

To: State Compensation Insurance Fund

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Subject: State Compensation Insurance Fund; Summary of IRS Rules Applicable to
Employee Personal Use of Employer-Provided Vehicles

WORKERS' COMP
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This memorandum summarizes the applicable federal income and employment tax rules for valuation, reporting, and withholding of employee personal use of employer-provided vehicles as they pertain to State Compensation Insurance Fund (“State Fund”).

1. Employer-Provided Vehicles: Working Condition Fringe v. Taxable Fringe.

In general, an employee’s gross income includes compensation for services, including receipt of fringe benefits, unless otherwise excepted.¹ The use of an employer-provided automobile is a fringe benefit includible in the employee’s gross income except to the extent it is specifically excluded from gross income.² An employee may exclude from gross income any fringe benefit that qualifies as a “working condition fringe,” which is defined as any property or services provided to an employee to the extent that, if the employee paid for such property or services, such payment would be allowable as a trade or business deduction for tax purposes.³

Personal, living or family expenses do not qualify as trade or business deductions. Similarly, an employee’s costs of commuting to a place of business or employment are personal expenses and do not qualify as deductions.⁴ Notwithstanding this general rule, transportation expenses paid or incurred by an employee commuting between (i) his or her residence and

¹ See § 61(a)(1) of Internal Revenue Code of 1986, as amended (the “Code”). In general, expenses that are deductible under Code Sections 162 or 167 are either ordinary and necessary expenses or amortizable or deductible as capital expenditures.

² Treas. Reg. § 1.61-21(a).

³ Code § 132.

⁴ Code § 262; Treas. Reg. §§ 1.162-2(e), 1.262-1(b)(5); see also IRS Publication 535 (2010).

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certain *temporary* work locations⁵ or (ii) between one business location and another business location generally are deductible.⁶

The value of property or services provided to an employee may not be excluded from the employee's gross income as a working condition fringe unless the applicable substantiation requirements of either Code Section 274(d) or Code Section 162, and the Treasury Regulations promulgated thereunder, as applicable, are satisfied.⁷ The applicable substantiation rules include tracking miles driven and the purpose thereof. For example, an employee may satisfy this substantiation rule by maintaining a monthly travel log that includes the following with respect to each vehicle trip: date, odometer readings, starting point and destination and purpose of trip.

Under the above-cited authorities, an employee's use of an employer-provided vehicle will constitute a working condition fringe under any of the following scenarios:

- A. The employer-provided vehicle is used exclusively for business reasons;
- B. The value of the employee's personal use is so small that accounting for it is unreasonable or administratively impractical;
- C. The employer maintains a written policy prohibiting the employee's personal use of the vehicle and such vehicle is used for valid business reasons; or
- D. The employer maintains a written policy that restricts the use of the vehicle to business and commuting *and* other specified conditions are met. However, under this alternative, the value of personal use (including commute miles) must be included in the employee's taxable wages as described below.

2. Valuation of Personal Use of Employer-Provided Vehicles.

If all or a portion of an employee's use of an employer-provided vehicle does not qualify as a working condition fringe (e.g., certain commuting use), as provided above, then such employee should be considered as using the vehicle for personal use, the value of which must be

⁵ Revenue Ruling 99-7 (citing Revenue Rulings 90-23 and 94-47).

⁶ Revenue Ruling 55-109, 1955-1 C.B. 261, *modified* by Rev. Rul. 90-23.

⁷ Treas. Reg. § 1.132-5(c)(1).

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computed by the employer under one of the methods described below, as applicable, and included in such employee's taxable wages.

(a) *Safe Harbor FMV Rule (Annual Lease Value).*

As a general safe harbor rule, the value of personal use of an employer-provided vehicle is determined by reference to fair market value ("FMV") of the vehicle unless one of the "special valuation rules" is used.⁸ FMV is used to determine the *annual lease value* of the vehicle as of the first day such vehicle is made available to the employee.⁹ Annual lease value is the amount an individual would have to pay in an arm's length transaction to lease the same or comparable vehicle on the same or comparable conditions in the geographic area in which the vehicle is available for use.¹⁰

It should be noted that the safe harbor FMV rule does not include the FMV of maintenance and insurance for the employer-provided vehicle nor does it include the FMV of employer-provided fuel, regardless of whether the fuel is provided in-kind or reimbursed. As such, the FMV of the foregoing items must also be included to determine the total taxable benefit.¹¹

Once an annual lease value determination and amount of employer-provided maintenance, insurance and fuel is made, such value must be apportioned on the basis of an employee's mileage logs to determine the taxable benefit. The annual lease value plus employer-provided maintenance, insurance and fuel is multiplied by the percentage of personal use to determine the amount constituting taxable wages.

(b) *Special Valuation Rules.*

To the extent an employer seeks to report the value of an employee's personal use of an employer-provided vehicle as something other than the safe harbor FMV, three special valuation rules are potentially available: (i) automobile lease valuation rule;¹² (ii) commuting

⁸ Treas. Reg. §1.61-21(b)(4).

⁹ Note that the annual lease value may be determined even if the employer-provided vehicle is not actually leased by the employer, i.e., is owned by the employer.

¹⁰ Treas. Reg. §1.61-21(d)(5); *see also* IRS Publication 15-B (2010).

¹¹ Treas. Reg. §1.61-21(b)(4).

¹² Treas. Reg. §1.61-21(d)(2).

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valuation rule,¹³ and (iii) vehicle cents-per-mile valuation rule.¹⁴ Specific requirements must be met in order to use these rules, as summarized below, and such rules must be consistently applied from year-to-year.

(i) *Automobile Lease Valuation Rule.*

The automobile lease valuation rule may be used to calculate the annual lease value of an employer-provided vehicle. The automobile lease valuation rule may be applied as follows:

A. The employer determines the FMV of the vehicle as of the first date the vehicle is available for personal use;

B. Using the IRS Annual Lease Value Table (which is updated annually),¹⁵ the employer determines the dollar range within which the FMV of the vehicle falls. The IRS Annual Lease Table then provides the corresponding annual lease value;

C. For employers with vehicle fleets of 20 or more vehicles (like State Fund), the employer may use a fleet-average valuation rule which allows the employer to determine the average of the fair market values of all automobiles in the fleet for purposes of the IRS Annual Lease Value Table. For calendar year 2010, vehicles with a FMV above \$20,300 (this amount is subject to change periodically by IRS) are not eligible for this special rule;¹⁶ and

D. The employer calculates and apportions the annual lease value between business and personal use of the vehicle reports the difference as a taxable fringe benefit to the employee.

It should be noted that the IRS Annual Lease Value Table already includes the FMV of maintenance and insurance for the employer-provided vehicle but does not include the FMV of employer-provided fuel, regardless of whether the fuel is provided in-kind or

¹³ Treas. Reg. § 1.61-21(f).

¹⁴ Treas. Reg. § 1.61-21(e).

¹⁵ See IRS Publication 15-B (2010).

¹⁶ Rev. Proc. 2010-10.

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reimbursed. Fuel should be valued at 5.5 cents per mile for all personal miles driven by the employee in 2010.¹⁷

It should be further noted that the annual lease values calculated under this rule are based on a four-year lease term, and thus, such rule must be used by the employer for all subsequent years in which the vehicle is made available to the employee. The annual lease values will generally stay the same for the period that begins with the first date of use and ends on December 31 of the fourth full calendar year following such date. The annual lease value must be recalculated if the vehicle remains in use by the same employee for every subsequent four-year period. If the vehicle is not available for a full year then the lease value should be prorated based on the portion of the year it was available.

(ii) Commuting Valuation Rule.

Under circumstances where an employer “requires an employee to commute” using an employer-provided vehicle, and commuting (and *de minimis* personal use) is the *only* form of personal use, the “commuting valuation rule” can be used to determine the value of personal use of an employer-provided vehicle under certain circumstances as described below.¹⁸ If used, the employer determines the commuting value by multiplying each one-way commute (from home to work or from work to home) by \$1.50.¹⁹ If more than one employee commutes in the same employer-provided vehicle, the tabulated value applies to each employee.

To use the commuting valuation rule, an employer must meet all the following requirements:

A. The vehicle is owned or leased by the employer and is provided to one or more employees for use in connection with the employer's trade or business, and is used in the employer's trade or business;

B. For “bona fide noncompensatory business reasons,” the employer *requires* the employee to commute to and/or from work in the vehicle (i.e., commuting use is not voluntary on the employee's part);

¹⁷ See Rev. Proc. 2009-54. The 5.5 cents per mile is the rate established by the IRS for 2010, and could vary in future years. Also, in lieu of IRS established per mile rates, State Fund may use its actual fuel cost per mile if lower.

¹⁸ As provided above, such value includes the value of employer-provided fuel. See Treas. Reg. § 1.132-5(f).

¹⁹ Treas. Reg. § 1.61-21(f)(1)-(3).

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C. The employer has established a written policy whereby neither the employee (nor any individual whose use would be taxable to the employee), may use the vehicle for personal purposes, other than for commuting or *de minimis* personal use (such as a stop for a personal errand on the way to the office);

D. Except for *de minimis* personal use, the employee does not use the vehicle for any personal purposes other than commuting; and

E. The employee required to use the vehicle for commuting is not a “control employee” of the employer. For employees of agencies of the State of California, including State Fund employees, a control employee refers to (i) an elected official; (ii) a state agency/departmental official appointed by the governor; or (iii) an employee whose compensation²⁰ equals or exceeds the compensation paid to a federal government employee holding a position at Executive Level V, determined under Chapter 11 of Title 2, United States Code, as adjusted by Section 5318 of Title 5 United States Code. For calendar year 2010, Executive Level V compensation amounts to \$145,700.²¹ In the alternative, the Treasury Regulations provide that a government employer may, but is not required to, treat all “highly compensated employees” as control employees for purposes of the commuting valuation rule. A highly compensated employee is an employee receiving more than \$105,000 in pay for the preceding year and who is ranked in the top 20% of employees when ranked by pay for the preceding year by the employer.²²

(iii) Vehicle Cents-Per-Mile Rule.

If an employee is provided with a vehicle that is either reasonably expected to be used “regularly in the employer’s trade or business throughout the calendar year” or satisfies the mileage rule requirements below, the value of the personal use under this rule is the applicable federal standard mileage rate multiplied by the total miles the employee drives the

²⁰ The term “compensation” has the meaning ascribed in Code Section 414(q)(7), and includes all “earned income,” including fringe benefits. Treas. Reg. §1.61-21(f)(7).

²¹ Treas. Reg. § 1.61-21(f)(6); see also www.opm.gov/oca/payrates/index.asp.

²² *Id.*; see also Treas. Reg. § 1.132-8(f).

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vehicle for personal use.²³ For calendar year 2010, this rate is 50 cents per mile for all miles and must be applied to personal miles independent of business miles.²⁴

An employer may report under the cents-per-mile rule if the applicable employer-provided vehicle is actually driven at least 10,000 total miles in the applicable calendar year (and the employer-provided vehicle must be used during the year primarily by employees) or is used at least 50% for business mileage.²⁵

It should be noted that the cents-per-mile rate includes the FMV of maintenance and insurance for the vehicle. For miles driven in the United States, the cents-per-mile rate also includes the FMV of employer-provided fuel. If fuel is not provided, the rate may be reduced by no more than 5.5 cents per mile for calendar year 2010 (this amount is subject to change periodically by IRS).

It should be further noted that the cents-per-mile rule should not be used to determine the value of the personal use of an employer-provided vehicle if the FMV of such vehicle on the first date on which it is made available to an employee(s) for personal use exceeds \$15,200, for calendar year 2010.²⁶

It should be further noted that the cents-per-mile rule must be used by the employer for all subsequent years in which a vehicle is valued and made available to an employee except to the extent it may qualify for the commuter valuation rule. As discussed in more detail below, employees also are required under this rule to keep track of actual mileage

²³ IRS Publication 15-B (2010) provides that a vehicle is considered “regularly used in the employer’s trade or business” if (i) at least 50% of the total annual mileage is incurred in connection with the employer’s trade or business or (ii) it is regularly used in the employer’s trade or business based on all the facts and circumstances. Infrequent business use such as occasional business trips would probably not be considered regular use in the employer’s trade or business.

²⁴ See Rev. Proc. 2009-54; IRS Publication 15-B (2010).

²⁵ See Treas. Reg. §§ 1.61-21(e)(1). If the vehicle is not owned or leased during part of the year, the 10,000 mile requirement is reduced proportionately to reflect the periods when the vehicle was owned or leased. For purposes of the foregoing, an employer-provided vehicle is considered “used during the year primarily by employees” if employees use such vehicle *consistently* for commuting. See IRS Publication 15-B (2010).

²⁶ Such value is statutorily-derived as follows: “[...]FMV of such vehicle on the first date on which it is made available to an employee(s) for personal use exceeds the sum of the maximum recovery deductions allowable under Code Section 280F(a)(2) for the first 5 tax years in the recovery period for a vehicle first placed in service during a calendar year after 1986.” As provided above, for calendar year 2010, the maximum recovery deductions referred to under Code Section 280F(a)(2) is \$15,200. See also Treas. Reg. § 1.61-21(e)(1)(iii)(B); Rev. Proc. 2010-10.

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and periodically submit documentation to their employer showing dates traveled, personal mileage, and business mileage. As provided above, business mileage must either constitute at least 50% of the annual mileage or the employer-provided vehicle must be driven 10,000 or more miles per year.

(c) Notice of Adoption of Special Valuation Rule.

State Fund must report and the employee must include in income the value determined under the applicable special valuation rule (minus any reimbursement that the employee has paid to State Fund).²⁷

State Fund *must* notify affected employees of its election(s) to change the special valuation rule by January 31st of the calendar year for which the election will apply, or 30 days after the Fleet vehicle is received by the employee, whichever is later. Failure to do so could result in the IRS' disallowance of the special valuation rule(s).

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To comply with requirements imposed by the Department of the Treasury, we inform you that any U.S. tax advice contained in this memorandum (including any attachments) is not intended or written by us to be used, and that it cannot be used by any taxpayer, for the purpose of (i) avoiding penalties that may be imposed on the taxpayer, and (ii) supporting the promotion or marketing of any transactions or matters addressed herein. For information about this statement, go to www.manatt.com/circ230.

²⁷ See Treas. Reg. 1.61-21(c)(2) (providing for reimbursement payments to employer to compensate employer for an employee's personal use of an employer-provided vehicle).