LTR 9801002

Section 132 — Fringe Benefits

Summary

Employees' Use of Demo Cars Taxable

The Service has ruled in technical advice that the use of demonstration vehicles by the employees of a car dealership is not excludable from income as a working condition fringe because of a lack of necessary substantiation.

The dealer provided demonstration vehicles to both sales and nonsales employees for both business and personal use. The dealer conceded that no accurate records were kept to show which employees used which vehicles. The dealer did not require employees to maintain any records or to submit any records. Further, although nonsales employees provided oral statements to the employer regarding the percentage of monthly personal use, the statements were not detailed as to the elements of the business use and were not corroborated by other evidence.

The Service ruled that due to the lack of necessary substantiation within the meaning of section 274(d), the use of the demo cars by sales employees is not qualified automobile demonstration use under section 132(j)(3) and is not excludable from income as a working condition fringe under section 132(a)(3). Lack of substantiation, ruled the Service, also means the use of demo cars by nonsales employees is not excludable as a working condition fringe.

The Service also ruled that the dealer is not entitled to use the automobile lease valuation rule in reg. section 1.61-21(d) to value the personal use of vehicles provided to employees. Rather, concluded the IRS, under the general valuation rules, the includable amount is the fair market value that is generally equal to the amount an employee would have to pay in an arm's-length transaction to lease the same or a comparable vehicle in the same location under similar conditions. The cost incurred by the dealer for a vehicle, said the Service, is not determinative of its fair market value.

Finally, the Service ruled that the dealer is not relieved of its obligation for any employment taxes on the employee use of demo vehicles for which a particular employee cannot be identified.

Full Text

Date: September 3, 1997

Taxpayer's Name: * * *
Taxpayer's Address: * * *
Taxpayer's EIN: * * *
Years Involved: * * *
Conference of right held: * * *

LEGEND:
Dealer = * * *
X = * * *

[1] ISSUES

1. Are the applicable substantiation requirements satisfied so that the use of the vehicles provided to the Dealer's sales employees is "qualified automobile demonstration use" under section 132(j)(3) of the Code and is, thus, excludable from income under section 132(a)(3) as a working condition fringe for the years at issue?

2. Are the applicable substantiation requirements satisfied so that a portion of the use of the vehicles provided to the Dealer's nonsales employees is excludable from income under section 132(a)(3) of the Code as a working condition fringe for the years at issue?

3. Is the Dealer entitled to use the automobile lease valuation rule provided in section 1.61-21(d) of the regulations for purposes of valuing the personal use of vehicles provided to nonsales and sales employees during the years at issue?

4. Is the Dealer relieved of its obligation for any employment taxes imposed under sections 3101, 3111, and 3401 on the employee use of demonstration vehicles for which a particular employee cannot be identified?

FACTS

[2] During the years at issue, the Dealer provided demonstration vehicles /1/ to both sales and nonsales employees for both business and personal use. /2/ According to the taxpayer, except for employees who were hired or terminated during the year, each employee was assigned a demonstration vehicle for the entire year. During the years at issue, no amount for the use of any vehicle was included on the Forms W-2 issued to the sales employees. Conversely, the Dealer did include amounts for the use of the vehicles on the Forms W-2 issued to the nonsales employees during the years at issue, purportedly to reflect the fair market value of the personal use of such vehicles.

[3] The Dealer concedes that no accurate records were kept during the years at issue indicating which employees used which vehicles during such time. During the course of the examination, records were constructed as accurately as possible from information obtained from service department records and sales jackets and invoices. According to the information obtained from such records, some employees had multiple vehicles assigned to them at one time, while other employees had gaps in which no known vehicle was assigned for their use, despite the Dealer's assertion that each employee had a vehicle assigned for the entire year. According to the information constructed from the records, a few employees did not have a vehicle assigned to them. Perhaps correspondingly, a few demonstration vehicles with accumulated mileage could not be attributed, based on the information from the various records, to particular employees.

[4] The Dealer provided two written policies regarding the use of demonstration vehicles for the 1993 and 1994 years, respectively. According to the information submitted, the policies were updated periodically as needed, but not necessarily on a calendar year basis. Apparently, the Dealer provided copies of the written policies to both its sales and nonsales employees for their signatures. The copies presented to the Service during the examination were dated September 1993 with respect to the 1993 policies and were not dated with a year or were dated 1995 with respect to the 1994 policies. According to the taxpayer, the policies were usually signed at the start of the model year (i.e., approximately September), but were effective on January 1 of the same calendar year.

[5] Both policies prohibited storage of personal possessions in the vehicles and limited the personal use of the vehicle to only commuting and local errands. However, only the 1994 policy expressly prohibited the use of the vehicles for vacations and by persons other than the employees. Neither policy expressly limited the amount of use of the vehicles outside the normal working hours. Both policies stated that the employee must contact a particular named individual to take a vehicle out of demonstration service or to place a new vehicle

in demonstration service. The 1993 policy requested an employee's estimate of the total mileage to be driven using company vehicles during the year; however, such information was not provided by the employee on the copy presented to the Service. The 1994 policy requested additional information: the vehicle's stock number, in- service and out-service dates, and model type, implying that the employee was to sign a new policy with respect to each separate demonstration vehicle assigned to such employee. With the exception of the out-service date, this information was provided by the employees on the copies of the policy presented to the Service; however, no employee had multiple policies for a year, despite the fact that the majority of the employees used more than one demonstration vehicle during the year.

[6] Although the policies for both years stated that the demonstration vehicles must be taken out of demonstration service when the odometer reached 6000 miles, many of the vehicles (approximately 47 percent during the years at issue) had mileage in excess (some significantly in excess) of 6000 miles before they were removed from the demonstration vehicle roster. The Dealer maintains that the 6000 mile limitation, notwithstanding the policies' use of the word "must," was only a goal, not a requirement. The amount of miles placed on a vehicle in demonstration status was, according to the Dealer, a product of various factors, including the availability of replacement vehicles, the time of year with respect to the announcement of new models, the number of demonstration vehicles currently out of service waiting to be sold, and the percentage of new car inventory not used as demonstration vehicles. Furthermore, according to the taxpayer, some of the miles significantly in excess of 6000 are attributable to the parts and body shop managers.

[7] During 1993, managers of the Dealer completed monthly demonstration mileage statements showing each nonsales employee's personal use percentage on demonstration vehicles, presumedly based on the employee's undocumented and unverified statement to the employer. The total mileage of a particular demonstration vehicle (or of all demonstration vehicles) used by an employee during that month was not provided on such statement. The employees were not required to keep nor to provide to the employer any records to substantiate the implied percentage of nonpersonal (i.e., business) use not specifically indicated on the statement. The Dealer used the provided percentage of personal use to calculate the amount to be included on the Forms W-2; however, the Dealer kept no records regarding how such calculation was made. The only indications of the Dealer's method of calculation are the references to "lease value" in the 1993 and 1994 policies and the demonstration mileage statements, the policies' indication that the lease value is based on "invoice plus $200 as a cost basis," and the Dealer's reference to the current "IRS chart."

[8] In 1994, the Dealer changed its method for determining the Form W-2 amount for the nonsales employees because, according to the Dealer, the managers did not feel that the information provided by the nonsales employees was realistic. Therefore, the managers began determining the percentage of personal use for each nonsales employee based on the distance of the employee's commute, whether the employee had another personal vehicle, and the duties of the employee. The Dealer used this percentage to calculate the amount to be included on the Form W-2. Again, no records were kept with respect to such calculations.

APPLICABLE LAW

ISSUES ONE AND TWO

[9] Section 61(a)(1) of the Internal Revenue Code (the "Code") provides that, except as otherwise provided, gross income means all income from whatever source derived, including compensation for services, including fringe benefits. Section 1.61-21(b) of the regulations provides that an employee must include in gross income the amount by which the fair market value of the fringe benefit exceeds the sum of (i) the amount, if any, paid for the benefit by or on behalf of the recipient, and (ii) the amount, if any, specifically excluded from gross income by some other section of subtitle A of the Code.

[10] Section 132(a)(3) provides that gross income shall not include any fringe benefit which qualifies as a working condition fringe. Section 132(d) defines the term “working condition fringe” as any property or services provided to an employee of the employer to the extent that, if the employee paid for such property or services, such payment would be allowable as a deduction under section 162 or 167. Section 132(j)(3) specifically provides that qualified automobile demonstration use shall be treated as a working condition fringe.

[11] Section 162(a) allows a deduction for ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. However, section 274(d) of the Code provides, in part, that no deduction shall be allowed with respect to any listed property (as defined in section 280F(d)(4)) unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating the taxpayer’s own statement (A) the amount of such expense or other item, (B) the time and place of the use of the property, (C) the business purpose of the expense or other item, and (D) the business relationship to the taxpayer of persons using the property. Section 280F(d)(4)(A)(i) includes any passenger automobile in the term “listed property.” Consequently, the requirements of section 274(d) must be met in order to deduct the expenses incurred in connection with the business use of a vehicle.

[12] Similarly, regulations related to working condition fringe benefits at section 1.132-5(c)(1) provide that the value of property or services provided to an employee may not be excluded from the employee’s gross income as a working condition fringe, by either the employer or the employee, unless the applicable substantiation requirements of either section 274(d) or section 162 (whichever is applicable) and the regulations thereunder are satisfied. Section 1.132-5(c)(2) provides that the substantiation requirements of 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 section 274(d), will be sufficient to substantiate a working condition fringe exclusion. Under section 1.132-5(d), the safe harbor substantiation rules of section 1.274-6T are also applicable for the purposes of a working condition fringe.

[13] As noted above, section 132(j)(3) provides that qualified automobile demonstration use shall be treated as a working condition fringe. The term “qualified automobile demonstration use” means any use of an automobile by a full-time automobile salesman in the sales area in which the automobile dealer’s sales office is located if (i) such use is provided primarily to facilitate the salesman’s performance of services for the employer, and (ii) there are substantial restrictions on the personal use of the automobile by the salesman.

[14] Section 1.132-5(o) of the regulations discusses the specific exclusion of the value of qualified automobile demonstration use as a working condition fringe. Under section 1.132-5(o)(4), the necessary substantial restrictions on the personal use of a demonstration automobile exist when all of the following conditions are satisfied: (i) use by individuals other than the full-time automobile salesman (e.g., the salesman’s family) is prohibited; (ii) use for personal vacation trips is prohibited; (iii) the storage of personal possessions in the automobile is prohibited; and (iv) the total use by mileage of the automobile by the salesman outside the salesman’s normal working hours is limited.

[15] Section 1.132-5(o)(6) provides that, notwithstanding anything in section 1.132-5 to the contrary, the value of the use of a demonstration automobile may not be excluded from gross income as a working condition fringe, by either the employer or the employee, unless, with respect to the restrictions of section 1.132-5(o)(4), the substantiation requirements of section 274(d) and the regulations thereunder are satisfied. Section 1.132-5(o)(6) indicates that both the general and safe harbor rules relating to the requirements of section 274(d) are applicable.

[16] The general substantiation requirements of section 274(d) are fully explained in section 1.274-5T. The safe harbor substantiation rules are provided in section 1.274-6T. Section 1.274- 5T(c)(1) provides that, generally, the taxpayer must substantiate each element of an expenditure or use by adequate records or by sufficient evidence corroborating his own statement. Section 1.274- 5T(c)(2) provides that, to meet the "adequate records" requirements of section 274(d), a taxpayer shall maintain an account book, diary, log, statement of expense, trip sheets, or similar record, and documentary evidence which, in combination, are sufficient to establish each element of an expenditure or use. /3/ An account book, diary, log, statement of expense, trip sheet, or similar record must be prepared or maintained in such manner that each recording of an element of an expenditure or use is made at or near the time of the expenditure or use. The phrase "made at or near the time of the expenditure or use" means recorded at a time when, in relation to the use or making of an expenditure, the taxpayer has full present knowledge of each element of the expenditure or use. /4/ An expense account statement which is a transcription of an account book, diary, log, or similar record prepared or maintained in accordance with this paragraph shall be considered a record prepared or maintained in the manner prescribed in the preceding sentence if such expense account statement is submitted by an employee to his employer in the regular course of good business practice. For example, a log maintained on a weekly basis, which accounts for use during the week, shall be considered a record made at or near the time of such use.

[17] According to section 1.274-5T(c)(2)(ii)(C), in order to constitute an adequate record which substantiates the business use of listed property, the record must contain sufficient information as to each element of every business use. Furthermore, under section 1.274- 5T(c)(6)(i), each separate use by the taxpayer shall ordinarily be considered to constitute a separate expenditure for purposes of substantiation; however, uses which may be considered part of a single use, for example, a round trip or uninterrupted business use, may be accounted for by a single record. The level of detail required in an adequate record to substantiate business use may vary depending on the facts and circumstances. For example, a taxpayer who uses a truck for both business and personal purposes and whose only business use of a truck is to make deliveries to customers on an established route may satisfy the adequate record requirement by recording the total number of miles driven during the taxable year, the length of the delivery route once, and the date of each trip at or near the time of the trips. Section 1.274-5T(c)(2)(ii)(C).

[18] Section 1.274-5T(c)(3) provides that, if a taxpayer fails to establish to the satisfaction of the district director that he has substantially complied with the "adequate records" requirements discussed above with respect to an element of an expenditure or use, then, the taxpayer must establish such element (A) by his own statement, whether written or oral, containing specific information in detail as to such element; and (B) by other corroborative evidence sufficient to establish such element. If such element is the cost or amount, time, place, or date of an expenditure or use, the corroborative evidence shall be direct evidence, such as a statement in writing or the oral testimony of witnesses setting forth detailed information about such element, or the documentary evidence discussed in section 1.274-5T(c)(2)(iii).

[19] Section 1.274-5T(e) specifically discusses the substantiation of the business use of listed property made available by an employer for use by an employee. An employee may not exclude from gross income as a working condition fringe any amount of the value of the availability of listed property provided by an employer to the employee, unless the employee substantiates for the period of availability the amount of the exclusion in accordance with the requirements of section 274(d) and either section 1.274-5T or section 1.274-6T.

[20] For purposes of an employer's substantiation of the business use of listed property that is provided to an employee and for purposes of the employer's necessary disclosure on returns, the employer may rely on adequate records maintained by the employee or on the employee's own statement if corroborated by other

sufficient evidence unless the employer knows or has reason to know that the statement, records, or other evidence are not accurate. The employer must retain a copy of the adequate records maintained by the employee or the other sufficient evidence, if available. Alternatively, the employer may rely on a statement submitted by the employee that provides sufficient information to allow the employer to determine the business use of the property unless the employer knows or has reason to know that the statement is not based on adequate records or on the employee's own statement corroborated by other sufficient evidence. If the employer relies on the employee's statement, the employer must retain only a copy of the statement. The employee must retain a copy of the adequate records or other evidence. Section 1.274-5T(e)(2).

[21] However, as mentioned above, section 1.132-5(d) also makes applicable to working condition fringes the safe harbor substantiation rules found in section 1.274-6T. Section 1.274- 6T(a)(1) provides that two types of written policy statements satisfying certain conditions, if initiated and kept by an employer to implement a policy of no personal use, or no personal use except for commuting, of a vehicle provided by the employer, qualify as sufficient evidence corroborating the taxpayer's own statement and therefore will satisfy the employer's substantiation requirements of section 274(d).

[22] Specifically, under section 1.274-6T(a)(3), an employee, in lieu of substantiating the business use of an employer-provided vehicle under section 1.274-5T, may substantiate any exclusion allowed under section 132 for a working condition fringe by including in income the commuting value of the vehicle (determined by the employer pursuant to section 1.61-21(f)(3)) if all the following conditions are met:

(A) 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;

(B) For bona fide noncompensatory business reasons, the employer requires the employee to commute to and/or from work in the vehicle;

(C) Under a written policy of the employer, neither the employee, nor any individual whose use would be taxable to the employee, may 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);

(D) Except for de minimis personal use, neither the employee, nor any individual whose use would be taxable to the employee, uses the vehicle for any personal purpose other than commuting;

(E) The employee required to use the vehicle for commuting is not a control employee required to use an automobile; and

(F) The employee includes in gross income the commuting value determined by the employer as provided in section 1.61-21(f)(3) (to the extent that the employee does not reimburse the employer for the commuting use).

There must also be evidence that would enable the Commissioner to determine whether the use of the vehicle met the preceding six conditions.

[23] Similarly, section 1.132-5(f) provides that, for a vehicle described in section 1.274-6T(a)(3) (relating to certain vehicles not used for personal purposes other than commuting), the working condition fringe exclusion is equal to the value of the availability of the vehicle for purposes other than commuting if the employer used the method prescribed in section 1.274-6T(a)(3). This rule applies only if the special rule for valuing commuting use, as prescribed in section 1.61-21(f), is used and the amount determined under the special rule is either included in the employee's income or reimbursed by the employee.

ISSUE THREE

[24] To the extent the use of the demonstration vehicles is not excluded from income under the above rules, the fair market value of the use must be included in the employee's income. Section 1.61-21(b) of the regulations provides that an employee must include in gross income the amount by which the fair market value of the fringe benefit exceeds the sum of (i) the amount, if any, paid for the benefit by or on behalf of the recipient, and (ii) the amount, if any, specifically excluded from gross income by some other section of subtitle A of the Code. The fair market value of a fringe benefit is the amount that an individual would have to pay for the particular fringe benefit in an arm's-length transaction. Thus, for example, the effect of any special relationship that may exist between the employer and the employee must be disregarded. Similarly, an employee's subjective perception of the value of a fringe benefit is not relevant to the determination of the fringe benefit's fair market value nor is the cost incurred by the employer determinable of its fair market value.

[25] Specifically, unless a special valuation rule applies, the value of the availability of an employer-provided vehicle is determined under the general valuation principles. In general, that value equals the amount that an individual would have to pay in an arm's-length transaction to lease the same or comparable vehicle on the same or comparable conditions in the geographic area in which the vehicle is available for use. An example of a comparable condition is the amount of time that the vehicle is available to the employee for use, e.g., a one-year period. Section 1.61-21(b)(4) of the regulations.

[26] However, special vehicle valuation rules are provided in paragraphs (d), (e), and (f) of section 1.61-21. /5/ Section 1.61- 21(c)(5) provides that the valuation formulae contained in the special valuation rules are provided only for use in connection with those rules. Thus, when a special valuation rule is not properly applied to a fringe benefit, or when a special valuation rule is used to value a fringe benefit by a taxpayer not entitled to use the rule, the fair market value of that fringe benefit may not be determined by reference to any value calculated under any special valuation rule, but must be determined pursuant to the general valuation rules of section 1.61-21(b).

[27] Under the Automobile Lease Valuation rule of section 1.61- 21(d), the value of the use of an employer-provided automobile for an entire calendar year is the Annual Lease Value as set forth in section 1.61-21(d)(2). The Annual Lease Value of a particular automobile is calculated by determining the fair market value of the automobile as of the first date on which the automobile is made available to any employee of the employer for personal use and locating the Annual Lease Value as provided in the Annual Lease Value table in section 1.61-21(d)(2) for the applicable dollar range. Under section 1.61-21(d)(3), the fair market value of maintenance and insurance, but not fuel, are included in the Annual Lease Value.

[28] For purposes of determining the Annual Lease Value of an automobile, the fair market value of an automobile is the amount that an individual would have to pay in an arm's length transaction to purchase the particular automobile in the jurisdiction in which the vehicle is purchased or leased. That amount includes all amounts attributable to the purchase of an automobile such as sales tax and title fees as well as the purchase price of the automobile. Any special relationship between the employee and the employer must be disregarded. Also, the employee's subjective perception of the value of the automobile is not relevant to the determination of the automobile's fair market value, and, except as provided under a safe harbor rule discussed below, the cost incurred by the employer in connection with the purchase or lease of the automobile is not determinative of the fair market value of the automobile. Section 1.61-21(d)(5)(i).

[29] However, section 1.61-21(d)(5)(ii) provides that, for purposes of calculating the Annual Lease Value of an automobile, the safe-harbor value of the automobile may be used as the fair market value of the automobile. Under section 1.61-21(d)(5)(ii)(B), for an automobile owned by the employer, the safe-harbor

value of the automobile is the employer's cost of purchasing the automobile (including sales tax, title, and other expenses attributable to such purchase), provided the purchase is made at arm's-length. Notwithstanding the preceding sentence, this safe-harbor value is not available with respect to an automobile manufactured by the employer. Thus, for example, if one entity manufactures an automobile and sells it to an entity with which it is aggregated under section 414(b), (c), (m) or (o), this safe harbor does not apply for valuing the automobile by the aggregated employer. In this case, the value must be determined under the general rule of section 1.61-21(d)(5)(i).

[30] For an automobile leased by the employer, the safe-harbor value of the automobile is either the manufacturer's suggested retail price of the automobile less eight percent (including sales tax, title, and other expenses attributable to such purchase), or the value determined by reference to the retail value of such automobile as reported by a nationally recognized pricing source. Section 1.61- 21(d)(5)(ii)(C), as modified by Notice 89-110, 1989-2 C.B. 447, and section 1.61-21(d)(5)(iii). Notice 89-110 provided that the safe harbor rule of section 1.61-21(d)(5)(ii)(C) was to apply to automobiles leased by the employer, whether or not the employer (or its affiliate) also manufactured the automobiles.

[31] Notice 89-110 also provided an additional safe harbor for computing fair market value for purposes of the automobile lease valuation rule. For automobiles leased by an employer, the employer will be permitted to use the manufacturer's invoice price (including options) plus four percent as a safe harbor estimation of fair market value for all purposes under section 1.61-21(d)(5)(ii). This safe harbor is available regardless of whether the employer also manufactures the automobiles.

[32] Section 1.61-21(d)(6)(ii) provides that, if an automobile dealership provides an employee with the continuous availability of a demonstration automobile (as defined in section 1.132-5(o)(3)) during a period (though not necessarily the same demonstration automobile for the entire period), the employee is treated as having the use of a single demonstration automobile for the entire period, e.g., an entire calendar year. When applying the automobile lease valuation rule of section 1.61-21(d), the employer may treat the average of the fair market values of the demonstration automobiles which are available to an employee and held in the dealership's inventory during the calendar year as the fair market value of the demonstration automobile deemed available to the employee for the period for purposes of calculating the Annual Lease Value of the automobile. If under the facts and circumstances it is inappropriate to take into account, with respect to an employee, certain models of demonstration automobiles, the value of the benefit is determined without reference to the fair market values of such models.

[33] Notwithstanding any of the principles discussed above, under section 1.61-21(d)(7), an employer may adopt the automobile lease valuation rule for an automobile only if the rule is adopted to take effect by the later of (A) January 1, 1989, or (B) the first day on which the automobile is made available to an employee of the employer for personal use (or, if the commuting valuation rule of section 1.61-21(f) is used when the automobile is first made available to an employee of the employer for personal use, the first day on which the commuting valuation rule is not used).

[34] Under the special commuting valuation rule, the value of the commuting use of an employer-provided vehicle is $1.50 per one- way commute, if the necessary requirements of section 1.61-21(f) are met by the employer and employees with respect to the vehicle. The requirements are identical to the first five requirements under the safe harbor substantiation rule in section 1.274-6T(a)(3), as discussed above.

ISSUE FOUR

[35] Section 3111 of the Code imposes the employer portion of the Federal Insurance Contributions Act (FICA) tax on wages paid by the employer with respect to employment.

[36] Section 3101 imposes the employee portion of the FICA tax on wages received by the employee with respect to employment. Section 3102 provides that the tax imposed by section 3101 shall be collected by the employer, by deducting the amount of the tax from the wages as and when paid. Section 3121(a) defines the term “wages” for FICA tax purposes as all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash, with certain exceptions.

[37] Section 3402 requires every employer making payment of wages to deduct and withhold upon such wages an income tax determined according to prescribed tables or procedures. Section 3401(a) defines the term “wages” as all remuneration for services performed by an employee for his employer, including the cash value of all remuneration (including benefits) paid in any medium other than cash, with certain exceptions.

RATIONALE

ISSUE ONE

[38] The value of the use of employer-provided vehicles is a fringe benefit that must be included in gross income under section 61(a)(1) of the Code, unless otherwise excluded. To be excluded as a working condition fringe under section 132(a)(3), the use of the vehicle must be substantiated within the meaning of section 274(d) and the regulations thereunder. While section 132(j)(3) specifically provides that qualified automobile demonstration use shall be treated as a working condition fringe, under section 1.132-5(o)(6) of the regulations, the value of such use is not excluded as a working condition fringe unless the substantiation requirements of section 274(d) are met with respect to the substantial restrictions imposed on the use of such vehicles.

[39] The Dealer provided demonstration vehicles for the business and personal use of its sales employees during the years at issue. Whether the sales employees may exclude the entire value of the use of the vehicles from their incomes depends, in this case, on whether the Dealer substantially restricted the use of the vehicles, within the meaning of section 1.132-5(o)(4), and whether such restrictions were substantiated, within the meaning of section 1.132- 5(o)(6) and section 274(d).

[40] Whether the substantial restrictions existed must be determined on the basis of all the facts and circumstances. The mere existence of a written policy, if its terms are not followed, does not satisfy the requirement that substantial restrictions limiting and prohibiting certain uses of the demonstration vehicles exist.

[41] First, neither policy expressly limited the total use by mileage of the vehicles outside of the employee’s normal working hours, a necessary restriction under section 1.132-5(o)(4). Second, the policy effective during 1993 did not expressly prohibit the use of the vehicle by individuals other than the particular sales employee, another necessary restriction under section 1.132-5(o)(4). Such prohibition was added to the policy effective for 1994. Third, a copy of the written policy was apparently signed by each sales employee; however, in most, if not all cases, the policy was signed many months after the effective date of such policy, thus, calling into question the substance of the written policy. Finally, the incompleteness of the signed policies (i.e., no total mileage estimate, no out-of-service dates) and the lack of multiple policies for employees who used multiple vehicles also indicate that employee adherence to the restrictions may not have been sufficiently monitored, and therefore the alleged restrictions may have lacked substance.

[42] However, even assuming that the necessary restrictions existed and that they existed in substance during both years at issue, section 1.132-5(c) generally and section 1.132-5(o)(6) specifically requires

substantiation of such restrictions in accordance with the specific rules under section 274(d) and the applicable regulations.

[43] The sales employees were not required by the Dealer to maintain any records nor submit any records to the Dealer. Furthermore, the Dealer did not maintain records regarding which employee used which vehicles. Consequently, neither the adequate records method of section 1.274-5T(c)(2) nor the sufficient evidence corroborating the taxpayer's (i.e., employee's) statement method of section 1.274-5T(c)(3) was satisfied with respect to the use of the demonstration vehicles by the sales employees.

[44] The Dealer attempts to rely on the safe harbor substantiation method set forth in section 1.274-6T(a)(3). However, in order to be able to rely on the safe harbor for satisfying the substantiation requirements of section 274(d) without maintaining the otherwise necessary records, all of the listed criteria must be met. The Dealer admits that no amount was included in the sales employees Forms W-2 as the value of commuting under section 1.61-21(f) in accordance with section 1.274-6T(a)(3)(F). In light of the clear language of section 1.274-6T(a)(3), we find no valid basis for not applying the requirement of section 1.274-6T(a)(3)(F) to all taxpayers who attempt to rely on the safe harbor of section 1.274- 6T(a)(3) for purposes of meeting the substantiation requirements without maintaining the otherwise necessary records. /6/

[45] Consequently, neither the general substantiation requirements of section 1.274-5T nor the safe harbor substantiation requirements of section 1.274-6T have been met as required under section 1.132-5(c), section 1.132-5(o)(6), and section 1.274- 5T(e)(1). Therefore, the use of the demonstration vehicles by the sales employees is not qualified demonstration automobile use under section 132(j)(3) and is not excludable from income as a working condition fringe under section 132(a)(3).

ISSUE TWO

[46] As discussed above, to be excludable as a working condition fringe, section 1.132-5(c)(1) requires that the applicable substantiation requirements be met. The Dealer provided demonstration vehicles for the business and personal use of its nonsales employees during the years at issue. These employees were not required to maintain or submit to the employer any records. Consequently, the adequate records method of section 1.274-5T(c)(2) is not satisfied.

[47] Furthermore, even though it appears that the nonsales employees may have provided oral statements to the employer for the 1993 year (but not for the 1994 year) regarding the percentage of monthly PERSONAL use of the demonstration vehicles, such statements were not detailed as to the elements of the business use of the vehicles and the statements were not corroborated by other sufficient evidence. /7/ Therefore, the sufficient corroborating evidence method of section 1.274-5T(c)(3) is not satisfied in either year. The Dealer's admission that the managers doubted the accuracy of the employees' unverified statements further supports this conclusion.

[48] Since no part of the nonsales employees' use of the demonstration vehicles is substantiated to the employer within the meaning of section 274(d), under section 1.132-5(c)(1) and section 1.274-5T(e)(1), the value of the vehicle use may not be excluded from the employee's gross income as a working condition fringe, by either the employer or the employee.

ISSUE THREE

[49] The fair market value of the use of the demonstration vehicles by both the sales and nonsales employees must be included in the employees' income. Section 1.61-21(b)(1). At issue is whether the Dealer is entitled to use the automobile lease valuation rule of section 1.61-21(d) instead of the general valuation rule of section 1.61-21(b).

[50] With respect to the sales employees, for which no amount was included on the Forms W-2 during the years at issue, section 1.61-21(d)(7) is not satisfied because the automobile lease valuation rule was not adopted to take effect by the later of January 1, 1989, or the first day on which the automobiles were made available to an employee of the employer for personal use. Consequently, the Dealer is not entitled to use the automobile lease valuation rule of section 1.61-21(d) to value the use of the demonstration vehicles provided to the sales employees during the years at issue.

[51] With respect to the nonsales employees, for which an amount was included on the Forms W-2 during the years at issue, it appears, although it is not entirely clear, that the Dealer intended to adopt, under section 1.61-21(d)(7), the automobile lease valuation rule for valuing the personal use of the demonstration vehicles provided to the nonsales employees. However, section 1.61-21(c)(5) provides that if a special valuation rule is not properly applied to a fringe benefit, the fair market value of that fringe benefit may not be determined by reference to any value calculated under any special valuation rule, but must be determined pursuant to the general valuation rules of section 1.61-21(b).

[52] The Dealer did not properly apply the automobile lease valuation rule in connection with the nonsales employees' use of the demonstration vehicles: (1) the employer did not have any of the necessary records to substantiate the portion of the "lease value" that was excluded from the Forms W-2 as allegedly business use (see discussion above); and (2) each demonstration vehicle's fair market value (for purposes of determining the vehicle's "lease value" under section 1.61-21(d)(2)) was apparently based on "invoice plus $200," a seemingly unauthorized method for determining fair market value under section 1.61-21(d)(5). Consequently, under section 1.61-21(c)(5), the fair market value of the fringe benefits must be determined for the years at issue using the general valuation rules of section 1.61- 21(b); thus, the safe harbor fair market values under section 1.61- 21(d)(5)(ii) and Notice 89-110 are not available. Under the general rules, the fair market value generally equals the amount that an individual would have to pay in an arm's-length transaction to lease the same or comparable vehicle on the same or comparable conditions in the same geographic area in which the vehicle is available for use. The cost incurred by the Dealer for a vehicle is not determinative of its fair market value.

ISSUE FOUR

[53] Under section 3121(a) and 3401(a), benefits paid as remuneration for employment, such as the personal use of employer- provided vehicles, are wages for FICA tax and income tax withholding purposes, unless an exception applies. /8/

[54] As discussed above, the Dealer did not maintain records regarding which employees used which vehicles. Records were constructed for purposes of the examination by compiling information from the relevant sales jackets and invoices and service department records. However, the sales and service records were not helpful in identifying which employees were assigned to a few of the demonstration vehicles that had accumulated mileage (the "unknown" vehicles). No part of the mileage on the unknown vehicles has been substantiated as business use; therefore, to the extent the mileage appears to be attributable to employee use, such mileage is deemed to be for PERSONAL employee use and is wages for employment tax purposes.

[55] Sections 3101, 3111, and 3402 impose obligations on the Dealer to withhold and pay both portions of the FICA tax and the appropriate portion of income tax on all wages paid by the employer (subject to certain ceiling limitations for FICA tax purposes), including the benefit of personal use of employer-provided demonstration vehicles. The fact that the inadequacy of the Dealer's records may make it impossible to identify the particular employee to whom the employee use of the unknown vehicles should be attributed

does not relieve the Dealer from its withholding and payment obligations with respect to the amount of wages paid.

CONCLUSION

1. Due to the lack of necessary substantiation within the meaning of section 274(d), the use of demonstration vehicles by the Dealer's sales employees is not qualified automobile demonstration use within the meaning of section 132(j)(3) and is not excludable from gross income as a working condition fringe under section 132(a)(3) for the years at issue.

2. Due to the lack of necessary substantiation within the meaning of section 274(d), the use of demonstration vehicles by the Dealer's nonsales employees is not excludable from gross income as a working condition fringe under section 132(a)(3) for the years at issue.

3. The Dealer is not entitled to use the automobile lease valuation rule in section 1.61-21(d) for purposes of valuing the
personal use of vehicles provided to sales and nonsales employees during the years at issue.

4. The Dealer is not relieved of its obligation for any employment taxes imposed under sections 3101, 3111, and 3401 on the employee use of demonstration vehicles for which a particular employee cannot be identified.

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

FOOTNOTES

/1/ The terms "automobile" and "vehicle" are used interchangeably in the discussion below and are considered to have the same meaning for purposes of this document.

/2/ For the following discussion, note that all references to "employee" or "employees" do not include X, who kept records regarding his use of demonstration vehicles and whose tax consequences are not at issue.

/3/ Generally, documentary evidence is required for (A) any expenditure for lodging while traveling away from home, and (B) any other expenditure of $75 or more. See section 1.274-5T(c)(2)(iii), as amended by T.D. 8715, March 25, 1997.

/4/ We note that section 1.274-5T(c)(1) recognizes that a contemporaneous log is not required, but indicates that a record of the elements of an expenditure or of a business use of listed property made at or near the time of the expenditure or use, supported by sufficient documentary evidence, has a high degree of credibility not present with respect to a statement prepared subsequent thereto when generally there is a lack of accurate recall. Thus, the corroborative evidence required to support a statement not made at or near the time of the expenditure or use must have a high degree of probative value to elevate such statement and evidence to the level of credibility reflected by a record made at or near the time of the expenditure or use supported by sufficient documentary evidence. The substantiation requirements of section 274(d) are designed to encourage taxpayers to maintain the records, together with the documentary evidence.

/5/ The vehicle cents-per-mile valuation rule of section 1.61- 21(e) is not applicable to this case and will not be discussed herein.

/6/ The Dealer cites section 1.61-21(a)(2) of the regulations, which states, in part, that "[t]he fact that another section of subtitle A of the Internal Revenue Code addresses the taxation of a particular fringe benefit will

not preclude section 61 and the regulations thereunder from applying, to the extent that they are not inconsistent with such other section," in support of an argument that the requirement of section 1.274-6T(a)(3)(F) to include the commuting value in gross income is inconsistent with the exclusion for automobile salesman under section 132(j)(3) and, thus, should not apply to the salesman.

However, the commuting valuation rule of section 1.61-21(f) is specifically made applicable to the otherwise total exclusion under section 132(j)(3) for qualified automobile demonstration use BY SECTION 1.274-6T(a)(3)(F). If the taxpayer chooses to take advantage of the record-keeping relief provided in the safe harbor rule of section 1.274-6T(a)(3), the taxpayer must meet all the requirements of the rule, including the commuting value inclusion. Requiring this partial inclusion in exchange for lesser record-keeping requirements is not inconsistent with the total exclusion that is available under section 132(j)(3) WHEN THE GENERAL RECORD-KEEPING REQUIREMENTS OF SECTION 274(d) ARE MET. See the follow-up language in section 1.61- 21(a)(2) to the sentence quoted above: "For example, many fringe benefits specifically addressed in other sections of subtitle A of the Internal Revenue Code are excluded from gross income only to the extent that they do not exceed specific dollar or percentage limits, or only if certain other requirements are met. If the limits are exceeded OR THE REQUIREMENTS ARE NOT MET, some or all of the fringe benefit may be includible in gross income pursuant to section 61″ (emphasis added).

/7/ The odometer mileage statements for the relevant demonstration vehicles are not sufficient, direct evidence of the number of miles, if any, that were attributable to BUSINESS use by a particular employee.

/8/ We do not decide herein the applicability of any exception to wages for FICA tax and income tax withholding purposes; however, we assume for purposes of the continuing discussion that no exception applies.

END OF FOOTNOTES