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A special supplement to

Overdrive

Many Dealers Remain Confused About Taxability of Demonstrators

We continue to receive inquiries on a regular basis relating to the rules with regards to demonstrators and their status as taxable fringe benefits. Accordingly, and since the beginning of a new year is a good time to introduce changes, we have compiled this brief summary of the rules to assist you in dealing with this issue.

On November 30, 2001, the IRS released Revenue Procedure 2001-56 in a 51-question and answer format, an optional simplified method for dealerships to use in determining the value of the use of demonstrator vehicles provided to employees. The new method was effective beginning in 2002, yet many dealers are still failing to comply with the regulations. An automobile dealer is not required to use the optional simplified methods described in this revenue procedure, but the adoption of these methods is something of a safe-harbor for those dealers who do adopt the procedures.

This revenue procedure is designed to provide a comprehensive framework for addressing the tax treatment of demonstrator automobiles provided by dealers to their employees. The simplified methods have been structured sequentially so that if the use by an employee does not qualify for treatment under one method, the use can nonetheless be taken into account under a subsequent method with no additional recordkeeping or change in determination period.

The methods provided are:

1. Simplified method for the full exclusion of qualified automobile demonstrator use (simplified out/in method).
2. Partial exclusion of demonstrator automobile use by full-time salespeople.
3. Inclusion of the value of demonstrator automobile use when no exclusion applies.
4. Application of the general rule when the methods in the revenue procedure are not used.

An employer can choose to apply the different optional methods on an employee-by-employee basis. Thus, if some employees are unwilling to maintain the records necessary to satisfy the full exclusion method, the employer can account for their use under the partial or full inclusion methods while still retaining the ability to use the full exclusion method for the other employees.

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The application of the simplified methods for the full or partial exclusion of demonstrator automobile use is limited to use by full-time salespeople. To use the simplified full and partial exclusion methods, **the employer must have a written policy limiting the use of the demonstrator automobile and maintain certain records.** The employee is not required to maintain any records except to the extent the employee is required to provide information to the employer to allow the employer to maintain the records as noted above.

If an error is identified and corrected during the calendar year in which the demonstrator automobile was provided, the amount included may be determined under this revenue procedure. **If the error is not corrected during the calendar year in which the demonstrator automobile is provided, the amount included is determined under general valuation and substantiation rules.**

Full Exclusion Method

To use the full exclusion method, the employer must also determine, **no less often than monthly**, that the personal use of the vehicle is limited to establish that the restrictions provided by the Code and regulations are satisfied. **Personal mileage is limited to commuting** (as defined within the method) **and to an additional average number of miles per day of 10 miles or less.** A model qualified written policy, for purposes of the full exclusion, is provided in the appendix of the revenue procedure.

An employer can determine the total mileage that a demonstrator automobile is used outside of normal working hours under the Simplified Out/In Method, although any reasonable system may be used for recording out and in mileage. To satisfy the Simplified Out/In Method, the mileage on the automobile must be recorded under a reasonable system 1) at the end of the working hours of the salesperson using the automobile (out mileage), and 2) at the beginning of that salesperson's working hours on the next working day (in mileage). A reasonable system would also include mileage entries for the vehicles by the full-time salespeople using the vehicle if there was random verification of the accuracy of the entries by an employee other than the salespeople at least once in every determination period, i.e., no less than once each calendar month.

For each full-time salesperson whose personal use mileage exceeds the ten miles per day average for the applicable determination period, the employer must include all or a portion of the value of the use of the demonstrator automobile for the period in the income of that full-time salesperson. The employer may continue to use the full exclusion for all other full-time salespeople whose personal use mileage is limited.

The employer may implement the partial exclusion method by including amounts in income either in the current month or in the month immediately following. Whichever method is chosen, the employer must implement the exclusion in a consistent manner.

Partial Exclusion Method

Under the partial exclusion method, an amount is included in the full-time automobile salesperson's income and wages no less often than monthly. The remaining portion is deemed to represent business use that is excludable from income and wages as a working condition fringe.

An employer choosing not to use the full exclusion method can use the partial exclusion method to account for the use of any demonstrator automobile by a full-time salesperson. Moreover, the partial exclusion method is also available if a full-time salesperson exceeds the average ten miles per day of personal use or does not provide records with respect to business use of a demonstrator automobile. In such cases, the employer will generally be able to account for the use of the demonstrator automobile by using the partial exclusion method rather than including the full value of the use of the demonstrator automobile in the income of the full-time salesperson.

An employer may use any reasonable method to determine the value of the demonstrator automobile used by a full-time salesperson. That value is used in applying the table below.

<u>Value of the Demonstrator Automobile</u>	<u>Daily Inclusion Amount (including non-workdays)</u>
0 - \$14,999	\$ 3
\$15,000 - \$29,999	\$ 6
\$30,000 - \$44,999	\$ 9
\$45,000 - \$59,999	\$13
\$60,000 - \$74,999	\$17
\$75,000 and above	\$21

The Annual Average Look Back Method is considered a reasonable method. Under the annual average look back method, the value of the use of any new demonstrator automobile is based on the average sales price of all vehicles sold in the prior year. The average sales price is calculated by taking the sum of the sales prices of all new car and truck sales in the prior calendar year and dividing that sum by the number of new vehicles sold in the prior year. The average sales price is used to determine the value of the demonstration automobile and the corresponding daily inclusion amount above. This amount is included in the employee's income and wages for each day the employee used a demonstrator automobile. The amount must be included in income at least monthly. The average sales price must be determined in January of each year and must be applied no later than February of that year.

An employer using the annual average look back method must maintain evidence supporting the calculation of the annual average sales price. The employer must use a consistent method for calculating the value of the demonstrator automobiles. **There are extended rules involving used demonstrator automobiles and dealerships with multiple franchises at a single point.** A model qualified written policy, for purposes of the partial exclusion, is provided in the appendix of the revenue procedure.

An employer may not elect not to withhold income taxes from the portion of the vehicle fringe benefit required to be included under the partial exclusion method provided under this revenue procedure.

When No Exclusion Applies

If the employee provided the use of a demonstrator automobile is not a full-time salesperson, the full exclusion and the partial exclusion in this revenue procedure do not apply. To reduce recordkeeping with respect to use of a demonstrator automobile by an employee who is not a full-time salesperson, the employer may include in the employee's income and wages each month the full value of the demonstrator automobile determined with no reduction to take into account business use (the "full inclusion method"). Of course, other methods (including the \$1.50 per one-way commute) for excluding from an employee's income a portion of the value of the use of an employer-provided automobile remain available for those employees that are not full-time salespeople.

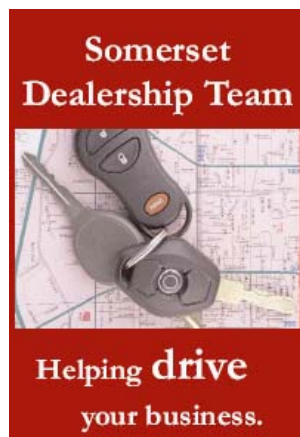
The employer must account for the use by an employee who is not a full-time salesperson by including in gross income and wages for each day in each period (no less often than monthly) the greater of \$3 per day or the pro rata portion of the amount specified in the annual lease value table at Treas. Reg. §1.61-21(d)(2)(iii) using the value of the demonstrator automobile. The pro rata portion of the annual lease value amount is the amount specified using the full value of the demonstrator automobile, divided by 365, rounding to nearest dollar amounts.

General Rule

Under Reg. §1.274-6T, certain types of written policy statements can be used to implement a policy of no personal use, or no personal use except commuting, of a vehicle provided by an employer. Among the requirements under Reg. §1.274-6T, for a policy of no personal use except commuting, is that the employer reasonably believes there is no personal use and that the employee does not use the vehicle for any personal use except for de minimis personal use in addition to commuting.

For purposes of Reg. §1.274-6T and this revenue procedure, de minimis personal use means personal use during the employee's commute and in conjunction with business use. Therefore, **if the employee travels to a location that is five miles away from the commuting route for a personal purpose, that use exceeds de minimis personal use even though it may be permitted under the full exclusion method described in this revenue procedure.**

The Bottom Line: The rules under Revenue Procedure 2001-56 are very detailed and complicated. **A member of the Somerset Dealership Team is eager to answer any questions or concerns that you, your office manager or your payroll clerk may have...just give us a call at 317-472-2200.**



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