MEMORANDUM OF LAW

DATE: August 25, 1992

TO: Eugene Ruzzini, Audit Division Manager

FROM: City Attorney

SUBJECT: Tax Implications of Take Home City Vehicles

Recently the issue of City employees take home use of City vehicles has raised concerns about the tax implications of this practice. This is especially true of police department personnel because of the extensive use of unmarked vehicles. As a result, an audit of the subject is being conducted by your department and a number of questions have arisen. You have asked for a legal response to those questions. The questions you have asked are numerous and involved, therefore each question will be addressed separately. The following responds to your questions.

QUESTION: 1. Is driving to and from work "commuting" in a Police or Fire vehicle a taxable benefit to the employee?

. In a marked vehicle?
. In an unmarked vehicle?
. By a sworn officer?
. By a non-sworn officer?

RESPONSE: As a general rule, personal use of an employer provided vehicle is includible in an employee's gross income. However, gross income does not include the value of a working condition fringe. "A 'working condition fringe' is any property or service provided to an employee of an employer to the extent that, if the employee paid for the property or service, the amount paid would be allowable as a deduction under section 162 or 167." Treas. Reg. Section 1.132.5 (1992). (All regulation citations hereafter are to Treasury Regulations.) Internal Revenue Code ("IRC") section 162 outlines business expenses and section 167 deals with depreciation, therefore, under most circumstances the personal use of an employer's vehicle would be a taxable benefit for the employee.

However, the value of the use of a "nonpersonal use vehicle" is not taxed because it is a "working condition fringe" benefit. Treas. Reg. Section 1.132-5(h) (1992).

Nonpersonal use vehicles are defined as follows:

Exceptions for qualified nonpersonal use vehicles - (1) In general. The substantiation requirements of section 274(d) and this section do not apply to any qualified nonpersonal use vehicle (as defined in paragraph (k)(2) of this section).

(2) Qualified nonpersonal use vehicle - (i) In general. For purposes of section 274(d) and this section, the term "qualified nonpersonal use vehicle" means any vehicle which, by reason of its nature (i.e., design), is not likely to be used more than a de minimis amount for personal purposes.

(ii) List of vehicles. Vehicles which are qualified nonpersonal use vehicles include the following-(A) Clearly marked police and fire vehicles (as defined and to the extent provided in paragraph (k)(3) of this section),

(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"),

(E) Cement mixers,

(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 (as defined in paragraph (k)(4) of this section),
(N) Qualified specialized utility repair trucks (as defined in paragraph (k)(5) of this section),
(O) Refrigerated trucks,
(P) School buses (as defined in section 4221(d)(7)(C)),
(Q) Tractors and other special purpose farm vehicles,
(R) Unmarked vehicles used by law enforcement officers (as defined in paragraph (k)(6) of this section) if the use is officially authorized, and
(S) Such other vehicles as the Commissioner may designate.

Treas. Reg. Section 1.274-5T(k)(6) (1992) (emphasis added).

Therefore, under the regulations, commuting in a marked police or fire vehicle is not a taxable benefit to the employee. This assumes, however, that the marked vehicle is essential to the officers use for some purpose. Use of a canine car for commuting is one example because the officer and the dog must be together at all times. The value of the use of an unmarked police vehicle is also excluded from income when the following conditions are met:

1. It is used by a "law enforcement officer."
2. Use is "incident" to law-enforcement functions.
3. The City authorizes the personal use.
4. Use is not for vacation or recreation trips. (However, see question number four.)

A law enforcement officer is defined as a full-time employee responsible for the prevention or investigation of crime involving injury to persons or property. The officer must be authorized by law to carry firearms, execute search warrants, and make arrests. Also the officer must, in fact, regularly carry firearms. Treas. Reg. Section 1.274-5T(k)(6)(ii) (1992).

Use is incident to law enforcement functions when the car is required for the officer to report directly from home to a stakeout or surveillance site or to an emergency. For example, used of the unmarked vehicle for commuting between workplace and home and for personal errands is "incident" when the car otherwise is needed to report to an emergency, etc. Treas. Reg. Section 1.274-5(k)(8) (1992), Examples (1) and (2).

The City Council does not have to be the authorizing body.

Authorization can be granted by the police department. It clearly also is best if the police department specifically prohibits use of the car for recreational purposes and vacations. Id.

Thus, under the above rules, use of a marked police vehicle is not taxable to an employee because of the nature of the vehicle. Use of an unmarked vehicle is taxable to an employee unless the above conditions are met. Use of an unmarked vehicle by an employee who could not meet the law enforcement officer's criteria would therefore be a taxable benefit.

Recordkeeping is required for all taxable personal use of an employer's vehicle unless one of the exceptions is present. The substantiation requirements of Internal Revenue Code ("IRC") section 274(d) are satisfied by adequate records or sufficient evidence corroborating the employee's own statement. Therefore, such records or evidence provided by the employee, and relied upon by the employer to the extent permitted by the regulations promulgated under IRC section 274(d), will be sufficient to substantiate a working condition fringe exclusion.

QUESTION: 2. Is driving to and from work "commuting" in a non-Police/Fire vehicle a taxable benefit to the employee?

. In a marked vehicle?

. In an unmarked vehicle?

If the answer is no, are there any restrictions or conditions that must be met? Is any recordkeeping required?

RESPONSE: There is no difference between marked and unmarked City vehicles except for police and fire vehicles. Driving to and from work in an unmarked City vehicle, in most circumstances, is commuting. Use of a City vehicle for commuting is considered non-personal use if the vehicle is one of the vehicles specifically listed in the response to question number one and is therefore not a taxable benefit. For example, an employee who drives a City water truck home so that he or she may report directly to an offsite worksite the following day would not be receiving a taxable benefit. However, an employee who uses a pool car that is marked with a City seal and an employee using an unmarked City vehicle would each receive a taxable benefit because personal use is not precluded simply by the nature of the vehicle. Separate regulations have been promulgated for use of employer vehicles for car pool purposes. The same reporting and recordkeeping requirements as found in question number one must be met.

QUESTION: 3. If the answers to the questions 1 and 2 are yes, what is the required method of

recording the usage that is reported as taxable and how should the taxable benefit be computed?

. Is there a reporting difference between sworn officers and non-sworn officers?

. If an employee reimburses the City for personal usage, what rate should be used for this reimbursement?

RESPONSE: Generally, if an employee uses an employer-provided car for personal purposes, the employer must determine the value of such use and add the value to the employee's wages as reported on his Form W-2. If the value of an employer-provided fringe benefit is considered to be part of an employee's taxable wages, the employer must generally withhold income tax and the tax under the Federal Insurance Contributions Act (FICA) from the employee's wages in addition to paying its share of employment taxes under FICA and FUTA (i.e., the Federal Unemployment Tax Act).

There are four methods for computing the fringe benefit value of the use of an employer's vehicle. They are:

1. the fair market value of the benefit, Treas. Reg. Section 1.61-2T(b)(4) (1992), or
2. the value based on the "annual lease value" of the car (i.e., based on the "special rule"), Treas. Reg. Section 1.61-2T(d) (1992)
3. the value computed using the cents-per-mile method, or Treas. Reg. Section 1.61-2T(e) (1992)
4. the value computed using the commuting value method. Treas. Reg. Section 1.61-2T(f) (1992).

A valuation based on the fair market value of the benefit must be used unless a permitted special valuation rule is used. The fair market value of a car is based on all the facts and circumstances, and, in general, is the amount a hypothetical person would have to pay a hypothetical third party to lease the same or comparable car for one year on the same or comparable terms in the geographic area in which the car is used. Accordingly, any special relationship between the employer and the employee must be disregarded, and an employee's subjective perception of the value of the car is irrelevant to the determination of the car's fair market value. Unless the

employee can substantiate that the same or comparable vehicle could have been leased on a cents-per-mile basis, the value of the availability for the car cannot be determined by reference to a cents-per-mile method.

Special valuation rules are available for determining the value of the use of an automobile as a fringe benefit. The use of any of the special valuation rules is optional. Furthermore, an employer need not use the same special valuation rule for all vehicles provided to all employees. For example, an employer may use the automobile lease valuation rule for automobiles provided to some employees, and the commuting and vehicle cents-per-mile valuation rules for cars provided to other employees.

If an employer uses one special valuation rule, the employee may not use another special rule. However, the employee may use the general valuation rule (see above) even though his employer is using a special valuation rule. Furthermore, if the employer and employee both use a special rule, the employee must include in gross income the same amount as determined by his employer less any amount reimbursed by the employee to the employer.

A particular special valuation rule is deemed to have been elected if the employer (and, if applicable, the employee) reports the value of the fringe benefit by applying the special valuation rule and treats such value as the fair market value for income, employment tax, and other reporting purposes. No special notification to the IRS is required.

The fair market value rule is the general rule. The fair market value of an automobile is the amount that an individual would have to pay in an arm's length transaction. The purchase price amount includes all amounts attributable to the purchase, such as sales tax and title fees.

The annual lease value rule is one of the special optional methods of valuing the use of a car as a fringe benefit. The value is determined by evaluating what it would cost an employee to lease a like car for the tax year.

Each of the above methods of valuation would be useful only if a single employee has total control and use of the vehicle for the entire year. Of more practical use to the City is the cents-per-mile value rule.

The cents-per-mile valuation rule may only be used to value the miles driven for personal purposes. Accordingly, the employer must include in the employee's income the number of personal miles driven by the employee and the appropriate cents-per-mile rate. "Personal miles" encompass all miles for which the employee used the car except those driven in the employee's trade or business as an employee of the employer.

Finally, the City may use the commuting valuation method. The commuting use of an employer-provided car is valued at $1.50 per one-way commute (that is, from home to work or from work to home) if the following requirements are met:

1. 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.

2. The employer, for bona fide noncompensatory business reasons, requires the employee to commute to or from work in the vehicle.

3. The employer has established a written policy under which the employee may not 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 between a business delivery and the employee's home).

4. The employee, except for de minimis personal use, does not use the vehicle for any personal purposes other than commuting.

5. The employee required to use the vehicle for commuting is not a control employee of the employer.

A control employee of a government employer is either:

1. an elected official, or
2. an employee whose compensation is at least as great as a federal government employee at Executive Level V.

The $1.50 commuting value includes goods and services directly related to the vehicle, such as fuel. In the event that more than one employee commutes in the car such as an employer-sponsored car pool, the amount includible in the income of each employee is $1.50 per one-way commute. Finally, the rule may not be used to value the commuting use of passengers of chauffeur-driven cars. However, the rule may be applied to value the commuting use of the car by the chauffeur.

No difference exists between the reporting methods of valuation for sworn or non-sworn officers. Keep in mind, however, that if a sworn officer has use of the car for a qualified non-personal use (see question number one), there is no taxable benefit to the employee.

No specific information was found on the rate of reimbursement if the employee is reimbursing the City. However, the 1992 mileage rate, pursuant to the treasury regulations, is twenty-eight cents (.28) per mile. Presumably, if the employee is reimbursing the City for use of a vehicle, the same rate could be used.

QUESTION: 4. In addition to commuting what are the

guidelines for personal use?

- In a marked vehicle?
- In an unmarked vehicle?
- Are there limits or restrictions?
- How should the personal use be reported?
- What is the relationship between personal use and personal use necessary to help enforce the law?
- Is there a difference between usage in the City limits versus usage outside the City limits?

RESPONSE: As indicated in question number one, it is assumed by the regulations that plainly marked vehicles will be used for only de minimis personal use because of the nature of the vehicle. Therefore, no guidelines are necessary. Personal use in an unmarked police vehicle may be permitted only for an officially authorized "law enforcement officer." To qualify for this exception, any personal use must be authorized by the Federal, State, county, or local governmental agency or department that owns or leases the vehicle and employs the officer, and must be 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. However, if the officer is "on call," careful attention must be given to the details of how "on call" is defined. To overly restrict the officers actions while on call might invoke the wage and hours provisions of the Fair Labor Standards Act ("FLSA"). For example, in Madera Police Officers Assn. v. City of Madera, 36 Cal. 3d 403, 412 (1984), the Court said if there are no restrictions on officers who are on twenty-four hour call, other than the duty to report to work, if they are reached, and the officers do not have to be available for immediate recall at a specific phone number, no FLSA problems arise. Thus, recreational use of the unmarked vehicle, such as going to the movies, would be taxable. On the other hand, if the officer must be always available by telephone through the use of a pager, and is thus carefully restricted in his or her actions, recreational use would be non-taxable. All other personal uses, such as errands, to the extent it is necessary for an officer to be available, may be authorized without losing the tax-free status.

The substantiation rules, which apply to such business deductions as travel, entertainment and gifts, require that tax deductions and credits that are related to the enumerated types

of business expenses be substantiated by either adequate records or by sufficient evidence, either oral or written, corroborating the taxpayer's own statement. The IRS regulations make clear that approximations or unsupported testimony regarding the business use of a car will not be considered in determining the accuracy of a tax deduction or credit. Thus, the Cohan rule, which permitted deductions based upon approximations and unsupported testimony, may not be relied upon.

The IRS will consider the following as being "adequate records" in order to substantiate a claimed deduction for expenses related to the use of a car:

1. account books, diaries, and logs;
2. documentary evidence (e.g., receipts and paid bills);
3. trip sheets;
4. expense reports; or
5. written statements of witnesses.

The level of detail required in an adequate record to substantiate business use of a car may vary depending upon the facts and circumstances. The same type of records should be kept to separate personal from business use.

There is apparently no distinction made between in City, and outside the City, usage. The only prohibition is that barring recreation and vacation use. Based on this prohibition, one would assume that usage would be primarily within the city or, at most, the county.

QUESTION: 5. How would you define minimal personal purposes as used for qualified nonpersonal use vehicles?

RESPONSE: The de minimis exception provides that, if the value of the employee's use of the car is so small as to make accounting for it unreasonable or administratively impracticable, then such value need not be included in the employee's wages. The de minimis exception clearly applies in situations where the employee uses the car to drive to lunch or to make an occasional detour to go shopping. Care must be exercised, however, to ensure that such personal use does not become so frequent or significant that it is removed from the de minimis exception. IRC Section 132(e).

QUESTION: 6. What are the guidelines that establish a marked vehicle?

RESPONSE: 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 for purposes of this paragraph (k).

Treas. Reg. Section 1.274-5T (1992).

QUESTION: 7. Are motorcycles used by the Police Department considered vehicles? If not, what are the reporting requirements?

RESPONSE: Motorcycles are not specifically mentioned as a vehicle in the regulations. However, Treas. Reg. Section 1.61-21(f)(4) (1992) states in pertinent part:

> (4) Definition of vehicle. For purposes of this paragraph (f), the term "vehicle" means any motorized wheeled vehicle manufactured primarily for use on public streets, roads, and highways. The term "vehicle" includes an automobile as defined in paragraph (d)(1)(ii) of this section.

Additionally, clearly marked police motorcycles would fit within the parameters of the qualified nonpersonal use vehicles listed in question number one.

QUESTION: 8. Is the City liable in the event of an accident in a City vehicle that is taken home by an employee?

. While commuting?

. While on personal business?

RESPONSE: Liability will always be an issue any time a City vehicle is involved in an accident. Whether liability is actually imputed to the City will depend on the individual circumstances of each case. The number of potential permutations of the various factors is enormous. Due to the potential complexities of each variation, it is best to address each case as it arises, especially in light of the California Supreme Court's expansive view of the course and scope of employment in Mary M. v. City of Los Angeles, 54 Cal. 3d 202, 203 (1991).

JOHN W. WITT, City Attorney
By

Sharon A. Marshall
Deputy City Attorney

SAM:mrh:504(x043.2)
cc Ed Ryan
ML-92-77
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