

# CaseStudy

## LEASING BUSINESS AUTOS

AUTOMOBILE LEASES HAVE CERTAIN ADVANTAGES. They require a minimal investment and are convenient if the customer replaces the car every two or three years. With a lease, there is no hassle with selling or trading in the car. Instead, the lease customer simply drops it off at the end of the lease and arranges another lease for a new one.

Leases are normally worth considering if lease customers do not intend to drive the car beyond the end of the lease term and want to minimize their cash outlay. However, lease customers also must be prepared to maintain the car and stay within the mileage allowance; otherwise, they will be charged for excess wear and tear and mileage when the car is turned in.

### Lease Income Inclusion Rule for Luxury Autos

When a taxpayer leases an auto and uses it in a trade or business, the business use percentage of the lease expense can be deducted if the actual cost method for claiming auto expenses is used. However,

to achieve approximate parity with the depreciation limitations that apply to owned luxury cars, the IRS releases an annual table of leased “income inclusion” amounts that apply to luxury cars leased for 30 days or more. The annual income inclusion amount is subtracted from the lessee’s lease expense for the year to determine the net deduction for the year (Sec. 280F(c)(2)). The deductions of the car’s owner (the lessor) are not affected by this adjustment (Sec. 280F(c)(1)).

The amount to be included in income depends on the auto’s fair market value (FMV) on the first day of the lease term. There are two parts to the income inclusion table; the first part is for autos other than trucks and vans/SUVs, and the second part is for trucks and vans/SUVs. This is due to the higher depreciation limits for trucks and vans/SUVs.

The FMV of the leased auto is the amount that would be paid to buy the car in an arm’s-length transaction. The FMV for the leased income inclusion rules is the capitalized cost of the auto, if that cost is specified in the lease agreement (Temp. Regs. Sec. 1.280F-5T(h)(2)). If the capitalized cost is not furnished in the lease agreement, the leasing customer might refer to a publication (such as one of the NADA guides or the Kelley Blue Book) or a database that reports new or used car retail prices.

**Observation:** The annual gross lease income inclusion is minimal compared with the depreciation limits on passenger

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autos. However, the lease income inclusion amount represents a permanent difference (calculated to represent the time value of the extra lease deduction), while the depreciation limitations represent a timing difference that is eventually recovered through depreciation deductions or upon the vehicle's disposition.

A taxpayer may use the standard mileage rate method for an automobile that is leased in lieu of deducting all business operating and fixed costs (including lease payments). Use of the standard mileage rate allows the taxpayer to avoid the lease income inclusion rules.

### Depreciation Versus Lease Deductions

For owned autos used more than 50% for business, taxpayers can use regular MACRS depreciation, which is the 200% declining balance method applied to a five-year recovery period. However, for luxury autos depreciation is limited to the maximums listed in Sec. 280F(a) (as adjusted periodically for inflation). Thus, few cars provide the advantage of the accelerated depreciation deductions.

The general rule for leased autos used for business is to deduct the business percentage of the lease expense each year. However, to achieve approximate parity with the depreciation limitations that apply to owned luxury autos, the taxpayer must reduce the lease deduction by the business percentage of the income inclusion amount for the year.

**Note:** Certain trucks and vans (including some heavy SUVs) do not fall within the definition of a passenger automobile (see Sec. 280F(d)(5)). These vehicles can be depreciated using general MACRS depreciation even though they cost more than the luxury auto limit. Vehicles that fall outside the definition of a passenger automobile are exempt from the lease income inclusion rules, just as they are exempt from the luxury auto depreciation limitations if owned.

### Leasing Avoids Tax Basis Complexities

Taxpayers owning a business auto must contend with the following tax basis complexities:

1. When a taxpayer trades in an owned business auto rather than selling it, the basis of the new auto is the adjusted basis of the old auto plus any additional amount paid. After a few trade-ins, the luxury auto depreciation limitations cause the taxpayer's basis in the currently owned vehicle to build up to an inflated level.
2. If a taxpayer uses an owned auto less than 100% for business and then trades it in, one basis number is used for depreciation purposes and another for gain/loss purposes. The unrecovered basis for depreciation reflects a reduction for the full amount of depreciation that would have been allowed for 100% business use (Sec. 280F(d)(2)). However, for gain/loss purposes, the unrecovered basis in the trade-ins reflects only the actual depreciation deductions allowed (Sec. 1016(a)(2)).
3. When a taxpayer sells an owned auto used only partly for business, the transaction is treated as separate sales of a business asset and a personal asset (*Sharp*, 303 F.2d 783 (3d Cir. 1962)). The original purchase price and sales proceeds are allocated between the business and personal assets based on cumulative mileage. The allowable depreciation reduces the basis of the business portion.

A taxpayer can avoid all these complexities by leasing business autos. The basis buildup rule, the two basis numbers issue, and the complexities in calculating gain/loss on disposition of an owned auto do not apply if the taxpayer leases a business auto and simply returns it at the end of the lease term. Thus, leasing can be much less burdensome from an accounting and administration standpoint.

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#### EditorNotes

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