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Cars, Charity, Oprah, Depreciation and the Interest-Free Loan: Recent Developments of Relevance in the Motor City

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Recent Developments of Relevance in the Motor City

by Stuart Lazar

It is likely that the residents of the State of Michigan have more of an interest in automobiles than anyone else in America. Tax professionals have a heightened interest in anything related to tax. Thus, when the motor vehicle drives into the tax universe, Michigan's tax professionals take notice. This article discusses three such interesting intersections that have occurred in the past year.

Oprah Winfrey and the Pontiacs

Television talk show diva Oprah Winfrey opened the 2004-2005 season of her show by giving away 276 new 2005 Pontiac G6 sedans to the members of her television studio audience. Although it may have appeared that Oprah was the great benefactor, we learned that it was Pontiac (i.e., General Motors) that donated the cars that were to be distributed to the audience members. Although there were considerable screams of happiness and cries of joy by the new car owners, it soon became apparent that there were three tax issues that needed to be resolved: Did Pontiac's largesse constitute income to Oprah's audience? When would that income be recognized? And, how much income was required to be reported? Although some reports stated that Pontiac would pick up all of the taxes associated with these cars, in reality, Pontiac agreed only to cover the cost of the state sales tax.

With respect to the first issue, it is clear that Oprah's audience members will recognize gross income as a result of Pontiac's generosity. While some commentators initially posited that the cars were gifts excludable under Section 102 of the Internal Revenue Code, a more careful analysis concludes that these were not gifts. The seminal case in this area, *Commissioner v. Duberstein*, held that a gift comes from a detached and disinterested generosity and out of affection, respect, admiration, charity or like impulses on the part of the transferor.[1] What controls, according to the *Duberstein* court, is the transferor's intention. And while we might like to believe that Pontiac gave away 276 new G6 sedans out of a detached and disinterested generosity, it is more plausible to believe that such transfer was a publicity stunt made to enhance the value of the Pontiac name and to provide publicity to the brand. Audience members have "won" a prize as a result of their good fortune to appear at that particular taping of an episode of Oprah and, accordingly, are required to include the fair market value of the prize received in gross income under Section 74 of the Code.

As to when the audience members should be taxed on their prize, individuals are generally subject to tax on income when received. Although it appeared that the audience members would be driving their cars home from the show, Pontiac agreed to have the cars sent to the audience members' local dealerships for pick up between October 1, 2004 and February 28, 2005. At least one audience member reportedly decided to wait until January 1, 2005, so he could defer payment of the tax liability until April 15, 2006. Unfortunately, the doctrine of constructive receipt requires that a taxpayer report income either when actually received or such income is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given.[2] Although one might claim that administrative convenience and fairness would argue in favor of deferring such income until the cars are actually received, such argument lacks any support under the law. Since, in the present case, Oprah's audience members had the option of picking up their cars in 2004, it is likely that 2004 is the proper year for reporting such income.

As to the amount of income required to be reported, Treasury Regulation Section 1.61-1(a) states that gross income may be recognized in any form, whether money, property or services. Treasury Regulation Section 1.61-2(d)(1) states that where income is received in the form of property, the amount of income is equal to the fair market value of the property received. Thus, the issue is the fair market value of the 2005 Pontiac G6 sedans received by Oprah's audience members. For tax purposes, Treasury Regulation Section 20.2031-1(b) defines "fair market value" as "the price a willing buyer would pay a willing seller, with neither under a compulsion to buy or sell, and both having reasonable knowledge of relevant facts."

When Oprah's audience members pick up their new cars, Pontiac will issue them each a Form 1099 reflecting the amount of income to be reported. Presumably, Pontiac will take the position that the proper amount to report is the $28,400 manufacturer's suggested retail price (MSRP) of the car, plus the amount of state and local sales taxes that Pontiac has agreed to assume.

However, it is possible that Pontiac will report the fair market value of the automobiles as something less than the MSRP of the car. A fair market value that is below the MSRP would be justified if the car typically sells at a discount and/or is subject to manufacturer rebates or other special discounts. Nowhere is this more the case than here, in Michigan, where car buyers rarely pay the manufacturer's suggested retail price. Car manufacturers offer significant discounts to employees' friends and families, in order to increase the visibility of their vehicles – such discounts often resulting in a purchase price thousands of dollars below a vehicle's MSRP. In addition, vehicle prices are highly negotiated with the dealer. Should an "average negotiated price" be used as fair market value since it is clear that willing buyers often negotiate with auto dealers for prices below the MSRP? Or should we assume that the audience members would have been those few, rare individuals who would not have negotiated to buy the same car? Moreover, it is common for manufacturers to offer significant rebates on new car purchases. For example, at the time that this article was being written, General Motors was offering current GM owners a $1,500 discount off the purchase of any new vehicle. Should such a discount be considered in determining the fair market value of the prizes awarded to Oprah's studio audience?

Employee discounts, cash rebates and negotiating discounts off the MSRP are just a few incentives that auto manufacturers use to encourage car purchases. Another common incentive is to offer car buyers an attractive financing package. Many manufacturers are currently offering their vehicles with zero percent financing for 60 months. Again, at the time this article was being written, Pontiac was offering to finance the G6 sedan for 36 months with no interest. Would the audience members be justified in reducing the fair market value of their automobile to reflect a present value that takes into account the fact that Pontiac is offering the car with below-market loans?[3]

It is unclear as of the date of this writing whether Pontiac will report the income from receiving the G6 sedans at the MSRP or whether Pontiac will take into account the customs of the auto industry and report a lower fair market value on the audience members' Form 1099. In addition, it is unclear whether any audience member will report their income at an amount less than that determined by Pontiac. Such an inconsistent position, while perhaps defensible, might increase the likelihood of an IRS audit.

Depreciation Deductions, Interest-Free Loans and the SUV

Prior to the enactment of The American Jobs Creation Act of 2004, taxpayers who purchased eligible personal property for use in the active conduct of a trade or business could utilize several sections of the Code to expense the cost of such property. In 2004, Section 179 allowed a taxpayer to expense an aggregate of up to $102,000 of the cost of such eligible personal property used in the active conduct of a trade or business (subject to a phase-out of such amount and a requirement that the taxpayer have offsetting income in its trades or businesses). In addition, Section 168(k) allowed taxpayers to take a "bonus" depreciation deduction of 50 percent of the adjusted basis of such property in the first year that such property was placed into service (subject to the "original use requirement"). Finally, Section 168(a) allowed the taxpayer to depreciate the property under the MACRS depreciation system.

Section 179 expensing was allowed for "listed property" only if such property is used more than 50 percent in a qualified business use (and only to the extent of such use).[4] Section 280F(a)(1) limited the amount of depreciation that taxpayers could claim under Section 179 and MACRS for passenger automobiles.[5] In 2004, the maximum first-year deduction allowed for vehicles bought and placed in service was $2,960 for an auto and $3,260 for a light truck or van (increased to $10,610 and $10,910, respectively, if the bonus depreciation provisions of Section 168(k) applied). Although these limitations applied to cars, trucks, vans and sport-utility vehicles, these limitations did not apply to "heavy SUVs" – defined as those with a gross (loaded) vehicle weight rating (GVWR) of more than 6,000 pounds.[6] These rules provided a significant windfall to taxpayers who purchased SUVs with a GVWR of more than 6,000 pounds that were used entirely for business purposes, since under Section 179 such vehicles costing less than $102,000 could be deducted entirely in the year of purchase. In cases where the cost of the vehicle exceeded $102,000, Section 179, Section 168(k) and MACRS depreciation provided for a deduction of substantially the vehicle's entire purchase price. For example, a taxpayer who purchased a heavy SUV at a cost of $127,000 would be able to take a deduction of $117,000 in the year of purchase – resulting in tax savings of $46,800 in the year of purchase (assuming a combined federal and state tax rate of 40 percent).

For property placed in service after October 22, 2004 – the date that the American Jobs Creation Act of 2004 was enacted – Section 179 limits the ability of taxpayers to claim a Section 179 deduction for certain SUVs (those having a gross vehicle weight of 14,000 pounds or less) to $25,000.[7] In addition, the bonus depreciation rules set forth in Section 168(k) expired at the end of 2004. Thus, the same $127,000 vehicle described above purchased in 2005 would only entitle its owner to deductions of $45,400 in the year of purchase, rather than the $117,000 of deductions allowable prior to October 22, 2004.

Taxpayers who depreciate their vehicles should also be aware that only the purchase price of the vehicle (and not any interest paid to finance such purchase) can be depreciated – although such interest may be separately deductible if the vehicle is used in a trade or business. For purchases in which the taxpayer has received zero-percent financing or other low-interest financing (i.e., where the interest rate is less than the applicable federal rate), the taxpayer must allocate the amount paid between the purchase price of the vehicle and an unstated interest amount.[8] Although the author is unaware of any situation in which the Internal Revenue Service has required such a bifurcation of amount paid into the purchase price and an interest component, the potential for such a challenge exists – especially with taxpayers who purchase higher-priced automobiles and utilize the benefits of Section 179.

The IRS and the Charitable Contribution Deduction for Automobiles

Prior to January 1, 2005, taxpayers could take a tax deduction equal to the fair market value of the automobile donated to a charitable organization. Some taxpayers felt that meant that a car needing significant repairs could be donated to charity, and its owner could deduct the "blue book" value for such automobile to reduce his or her tax liability. In addition, Congressional hearings last year focused on alleged abuses by auto middlemen who auction the cars – taking large fees and returning only a fraction of the car's value to the charities to perform their charitable functions. As a result of perceived abuses, those who wish to donate their car to charity and take a deduction of greater than $500 will be required to adhere to a new set of rules.

For all charitable contributions where the taxpayer is claiming a deduction of at least $250 but no more than $500, the taxpayer must obtain a contemporaneous written acknowledgment from the charity. The acknowledgment must include (i) the name of the charity to which the donation was made, (ii) a description (but not value) of the property donated, and (iii) either (A) a statement that no goods or services were provided by the charity in return for the contribution, (B) a description and good-faith estimate of the value of goods or services, if any, that the charity provided in return for the contribution, or (C) a statement that goods or services that the charity provided in return for the contribution consisted entirely of intangible religious benefits. Such acknowledgment must be received on or before the earlier of the date the taxpayer files the return for the year contribution is made or the due date, including extensions, for filing the return.[9]

If the value of the donated vehicle exceeds $500, a taxpayer will be required to determine their tax deduction in one of two ways. If the car is sold without any significant intervening use or material improvement by the charity,, the taxpayer's deduction will be limited to the amount of gross proceeds received by the charity from the sale.[10] If, however, the charity intends to make significant intervening use of or materially improve the car, the taxpayer will be entitled to a deduction equal to the car's fair market value. For these purposes, the Conference Report to the new legislation states that to meet the "significant intervening use" test, an organization must actually use the vehicle to substantially further the organization's regularly conducted activities and the use must be significant. A "material improvement" includes major repairs to a vehicle or other improvements that better its condition in a way that significantly increases the vehicle's value – cleaning the vehicle, minor repairs, and routine maintenance are not considered material improvements.

In order to claim a tax deduction of more than $500, the acknowledgement from the charity to the taxpayer must contain the following information: (i) the taxpayer's name and taxpayer identification number, (ii) the vehicle identification number., (iii) a statement certifying that the charity sold the car in an arm's length transaction between unrelated parties, (iv) the gross proceeds from the sale, (v) a statement that the taxpayer's charitable contribution deduction may not be more than the gross proceeds from the sale, and (vi) the date of the contribution. If, however, there was significant intervening use of or material improvement to the car by the organization, the acknowledgement does not have to include items (iii), (iv), and (v). Instead, it must contain a certification of the intended use of or material improvement to the car, the intended duration of that use, and a certification that the vehicle will not be transferred in exchange for money,, other property,, or services before completion of that use or improvement. In such case, the amount of the deduction will be the fair market value of the donated vehicle as determined by the taxpayer. This acknowledgement must be provided within 30 days of the sale of the car or, if there is significant intervening use or material improvement of the car by the organization, within 30 days of the contribution. The organization also must provide this information to the IRS.[11]

If the taxpayer is claiming a deduction that is greater than $5,000 and the deduction is based on the fair market value of the automobile, a written appraisal by a qualified appraiser is required. The appraisal must be made no more than 60 days prior to the date of contribution, and must be received prior to the due date (including extensions) of the return on which the deduction is claimed. In addition, such appraisal is generally required to be attached to the taxpayer's tax return.

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Footnotes

1 363 U.S. 278 (1960).
2 Treas. Reg. Sec. 1.453-2(a).
3 Section 483(a) treats a portion of the purchase price as interest in situations where there is "total unstated interest" as defined in Section 453(b).
4 Section 280F(b); Treas. Reg. Section 1.280F-3T(c)(1).
5 Section 280F(a)(1); Section 280F(d)(1).
6 Section 280F(d)(5)(A).
7 Section 179(b)(6), as amended by Section 910 of the American Jobs Creation Act of 2004.
8 Section 483(a).
9 Section 170(f)(8).
10 Section 170(f)(12)(A)(ii), as amended by Section 884 of the American Jobs Creation Act of 2004.
11 Section 170(f)(12)(A)(i) and Section 170(f)(12)(B), as amended by Section 884 of the American Jobs Creation Act of 2004.