

Internal Revenue Service

Motor Vehicle Technical Advisor

Automotive Alert

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Industry Issue Resolution Pilot Program Results in Guidance on Proper Treatment of Demonstrator Automobiles

Introduction

On November 29, 2001 the IRS and Treasury announced the publication of Revenue Procedure 2001-56. The Revenue Procedure is the result of the new LMSB Industry Issue Resolution Pilot Program (IIR) and provides guidance on the proper tax treatment of demonstrator automobiles provided to automobile dealership employees. (Further information on the IIR Pilot Program can be found in Notice 2000-65 available at www.irs.gov/prod/ind_info/bullet.html)

The Service selected seven of the twenty-four issues suggested for inclusion in the IIR pilot program including the proper treatment of demonstrator vehicles (demos). Three separate submissions were received on demonstrator vehicles from (1) Auto Team America through Crowe, Chizek and Company LLP, (2) O'Conner & Drew P.C., and (3) The National Auto Dealers Association. All three submissions requested clarification of the substantiation requirements, limitations on mileage and the proper treatment of demonstration vehicles provided to non-salespersons.

The document provides a table of contents to direct the reader to the various options and is presented in a question and answer format to aid in understanding. In addition, the revenue procedure includes two model qualified written policies for use by an automobile dealer. Finally, the revenue procedure implements a comment period of 90 days.

Purpose

Revenue Procedure 2001-56 clarifies the existing full exclusion rules regarding demonstration automobiles and provides optional, simplified methods of determining the value of the use of demonstration automobiles provided to employees.

The methods include:

- 1 A **simplified** method for the **full exclusion** of qualified automobile

stration use (Simplified Out/In Method)

- 2 A **partial exclusion** of demonstration automobile use by full-time sales people
- 3 A **method** to include the value of demonstration automobile use **when no exclusion applies**
- 4 A method to apply the **general rule** when the methods in the revenue procedure are not used

The methods are sequentially structured so that if an employee does not qualify under one method, the use of the demo can be taken into account under a subsequent method. The full exclusion methods and the partial exclusion method require the dealership to implement a specific written policy statement on the use of demonstrator automobiles.

Applicability

The simplified methods are available to any automobile dealer engaged in the retail sale of new or used vehicles. The use of the simplified full or partial exclusion methods is limited to full-time sales people as defined in Treas. Reg. §1.132-5(o) and apply only to demonstrator automobiles as defined in Treas. Reg. §1.132-5(o)(3).

For purposes of the revenue procedure, demonstration automobiles include passenger vans, sport utility vehicles and light-duty trucks (gvw 14,000 lbs. or less).

Background

The provision of demonstrator vehicles to employees is addressed in several Internal Revenue Code (IRC) sections and the accompanying regulations. IRC §61, 132, and 274 all apply to demo vehicles.

Generally, IRC §61 provides that gross income means all income including compensation for services. Fringe benefits are specifically listed as compensation for services. In addition, IRC §132(j)(3) explicitly provides that

qualified automobile demonstration use by a full-time salesperson is treated as a working condition fringe benefit.

Although §61 specifically includes fringe benefits in gross income, IRC §132(a) permits certain working condition fringe benefits to be excluded from gross income. However, to qualify as excludible working condition fringe benefits, Treasury Regulation §1.132-5(c)(1) requires that the substantiation requirements of IRC §274 be met.

Full exclusion for qualified demo use is defined in IRC §132(j)(3). Full exclusion requires that the vehicle be provided to facilitate the salesperson's performance of duties, restrictions on the area of use be implemented, and there must be substantial restrictions on personal use of the vehicle. Treas. Reg. §1.132-5(o)(4) provides further information on the restriction on personal use requirement including the provision that total mileage by the salesperson outside normal working hours is limited.

Treas. Reg. §1.132-4(c)(1) imposes another requirement applicable to working condition fringe benefits. Generally, working condition fringe benefits may not be excluded unless the substantiation requirements of IRC §274 have been met. Therefore, even if the use of a demonstration vehicle qualifies as a working condition fringe benefit, it may not be excluded from the employee's income unless the business use is properly substantiated.

If all of the requirements for full exclusion are not met, the employer must include some or all of the value of the use of the vehicle in the employee's income.

Discussion

The IIR process is intended to provide guidance to resolve frequently disputed tax issues that are common to a significant number of taxpayers. According to the IIR submissions and our discussions with the industry representatives, the demonstrator vehicle issue met the IIR criteria.

The IIR pilot convened a cross-functional team to analyze the issues and draft guidance. An LMSB Director of Field Operations and a Territory Manager from the Heavy Manufacturing and Transportation division headed the team. Other members of the team included members of Chief Counsel (TEGE-employment tax and Income Tax and Accounting), Field Counsel, Appeals, The Motor Vehicle Technical Advisor from Prefiling and Technical Guidance, LMSB examination, and Treasury. Because the resolution of this issue will have direct impact on

small businesses, the team also included a representative of the SB/SE division.

To address the concerns of the industry representatives, the IIR team developed several simplified methods. The methods are elective and sequentially structured. A dealership can choose to comply with the traditional full exclusion requirements or choose one of the simplified methods.

The revenue procedure provides an in-depth discussion of each alternative in a question and answer format. Discussion in this Automotive Alert will be limited to an overview.

Simplified Full Exclusion Method (*Simplified Out/In Method*)

The discussion of the *Simplified Out/In* method can be found in questions 11-25 of Rev. Proc. 2001-56.

The Out/In Method requires an employer to have a qualified written policy limiting the use of the demonstration automobile and to have a reasonable belief that the salesperson complies with the policy. The revenue procedure provides a model written policy in Appendix A. The employer must also determine that the personal use was limited and maintain records to document that determination.

Addressing a specific concern of automobile dealers, the *Simplified Out/In* method provides a definition of limited personal use. For this method, personal use is considered limited if the total mileage a demonstration auto is used outside normal working hours less commuting mileage does not exceed an average of 10 miles per day. Question 22 of the revenue procedure provides an illustration of this concept.

To determine the total mileage that a demo vehicle is used outside of normal working hours, an employer must record the miles on each demo at the end of the working hours of the salesperson using the auto (out mileage) and at the beginning of that salesperson's working hours on the next working day (in mileage). Total miles that a demo is used during normal working hours are not taken into account under this method. See Question 16 for further discussion.

The revenue procedure includes a discussion of a reasonable system for recording out and in mileage, a definition of commuting mileage, and illustrations of the proper application of this method. See Questions 17-22.

The employer must maintain certain records in order to use the *Simplified Out/In* method. Those records include a copy of the written policy and evidence it was communicated to employees, records identifying the round trip commuting mileage of each salesperson, and records supporting the total use outside normal working hours.

The dealership employee is not required to maintain any specific records beyond those imposed by the dealership to allow it to maintain the required records.

If a full-time salesperson's personal use mileage exceeds the 10 miles per day average for the determination period, the employer must include all or a portion of the value of the use of the demo in the income of that salesperson. The full exclusion method may be used for all other full-time salesperson that properly limits personal mileage. Question 25 addresses the methods of implementing the *Simplified Out/In Method*.

Simplified Partial Exclusion Method

The discussion of the *Simplified Partial Exclusion* method can be found in Questions 26-39 of Rev. Proc. 2001-56.

The *Simplified Partial Exclusion* method may be chosen by an employer as the method used to account for the personal use of demos by full-time salespersons or may be applied to a full-time salesperson that does not comply with the requirements for the full exclusion methods. For instance, if a dealer elects to use the *Simplified Out/In Method* for full exclusion and a full-time salesperson exceeds the 10 miles per day of personal use, the employer may apply the Simplified Partial Exclusion Method.

The *Simplified Partial Exclusion* method requires a dealership to have a qualified written policy limiting the use of the demo and the dealer must reasonably believe that the salesperson complies with the policy. Appendix B of the revenue procedure provides a model written policy applicable to the Partial Exclusion method.

The *Simplified Partial Exclusion* method also requires that an amount be included in the full-time salesperson's income on a periodic basis. The applicable period is based on the dealership's payroll period but must be no less often than monthly. The inclusion amount is provided in a table in Question 35 and is based on the value of the demonstration automobile. The inclusion amount is a daily amount and is determined for each day (including non-work days) that a full-time salesperson is provided the use of a demo. Question 36 provides further information on how to determine the number of days that a salesperson has use of a demo.

The employer must determine the value of the demonstration vehicle provided to the salesperson in order to incorporate the daily inclusion amount into the salesperson's wages. The employer may use any reasonable method to determine the value of the ve-

hicle, however the revenue procedure provides the *Annual Average Look-Back* method as a reasonable method.

The *Annual Average Look-Back* method determines the value of the use of any new demonstration automobile based on the average sales price of all vehicles sold in the prior year. The average sales price of new vehicles is determined by computing the sum of the sales prices of all new car and truck sales and dividing the total by the number of vehicles sold during the year.

The average sales price for used vehicles is calculated by taking the sum of the sales prices of all used vehicles for the prior year and dividing by the number of vehicles sold in the prior year. New and used vehicles may not be combined to determine the average sales price.

Question 33 provides additional information on the computation of the average sales price and the application to salespersons that have use of both new and used vehicles. Question 33 also provides examples of the average price computation. Specific rules apply if a dealer operates more than one franchise from one location. See Question 34.

Question 38 addresses the records that must be maintained by the employer. Those records include records supporting the determination of the value of the demo, evidence that the amount was included in the salesperson's wages, and a copy of the written policy and evidence that it was communicated to employees.

Simplified Method for Inclusion of the Value of the Demo if Neither Full Nor Partial Inclusion Applies (Full Inclusion Method)

The Simplified Method for Inclusion is discussed in Section 6, Questions 39-47.

An employer can use the Simplified Full Inclusion method to account for demos provided to non-salespersons or for full-time salespersons that do not qualify for full or partial exclusion.

The employer must include in the employee's wages for each day in the 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 Tables (ALV). The ALV tables can be found in Treas. Reg. §1.61-21(d)(2)(iii). Question 44 provides a table containing the daily inclusion amount based on the ALV tables.

Under the full inclusion method, the value of the demo may be determined by any reasonable method including the Annual Average Look Back method provided in the revenue procedure.

To satisfy the full inclusion method, the dealer must maintain records supporting the determination of the value of the demo provided and that the amount was properly included in the employee's income.

Application of the General Rule When Method in the Revenue Procedure Are Not Used

Questions 48-51 address the Application of the General Rule.

Treas. Reg. §1.274-6T provides that 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. Revenue Procedure 2001-56 determined that generally, in the case of a full-time salesperson, satisfying the requirements of Treas. Reg. §1.274-6T would satisfy the requirements for full exclusion under the revenue procedure. For further information on this issue, see Questions 48-50.

Question 51 addresses the issue of what amount to include in the income of the employee if the use was not taken into account using the provisions of the revenue procedure.

Error Correction

The revenue procedure provides a limited error correction mechanism. If an error is identified and corrected during the calendar year the demo vehicle was provided, the amount included may be determined using the provision of the revenue procedure. If the error is not corrected during the calendar year, the amount is determined under the general valuation and substantiation rules. Question 51 discusses error correction and provides two examples of its application.

Request for Comments

The provision of demonstrator vehicles to auto dealership employees is a complex issue and the revenue procedure provides several simplifying options. However, in order to insure that the solutions meet the needs of the dealership industry, the revenue procedure includes a request for comments.

Section 10 requests comments on the methods included in the revenue procedure and specifically requests comments on two additional items. Comments are requested on the usefulness of specifying additional reasonable methods to determine the value of demos and includes two specific alternative options. In addition, comments are requested regarding the need for more detailed correction procedures.

Conclusion

Revenue Procedure 2001-56 is the product of the new IIR Pilot Program and as such the guidance will be evaluated to determine the success of the program. The IIR team believes that the methods provided in the revenue procedure ease the record-keeping burden and provide clarification on many concepts key to the proper reporting of demo use.

If you have any questions regarding the operation of the revenue procedure or comments on its provisions please contact the Motor Vehicle Technical Advisor at 616.235.1655 or by e-mail at Terri.S.Harris@irs.gov.