

IRS increases standard mileage rate; But does "actual expense method" yield better results?

In response to the record high gas prices, the IRS has raised the business standard mileage reimbursement rate from 50.5 cents-per-mile to 58.5 cents-per-mile. This new rate is effective for business travel beginning July 1, 2008 through December 31, 2008. While the increase is much needed, businesses should evaluate whether the IRS has done enough, or whether a switch to the actual expense method of calculating vehicle expense deductions may make more sense for 2008.

Comment. Not only did the IRS raise the standard business mileage reimbursement rate eight cents, to 58.5 cents-per-mile, it also increased the standard mileage rate for medical and moving expenses from 19 cents-per-mile to 27 cents-per-mile. These new rates are also effective July 1, 2008 through December 31, 2008. The charitable standard mileage rate remains at 14 cents, since it is fixed by the Tax Code.

Two reimbursement methods

There are two basic methods that business taxpayers may choose to compute their deduction for the business use of automobiles (including vans and light trucks): the IRS's standard mileage rate (SMR) and the actual expense method. The method a business chooses in the first year the vehicle is placed in service is important, as it affects whether a change in method can be made in later years.

Taxpayers may use the higher rate for business use of an automobile for the period starting July 1, 2008 through December 31, 2008. Travel before July 1 must be computed using the previous rate of 50.5 cents-per-mile. A business cannot split use of the actual method for one period and the standard mileage rate for the other - it is either one or the other for the entire 2008 tax year (The same rules apply to the medical and moving mileage rates of 19 cents for expenses before July 1 and 27 cents for the remainder of the year).

Standard mileage rate

Under the SMR method, the fixed and operating costs of the vehicle are generally calculated by multiplying the number of business miles traveled during the year by the business standard mileage rate (for example, 58.5 cents-per-mile for July 1, 2008 through December 31, 2008). Although a business using the SMR method cannot deduct any of the actual expenses incurred for operating or maintaining the car, the IRS does allow additional deductions for business-related parking costs and tolls, as well as interest paid on vehicle loans and any state or local personal property tax paid on the vehicle.

Actual expense method

Under the actual expense method, taxpayers can deduct the operating and maintenance costs incurred for the car during the current year, which include:

- Gas and oil;
- License and registration fees;
- Insurance;
- Garage rent;
- Tires;
- Minor and major repairs;
- Maintenance items such as oil changes and tire rotation
- Interest paid on a car or truck loan; and
- Car washes and detailing.

If the business use of the vehicle is less than 100 percent, expenses need to be allocated between business and personal use. For example, if based on the taxpayer's records, the total actual vehicle expenses for 2008 are \$3,000, and the vehicle is only used 60 percent for business, the allowable deduction under the actual expense method is \$1,800 ($\$3,000 \times .60$).

Switching methods

Once actual depreciation in excess of straight-line has been claimed on a vehicle, the SMR cannot be used. Absent this prohibition (which usually is triggered if depreciation is taken), a business can switch from the SMR method to the actual expense method from year to year. Businesses cannot, however, make mid-year method changes either to, or from, one method to the other. Additionally, if a taxpayer uses the actual expense method for the first year that a vehicle is placed in service, it cannot switch to the SMR method for that vehicle in later years. The actual expense method must always be used for that vehicle.

Comment. While a change cannot be made effective at mid-year, a business is free to decide at any time to switch from the SMR to the actual expense method for the entire year, as long as the decision is made before the time at which the federal income tax return is filed. That is, a taxpayer cannot use the SMR for part of the year and then use the actual expense method for the remainder of the year. If the actual expense method is used, only those expenses that are properly substantiated are allowed.

Example. Toy Store, Inc. has been using the SMR since its van was new back in 2006. With \$90 fill-ups every other day, Toy Store is figuring that it might do better keeping tabs on how much it spends for gas, especially since it had a \$2,500 transmission repair this year as well.

As long as Toy Store has records (e.g., credit card receipts and repair bills), it can decide on either the actual expense method or the SMR right up until it files its return for 2008.

For leased vehicles, the rule is even more stringent. A taxpayer who uses the SMR method for the first year the car is placed in service in the business must use the SMR for the *entire* lease period.

SMR and depreciation limits

The SMR method includes an amount for depreciation, measured by the cost of the vehicle and limited by the luxury depreciation limits. A taxpayer who changes from the SMR method to the actual cost method in a later year, and before the car has been fully depreciated, must use straight-line depreciation for the car's estimated remaining useful life. Therefore, taxpayers cannot claim an additional accelerated deduction for depreciation when using the SMR method. Based on statutory language, whether intended or not, bonus depreciation may not be claimed if the SMR is taken. Election of the standard mileage rate is considered an election out of MACRS.

Bonus depreciation

The 2008 Economic Stimulus Act also reprised bonus depreciation that was used to accelerate economic recovery after 9-11 and Hurricane Katrina. Under the new law, qualifying businesses can take 50-percent first-year bonus depreciation of the adjusted basis of qualifying property. The original use of the property must begin with the taxpayer and occur during the 2008 year. The taxpayer must place transportation property in service before December 31, 2009.

To reflect bonus depreciation as it applied specifically to passenger vehicles, the new law raised the Code Sec. 280F cap on "luxury" automobile depreciation to \$8,000 if bonus depreciation is claimed for a qualifying taxpayer (for a maximum first-year depreciation of no more than \$10,960 and \$11,160 for vans and light trucks).

For passenger automobiles first placed in service in 2008 and to which the 50-percent additional first-year depreciation deduction does *not* apply, the depreciation deduction limitations for the first three tax years are \$2,960, \$4,800, and \$2,850, respectively, and \$1,775 for each succeeding year. For trucks and vans first placed in service in 2008 and to which the 50-percent additional first-year depreciation deduction

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Documentation and substantiation

The types of records required to substantiate expenses associated with the business use of an automobile depend on whether the SMR or actual expense method is used. In general, adequate substantiation for deduction purposes (for both SMR and actual expense method taxpayers) require that the following be recorded:

- The amount of use (i.e. the number of miles driven for business, and even personal, use);
- The date of the expenditure or use; and
- The business purpose of the expenditure or use.

Taxpayers using the SMR should maintain a daily log book or "diary" that substantiates miles driven, the dates of the vehicle's use, the destination, and the business purposes of the trip. For taxpayers who deduct the actual expenses associated with the business use of an automobile, substantiating costs will be more complicated and time-consuming. A mileage log is a necessity, as it should thoroughly account for miles driven (bifurcating both business and personal use).

Taxpayers should also keep receipts, copies of cancelled checks, bills paid, and any other documentation showing costs incurred and expenditures made. For depreciation purposes, taxpayers also need to document the original cost of the vehicle and any improvements made to the automobile, as well as the date the vehicle was placed in service.

With the price of fuel biting into your budget, getting as much of your spending back through smart tax planning makes more sense than ever these days. In addition to the fuel efficiency of your vehicle, don't forget to add its tax efficiency in computing bottom line ownership and operating costs.