Taxpayers run hot and cold when it comes to automobile expenses. They run hot when they take a mileage deduction without having kept the required documentation of their business use. (Hot describes how the IRS will feel about you taking a deduction under these circumstances.) But taxpayers sometimes run cold when they take a deduction based on miles driven and not an actual percentage of car expenses based on the percent business use of the automobile. (Cold describes how the taxpayer feels when they realize they could have written off more of the expenses they incurred.) This hot and cold treatment of their car expenses is often due to a lack of taxpayer knowledge on what tax benefits are available for the use of vehicles, as well as lack of information about how they can qualify for those benefits.

Methods for deducting automobile expenses

There are two ways a taxpayer can deduct the expenses of operating a vehicle.[i] Both methods require that the taxpayer keep written track of the different types of miles he or she drives in the vehicle. (More on this later.) First, based on mileage rates set by the IRS, the taxpayer can deduct an estimated car expense using that mileage rate. The different types of mileage rates are: 1) trade or business (either as an employee, independent contractor, or landlord), 2) medical (based on miles driven to and from places that lead the taxpayer to incur deductible medical expenses), 3) charitable miles (based on miles driven to and from volunteer activities for a charity for which cash donations are deductible), and 4) moving (where the taxpayer move would qualify for a moving expense deduction.)[ii]

The second method of deducting vehicle operation expenses, which is only available for trade or business use, is called the actual expense method. Here, the taxpayer keeps documentation supporting the amounts of actual operating expenses, including gas, oil changes, car washes, repairs, maintenance, tires, insurance, license and registration fees, interest on car loans, etc.[iii] The taxpayer then takes the percentage of business miles driven over total miles driven during the year to get a business use percentage. This is an important concept, so if you are interested in using this method it is imperative that you not only keep good track of your miles driven, but also, on December 31st, make note of your odometer reading.[iv]

Taxpayers may choose to use the standard mileage rate on a yearly basis. However, there are limitations to its use. For example, it is not available for vehicles that are for hire (such as taxis). It is also not available for vehicles that have been depreciated on an accelerated basis. Thus, if the taxpayer uses the actual expense method in the first year the car is placed in service, he or she may be precluded from going back to the standard mileage rate unless the alternative straight line depreciation method is used in the first year.

How to keep track of miles driven

Many tax practitioners consider it one of the most distasteful parts of their job – telling clients they cannot take an automobile expense deduction unless they have kept a mileage log. Everyone finds it hard to do, and the busier the taxpayer, the more burdensome this requirement becomes. However, this burden was imposed by Congress for a reason – we often use our vehicles for personal purposes in addition to the deductible purposes, and our memories aren't that good several months or years after the fact.

It is not unusual for some independent contractors who rely heavily on their vehicles for business purposes to completely dedicate a vehicle to that purpose and never use it for personal reasons. They claim 100% business miles for those vehicles. To the extent these taxpayers can show the IRS that they have alternative means of transportation, this wouldn't seem so bad. However, the IRS wants to know *how* the vehicle is used. If the taxpayer doesn't keep track of what the miles were for, i.e., the business purpose for each and every trip, it is just his or her word against the IRS. Because deductions are a matter of legislative grace, the taxpayer has the burden of proving legitimate business usage. Further, the IRS will use methods such as income earned from the business, statistics on vehicle usage in the taxpayer's industry, and business records such as invoices to determine whether or not it is likely that the taxpayer indeed used the vehicle 100% in his or her business. The next thing you know, you've opened up a whole can of worms just because you weren't willing to write down in a mileage log that you paid a quick call on a customer at 2 PM on March 23rd.

There are many ways to contemporaneously document your miles and their business purpose. One is to use a daily or weekly planner and write down all the places you have driven to for business, medical, or other reasons, and the purpose of the trip. At year end add it all up (or better yet, enter the information into a worksheet such as Quicken or Excel on a periodic basis) and write the information down in your tax organizer. You can also print out MapQuest driving instructions on the day of the trip and as long as that is the route you follow, you can save the print-out as support. (It also provides room to write down the purpose of the trip.) Again, at the end of the year, you add up all the miles and enter them into the tax organizer.

The IRS has provided a sample of a mileage log in Publication 463.[v] Also, many vendors on the internet sell paper logs, electronic logs and even automated devices that attach to your vehicle.[vi] Some software developers offer free electronic logs.[vii] On the KCA website you can find mileage sheets that may be downloaded for your use. You may even keep track on your Blackberry or Palm Pilot, as long as the data can be printed, or saved in an electronic format for later printing. The bottom line is for you to use whatever is reasonable given your situation. Just know that not keeping written track of your deductible miles is not an option.[viii]

<u>Illustrative example</u>

Jack Black is a single retiree and has an investment portfolio which is managed by KCA. He visits our office twice a year to discuss tax and financial planning issues. Jack also owns two buildings that he rents out for additional income. He regularly goes to these buildings to collect rent, check on maintenance issues, and supervise landscaping/repair projects. He attends church services every

Sunday and works in their Soup Kitchen two nights a week. He has a few serious medical ailments for which he regularly visits physicians, laboratories and such. Invariably, his medical expenses exceed the minimum amount needed for deductibility.

Jack bought a used red Volvo on January 1, 2006 for $15,000 cash (no loan) and has used it for all of his driving needs ever since. He keeps track of his miles in a weekly planner, which he leaves in his car at all times. On December 31, 2007 he checked his odometer and wrote down the total miles for the year – 27,451. He subtracts his odometer reading on December 31, 2006 (12,283) and comes up with total miles for 2007 of 15,168.

Based on Jack's computations of the mileage information that he wrote in his log, it was determined that he drove 1,040 miles for his Soup Kitchen volunteer work, 126 miles for his KCA visits, 4,502 miles on activities related to his rental properties, and 788 miles for his provider visits. He presumed that the remaining 8,712 miles that he drove were all personal. The trade or business mileage percentages for the actual expense method of automobile expense deduction were: rental activity, 29.7%, and investment activity, .83%. The 2007 mileage rates for the different types of mileage were: trade or business activity, 48.5 cents/mile, charitable activity – 14 cents/mile, and medical activity – 20 cents/mile.

Based on Jack's receipts he spent $1,280 on gas and oil changes, $525 on car washes, $848 on scheduled maintenance, $1,450 on insurance, $95 for his AAA membership, $615 on registration/plates, and $86 for doo-hickies for the car (like a CD holder for the visor.) The total amount of out-of-pocket car expenses equals $ 4,899. Depreciation on his car (under the alternative straight-line method) is $3,000. Jack's total car operating expenses for 2007 are $7,899.

If he chose the standard mileage method, Jack's car expense deductions would be: trade or business – rental activity, $2,183, trade or business – investment activity, $61, charitable activity – $146, and medical activity – $158. If he chose the actual expense method for his trade or business activities, his deductions would be slightly higher: rental activity, $2,204, and investment activity, $42[ix]. Generally, the higher the operating expenses, the greater likelihood that the actual expense method will result in the greatest deduction. However, for ease of recordkeeping, many taxpayers decide to use the mileage method. As you can see from Jack's example, he did not lose too much.

Conclusion

The vehicle expense deduction can be significant for those who regularly use their cars in their business. The mileage deduction is also attractive for those who often use their cars for medical or volunteer purposes. However, in order to get those deductions, a taxpayer needs to keep written records on the expenses incurred and the miles driven. These records need to show the detailed information as stated above, and they need to be created within a reasonable time from when the expense was incurred or the miles driven. There are many other issues with respect to car expenses which are beyond the scope of this article.[x] However, for purposes of vehicle recordkeeping requirements, what you need to know is right here. Make your tax preparer happy – keep a mileage log!

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[i] There are also tax credits available for the purchase of certain types of vehicles, such as hybrids or electric cars. Please contact our Tax Department if you would like to learn more.
[ii] For the last three types of mileage, the taxpayer must use the first method.
[iii] Parking fees and tolls incurred for business purposes are always 100% deductible. Please note that parking tickets or fines for moving violations are never deductible, even if business-related.
[iv] You will also need your odometer reading from the beginning of your business use.
[v] Table 6.2, obtainable at www.irs.gov.
[vi] See www.mileagelogger.com, www.mileagewiz.com, www.vertex42.com, and www.automationusa.com. These site addresses are provided as examples only. Your personal preferences will dictate which mileage tracking method or web site is best for you.
[vii] One such program is the Auto Expense Manager 2009, which can be downloaded for free from www.turbosystems.com/automan.htm.
[viii] For out-of-pocket car expenses (i.e., gas, repairs, insurance, etc.), taxpayers must maintain records substantiating the amount of the expense, the date paid, and a description of the expense. Receipts usually suffice.
[ix] Under the actual expense method, depreciation cannot be taken where the use of the vehicle is investment activity; however, other car expenses may be deducted.
[x] For example, luxury auto limitations on depreciation, vehicles provided by employers, and the use of leased vehicles in a trade or business.