 to $32,030. Qualified nonpersonal-use vehicles or vehicles over 6,000 lbs GVW with over 50% business use, are exempt from the limits.

Clean-fuel vehicle deduction (IRS Code Sec 179A): the deduction is based on the GVW and ranges from $2,000 (GVW 10,000 lbs or less) to $50,000 (GVW over 26,000 lbs). The taxpayer must be the original purchaser and user of the vehicle. Gas or electric hybrid vehicles qualify for the deduction.

QEV tax credit (IRS Code Sec 30): a credit of 10% of the cost of the vehicle up to $4,000 is allowed. The QEV must be a four-wheeled vehicle powered primarily by an electric motor and manufactured for use on public roads. The taxpayer must be the original purchaser and user of the QEV. The credit reduces the cost or depreciable basis of the vehicle.

Both the QEV credit and Clean-Fuel Vehicle deduction will phase out (be reduced) beginning in 2004. The phase out will be completed by 2007. The Clean-Fuel Vehicle deduction cannot be claimed on vehicles that qualify for the QEV credit. Note: the QEV credit and Clean-Fuel Vehicle deduction **may be claimed for personal use vehicles.**

Tax credit is more valuable than deduction: as a general rule, a tax credit results in greater tax savings than a tax deduction of the same amount for the following reason: a credit reduces your income tax dollar for dollar whereas a tax deduction reduces your taxable income upon which your tax

is based. Example: you have a choice between a $1,000 tax credit and a $1,000 tax deduction. You are in the 30% combined federal and state tax bracket. Your taxable income is 120,000 and your tax before
the deduction or credit is $36,000. Your tax credit simply reduces your tax from $36,000 to $35,000 (you have saved $1,000). Your $1,000 deduction reduces your taxable income of $120,000 to $119,000. Since your tax rate is 30%, the tax on $119,000 is $35,700. The deduction saved you $300 ($36,000-$35,700). Therefore, your tax credit saved you $700 more than the deduction ($1,000-$300).

No double/triple-dipping allowed: you may not claim the bonus depreciation, Section 179 deduction, special credits and regular depreciation deduction by basing them all on the original depreciable cost basis of the vehicle. These special

deductions and credits must be taken in a certain order and the depreciable cost basis must be adjusted accordingly. For example, as a general rule, the Section 179 expensing deduction would be claimed first. The cost of the vehicle is then reduced by the amount of the deduction. The special bonus depreciation deduction may be claimed next and the cost is further reduced by the amount of the deduction. If any cost basis is left over, you may claim the following deductions and credits, each of which further reduces the depreciable cost basis of the vehicle: (1) clean-fuel deduction; (2) QEV credit and (3) regular depreciation (e.g., MACRS) over the useful life of the vehicle (5 years).

Selecting the "right method" of depreciation or expensing option for your business vehicle is critical to getting the highest possible tax deduction or credit. Sometimes many thousands of dollars are at stake. Because the rules of the game are complex and ever changing, I strongly suggest that you thoroughly study all the relevant IRS and other tax publications on the subject. Then, you should gather all of the facts about your vehicle (or vehicles), including: type; how acquired (purchased or leased); date purchased or placed in service; condition (new or used); percentage of business use; weight; how the vehicle will be used in the business and what makes it go (gasoline, diesel, clean fuel or electricity). Once you have analyzed all the information, you should then select the best tax saving option: elect 30% or 50% bonus depreciation; Section 179 expensing; accelerated or straight line depreciation; special credit/deduction or a combination thereof.

By now, your eyes have glazed over and you're asking yourself, "is he serious?" Well, a little facetious humor never hurts, especially when you are dealing with the subject of taxes which has been known to drive people insane, make them lose their hair or raise their blood pressure. I am serious

though about the need to become aware of or to educate oneself about the powerful tax saving opportunities available to a taxpayer. You don't need to know all of the excruciating details of the tax law but you should know what your options are and be able to **"ask the right questions"** of your tax preparer or advisor. Admittedly, I'm a bit biased in this regard but I do feel that most taxpayers who claim business write-offs should consult with an experienced tax practitioner to guide them through the tax maze. The old cliché, about being "penny-wise and pound foolish", is appropriate in this context. Many taxpayers take delight in the few bucks they save by doing their own tax return only to give up thousands of dollars in potential tax savings.

For More Information:

Learn more about tax laws and rules dealing with vehicles and depreciation by reading IRS Publications 17, 463, 535, 551, 946 and instructions for Form 4562 (depreciation). Pub 534 covers pre-1997 depreciation. They can be found on the IRS website at www.irs.gov. Armed with knowledge of the rules of the game, you will be able to take full advantage of all the deductions and credits available to you and reap greater tax savings for your business.

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