

Part III

Administrative, Procedural, and Miscellaneous

26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.

(Also Part I, §§ 62, 162, 170, 213, 217, 274, 1016; 1.62-2, 1.162-17, 1.170A-1, 1.213-1, 1.217-2, 1.274-5, 1.1016-3.)

Rev. Proc. 2005-78

SECTION 1. PURPOSE

This revenue procedure updates Rev. Proc. 2004-64, 2004-49 I.R.B. 898, as modified by Announcement 2005-71, 2005-41 I.R.B. 714, and provides optional standard mileage rates for employees, self-employed individuals, or other taxpayers to use in computing the deductible costs of operating an automobile for business, charitable, medical, or moving expense purposes. In addition, this revenue procedure provides optional standard mileage rates for computing the deductible costs of operating an automobile in providing donated services to charity for the provision of relief related to Hurricane Katrina and for determining the amount that may be excluded from income by taxpayers who are reimbursed for such use. This revenue procedure also provides rules under which the amount of ordinary and necessary expenses of local travel or transportation away from home that are paid or incurred by an employee will be deemed substantiated under § 1.274-5 of the Income Tax Regulations if a payor (the employer, its agent, or a third party) provides a mileage allowance under a reimbursement or other expense allowance arrangement to pay for the expenses. Use

of a method of substantiation described in this revenue procedure is not mandatory and a taxpayer may use actual allowable expenses if the taxpayer maintains adequate records or other sufficient evidence for proper substantiation. The Internal Revenue Service prospectively adjusts the business, medical, and moving standard mileage rates annually (to the extent warranted).

SECTION 2. SUMMARY OF STANDARD MILEAGE RATES

.01 Standard mileage rates

(1) Business (section 5 below)	44.5 cents per mile
(2) Charitable contribution (section 7 below)	
(a) General	14 cents per mile
(b) Hurricane Katrina deduction	32 cents per mile
(c) Hurricane Katrina reimbursement	44.5 cents per mile
(3) Medical and moving (section 7 below)	18 cents per mile

.02 Determination of standard mileage rates. The business, medical, and moving standard mileage rates reflected in this revenue procedure are based on an annual study of the fixed and variable costs of operating an automobile conducted on behalf of the Service by an independent contractor. The charitable contribution standard mileage rate is provided in § 170(i) of the Internal Revenue Code. The Hurricane Katrina charitable contribution deduction standard mileage rate is established by § 303 of the Katrina Emergency Tax Relief Act of 2005, Pub. L. No. 109-73, 119 Stat. 2016 (KETRA). The Hurricane Katrina charitable contribution reimbursement standard mileage rate is established by § 304 of KETRA.

SECTION 3. BACKGROUND AND CHANGES

.01 Section 162(a) allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Under that provision, an employee or self-employed individual may deduct the cost of operating an automobile to the extent that it is used in a trade or business. However, under § 262, no portion of the cost of operating an automobile that is attributable to personal use is deductible.

.02 Section 274(d) provides, in part, that no deduction is allowed under § 162 with respect to any listed property (as defined in § 280F(d)(4) to include passenger automobiles and any other property used as a means of transportation) unless the taxpayer complies with certain substantiation requirements. Section 274(d) further provides that regulations may prescribe that some or all of the substantiation requirements do not apply to an expense that does not exceed an amount prescribed by the regulations.

.03 Section 1.274-5(j), in part, grants the Commissioner of Internal Revenue the authority to establish a method under which a taxpayer may use mileage rates to substantiate, for purposes of § 274(d), the amount of the ordinary and necessary expenses of using a vehicle for local transportation and transportation to, from, and at the destination while traveling away from home.

.04 Section 1.274-5(g), in part, grants the Commissioner the authority to prescribe rules relating to mileage allowances for ordinary and necessary expenses of using a vehicle for local transportation and transportation to, from, and at the destination

while traveling away from home. Pursuant to this grant of authority, the Commissioner may prescribe rules under which the allowances, if in accordance with reasonable business practice, will be regarded as (1) equivalent to substantiation, by adequate records or other sufficient evidence, of the amount of the travel and transportation expenses for purposes of § 1.274-5(c), and (2) satisfying the requirements of an adequate accounting to the employer of the amount of the expenses for purposes of § 1.274-5(f).

.05 Section 62(a)(2)(A) allows an employee, in determining adjusted gross income, a deduction for the expenses allowed by Part VI (§ 161 and following), subchapter B, chapter 1 of the Code, paid or incurred by the employee in connection with the performance of services as an employee under a reimbursement or other expense allowance arrangement with a payor.

.06 Section 62(c) provides that an arrangement will not be treated as a reimbursement or other expense allowance arrangement for purposes of § 62(a)(2)(A) if it--

(1) does not require the employee to substantiate the expenses covered by the arrangement to the payor, or

(2) provides the employee with the right to retain any amount in excess of the substantiated expenses covered under the arrangement.

Section 62(c) further provides that the substantiation requirements described therein do not apply to any expense to the extent that, under the grant of regulatory authority in § 274(d), the Commissioner has provided that substantiation is not required for the

expense.

.07 Under § 1.62-2(c)(1), a reimbursement or other expense allowance arrangement satisfies the requirements of § 62(c) if it meets the requirements of business connection, substantiation, and returning amounts in excess of expenses as specified in the regulations. Section 1.62-2(e)(2) specifically provides that substantiation of certain business expenses in accordance with rules prescribed under the authority of § 1.274-5(g) will be treated as substantiation of the amount of the expenses for purposes of § 1.62-2. Under § 1.62-2(f)(2), the Commissioner may prescribe rules under which an arrangement providing mileage allowances will be treated as satisfying the requirement of returning amounts in excess of expenses, even though the arrangement does not require the employee to return the portion of the allowance that relates to miles of travel substantiated and that exceeds the amount of the employee's expenses deemed substantiated pursuant to rules prescribed under § 274(d), provided the allowance is reasonably calculated not to exceed the amount of the employee's expenses or anticipated expenses and the employee is required to return any portion of the allowance that relates to miles of travel not substantiated.

.08 Section 1.62-2(h)(2)(i)(B) provides that if a payor pays a mileage allowance under an arrangement that meets the requirements of § 1.62-2(c)(1), the portion, if any, of the allowance that relates to miles of travel substantiated in accordance with § 1.62-2(e), that exceeds the amount of the employee's expenses deemed substantiated for the travel pursuant to rules prescribed under § 274(d) and § 1.274-5(g), and that the employee is not required to return, is subject to withholding

and payment of employment taxes. See §§ 31.3121(a)-3, 31.3231(e)-1(a)(5), 31.3306(b)-2, and 31.3401(a)-4 of the Employment Tax Regulations. Because the employee is not required to return this excess portion, the reasonable period of time provisions of § 1.62-2(g) (relating to the return of excess amounts) do not apply to this excess portion.

.09 Under § 1.62-2(h)(2)(i)(B)(4), the Commissioner may provide special rules regarding the timing of withholding and payment of employment taxes on mileage allowances.

.10 Section 303 of KETRA provides that the standard mileage rate for purposes of computing the amount allowable as a charitable contribution deduction for the cost of operating an automobile for the provision of relief related to Hurricane Katrina during the period beginning on August 25, 2005, and ending on December 31, 2006, shall be 70 percent of the business standard mileage rate in effect. Section 304 of KETRA provides that taxpayers may exclude from income an amount computed at the business standard mileage rate received from a charity as reimbursement for the cost of operating an automobile for the provision of relief related to Hurricane Katrina during the period beginning on August 25, 2005, and ending on December 31, 2006. Sections 2.01 and 7.01 of this revenue procedure are revised to include these special charitable contribution standard mileage rates for 2006. For the period beginning on August 25, 2005, and ending on August 31, 2005, the charitable contribution standard mileage rate is 29 cents for deduction purposes and 40.5 cents for reimbursement purposes. For the period beginning on September 1, 2005, and ending on December 31, 2005, the

charitable contribution standard mileage rate is 34 cents for deduction purposes and 48.5 cents for reimbursement purposes.

.11 Section 5.06(3) of this revenue procedure clarifies the limitation on use of the business standard mileage rate by a taxpayer that has claimed the special depreciation allowance under § 168(k). Section 8.04(1) clarifies the limitation on use of a fixed and variable rate (FAVR) allowance with respect to an automobile for which an employee has claimed the special depreciation allowance under § 168(k). Section 8.05(4) clarifies the requirement that an employer's FAVR allowance or allowances must cover at least five or more employees. Section 8.05(5) clarifies the requirement that an employee may not participate in a FAVR allowance unless the cost of the employee's automobile was at least 90 percent of the standard automobile cost.

SECTION 4. DEFINITIONS

.01 *Standard mileage rate.* The term "standard mileage rate" means the applicable amount provided by the Service for optional use by employees or self-employed individuals in computing the deductible costs of operating automobiles (including vans, pickups, or panel trucks) they own or lease for business purposes, or by taxpayers in computing the deductible costs of operating automobiles for charitable, medical, or moving expense purposes.

.02 *Transportation expenses.* The term "transportation expenses" means the expenses of operating an automobile for local travel or transportation away from home.

.03 *Mileage allowance.* The term "mileage allowance" means a payment under a reimbursement or other expense allowance arrangement that meets the requirements

specified in § 1.62-2(c)(1) and that is:

(1) paid with respect to the ordinary and necessary business expenses incurred, or that the payor reasonably anticipates will be incurred, by an employee for transportation expenses in connection with the performance of services as an employee of the employer,

(2) reasonably calculated not to exceed the amount of the expenses or the anticipated expenses, and

(3) paid at the applicable standard mileage rate, a flat rate or stated schedule, or in accordance with any other Service-specified rate or schedule.

.04 Flat rate or stated schedule. A mileage allowance is paid at a flat rate or stated schedule if it is provided on a uniform and objective basis with respect to the expenses described in section 4.03 of this revenue procedure. The allowance may be paid periodically at a fixed rate, at a cents-per-mile rate, at a variable rate based on a stated schedule, at a rate that combines any of these rates, or on any other basis that is consistently applied and in accordance with reasonable business practice. Thus, for example, a periodic payment at a fixed rate to cover the fixed costs (including depreciation (or lease payments), insurance, registration and license fees, and personal property taxes) of driving an automobile in connection with the performance of services as an employee of the employer, coupled with a periodic payment at a cents-per-mile rate to cover the operating costs (including gasoline and all taxes thereon, oil, tires, and routine maintenance and repairs) of using an automobile for those purposes, is an allowance paid at a flat rate or stated schedule. Likewise, a periodic payment at a

variable rate based on a stated schedule for different locales to cover the costs of driving an automobile in connection with the performance of services as an employee is an allowance paid at a flat rate or stated schedule.

SECTION 5. BUSINESS STANDARD MILEAGE RATE

.01 *In general.* The standard mileage rate for transportation expenses is 44.5 cents per mile for all miles of use for business purposes.

.02 *Use of the business standard mileage rate.* A taxpayer may use the business standard mileage rate with respect to an automobile that is either owned or leased by the taxpayer. A taxpayer generally may deduct an amount equal to either the business standard mileage rate times the number of business miles traveled or the actual costs (both operating and fixed) paid or incurred by the taxpayer that are allocable to traveling those business miles.

.03 *Business standard mileage rate in lieu of operating and fixed costs.* A deduction using the standard mileage rate for business miles is computed on a yearly basis and is in lieu of all operating and fixed costs of the automobile allocable to business purposes (except as provided in section 9.06 of this revenue procedure). Items such as depreciation (or lease payments), maintenance and repairs, tires, gasoline (including all taxes thereon), oil, insurance, and license and registration fees are included in operating and fixed costs for this purpose.

.04 *Parking fees, tolls, interest, and taxes.* Parking fees and tolls attributable to use of the automobile for business purposes may be deducted as separate items. Likewise, interest relating to the purchase of the automobile as well as state and local

personal property taxes may be deducted as separate items, but only to the extent allowable under § 163 or § 164, respectively. Section 163(h)(2)(A) expressly provides that interest is nondeductible personal interest if it is paid or accrued on indebtedness properly allocable to the trade or business of performing services as an employee. Section 164 expressly provides that state and local taxes that are paid or accrued by a taxpayer in connection with an acquisition or disposition of property will be treated as part of the cost of the acquired property or as a reduction in the amount realized on the disposition of the property. If the automobile is operated less than 100 percent for business purposes, an allocation is required to determine the business and nonbusiness portion of the taxes and interest deduction allowable.

.05 Depreciation. For owned automobiles placed in service for business purposes, and for which the business standard mileage rate has been used for any year, depreciation will be considered to have been allowed at the rate of 15 cents per mile for 2002, 16 cents per mile for 2003 and 2004, and 17 cents per mile for 2005 and 2006, for those years in which the business standard mileage rate was used. If actual costs were used for one or more of those years, the rates above do not apply to any year in which actual costs were used. The depreciation described above will reduce the basis of the automobile (but not below zero) in determining adjusted basis as required by § 1016.

.06 Limitations.

(1) The business standard mileage rate may not be used to compute the deductible expenses of (a) automobiles used for hire, such as taxicabs, or (b) five or more automobiles owned or leased by a taxpayer and used simultaneously (such as in fleet operations).

(2) The business standard mileage rate may not be used to compute the deductible business expenses of an automobile leased by a taxpayer unless the taxpayer uses either the business standard mileage rate or a FAVR allowance (as provided in section 8 of this revenue procedure) to compute the deductible business expenses of the automobile for the entire lease period (including renewals). For a lease commencing on or before December 31, 1997, the "entire lease period" means the portion of the lease period (including renewals) remaining after that date.

(3) The business standard mileage rate may not be used to compute the deductible expenses of an automobile for which the taxpayer has (a) claimed depreciation using a method other than straight-line for its estimated useful life, (b) claimed a § 179 deduction, (c) claimed the special depreciation allowance under § 168(k), or (d) used the Accelerated Cost Recovery System (ACRS) under former § 168 or the Modified Accelerated Cost Recovery System (MACRS) under current § 168. By using the business standard mileage rate, the taxpayer has elected to exclude the automobile (if owned) from MACRS pursuant to § 168(f)(1). If, after using the business standard mileage rate, the taxpayer uses actual costs, the taxpayer must use straight-line depreciation for the automobile's remaining estimated useful life

(subject to the applicable depreciation deduction limitations under § 280F).

(4) The business standard mileage rate and this revenue procedure may not be used to compute the amount of the deductible automobile expenses of an employee of the United States Postal Service incurred in performing services involving the collection and delivery of mail on a rural route if the employee receives qualified reimbursements (as defined in § 162(o)) for the expenses. See § 162(o) for the rules that apply to these qualified reimbursements.

SECTION 6. RESERVED

SECTION 7. CHARITABLE, MEDICAL, AND MOVING STANDARD MILEAGE RATES

.01 *Charitable.* Section 170(i) provides a standard mileage rate of 14 cents per mile for purposes of computing the charitable contribution deduction for use of an automobile in connection with rendering gratuitous services to a charitable organization under § 170. The standard mileage rate is 32 cents per mile for purposes of computing the charitable contribution deduction for use of an automobile in providing donated services to charity for the provision of relief related to Hurricane Katrina. The standard mileage rate is 44.5 cents per mile for purposes of determining the amount that may be excluded from income by taxpayers who are reimbursed for the use of an automobile in providing donated services to charity for the provision of relief related to Hurricane Katrina.

.02 *Medical and moving.* The standard mileage rate is 18 cents per mile for use of an automobile (a) to obtain medical care described in § 213, or (b) as part of a move for which the expenses are deductible under § 217.

.03 Charitable, medical, or moving expense standard mileage rates in lieu of operating expenses. A deduction computed using the applicable standard mileage rate for charitable, medical, or moving expense miles is in lieu of all operating expenses (including gasoline and oil) of the automobile allocable to those purposes. Costs for items such as depreciation (or lease payments), insurance, and license and registration fees are not deductible, and are not included in the standard mileage rates.

.04 Parking fees, tolls, interest, and taxes. Parking fees and tolls attributable to the use of the automobile for charitable, medical, or moving expense purposes may be deducted as separate items. Interest relating to the purchase of the automobile and state and local personal property taxes are not deductible as charitable, medical, or moving expenses, but they may be deducted as separate items to the extent allowable under § 163 or § 164, respectively.

SECTION 8. FIXED AND VARIABLE RATE ALLOWANCE

.01 In general.

(1) The ordinary and necessary expenses paid or incurred by an employee in driving an automobile owned or leased by the employee in connection with the performance of services as an employee of the employer will be deemed substantiated (in an amount determined under section 9 of this revenue procedure) when a payor reimburses those expenses with a mileage allowance using a flat rate or stated schedule that combines periodic fixed and variable rate payments that meet all the requirements of section 8 of this revenue procedure (a FAVR allowance).

(2) The amount of a FAVR allowance must be based on data that (a) is

derived from the base locality, (b) reflects retail prices paid by consumers, and (c) is reasonable and statistically defensible in approximating the actual expenses employees receiving the allowance would incur as owners of the standard automobile.

.02 Computation of FAVR allowance.

(1) *FAVR allowance.* A FAVR allowance includes periodic fixed payments and periodic variable payments. A payor may maintain more than one FAVR allowance. A FAVR allowance that uses the same payor, standard automobile (or an automobile of the same make and model that is comparably equipped), retention period, and business use percentage is considered one FAVR allowance, even though other features of the allowance may vary. A FAVR allowance also includes any optional high mileage payments; however, optional high mileage payments are included in the employee's gross income, are reported as wages or other compensation on the employee's Form W-2, and are subject to withholding and payment of employment taxes when paid. See section 9.05 of this revenue procedure. An optional high mileage payment covers the additional depreciation for a standard automobile attributable to business miles driven and substantiated by the employee for a calendar year in excess of the annual business mileage for that year. If an employee is covered by the FAVR allowance for less than the entire calendar year, the annual business mileage may be prorated on a monthly basis for purposes of the preceding sentence.

(2) *Periodic fixed payment.* A periodic fixed payment covers the projected fixed costs (including depreciation (or lease payments), insurance, registration and license fees, and personal property taxes) of driving the standard automobile in

connection with the performance of services as an employee of the employer in a base locality, and must be paid at least quarterly. A periodic fixed payment may be computed by (a) dividing the total projected fixed costs of the standard automobile for all years of the retention period, determined at the beginning of the retention period, by the number of periodic fixed payments in the retention period, and (b) multiplying the resulting amount by the business use percentage.

(3) *Periodic variable payment.* A periodic variable payment covers the projected operating costs (including gasoline and all taxes thereon, oil, tires, and routine maintenance and repairs) of driving a standard automobile in connection with the performance of services as an employee of the employer in a base locality, and must be paid at least quarterly. The rate of a periodic variable payment for a computation period may be computed by dividing the total projected operating costs for the standard automobile for the computation period, determined at the beginning of the computation period, by the computation period mileage. A computation period can be any period of a year or less. Computation period mileage is the total mileage (business and personal) a payor reasonably projects a standard automobile will be driven during a computation period and equals the retention mileage divided by the number of computation periods in the retention period. For each business mile substantiated by the employee for the computation period, the periodic variable payment must be paid at a rate that does not exceed the rate for that computation period.

(4) *Base locality.* A base locality is the particular geographic locality or region of the United States in which the costs of driving an automobile in connection

with the performance of services as an employee of the employer are generally paid or incurred by the employee. Thus, for purposes of determining the amount of fixed costs, the base locality is generally the geographic locality or region in which the employee resides. For purposes of determining the amount of operating costs, the base locality is generally the geographic locality or region in which the employee drives the automobile in connection with the performance of services as an employee of the employer.

(5) *Standard automobile.* A standard automobile is the automobile selected by the payor on which a specific FAVR allowance is based.

(6) *Standard automobile cost.* The standard automobile cost for a calendar year may not exceed 95 percent of the sum of (a) the retail dealer invoice cost of the standard automobile in the base locality, and (b) state and local sales or use taxes applicable on the purchase of the automobile. Further, the standard automobile cost may not exceed \$27,400.

(7) *Annual mileage.* Annual mileage is the total mileage (business and personal) a payor reasonably projects a standard automobile will be driven during a calendar year. Annual mileage equals the annual business mileage divided by the business use percentage.

(8) *Annual business mileage.* Annual business mileage is the mileage a payor reasonably projects a standard automobile will be driven by an employee in connection with the performance of services as an employee of the employer during the calendar year, but may not be less than 6,250 miles for a calendar year. Annual business mileage equals the annual mileage multiplied by the business use percentage.

(9) *Business use percentage.* A business use percentage is determined by dividing the annual business mileage by the annual mileage. The business use percentage may not exceed 75 percent. In lieu of demonstrating the reasonableness of the business use percentage based on records of total mileage and business mileage driven by the employees annually, a payor may use a business use percentage that is less than or equal to the following percentages for a FAVR allowance that is paid for the following annual business mileage:

<i>Annual business mileage</i>	<i>Business use percentage</i>
6,250 or more but less than 10,000	45 percent
10,000 or more but less than 15,000	55 percent
15,000 or more but less than 20,000	65 percent
20,000 or more	75 percent

(10) *Retention period.* A retention period is the period in calendar years selected by the payor during which the payor expects an employee to drive a standard automobile in connection with the performance of services as an employee of the employer before the automobile is replaced. The period may not be less than two calendar years.

(11) *Retention mileage.* Retention mileage is the annual mileage multiplied by the number of calendar years in the retention period.

(12) *Residual value.* The residual value of a standard automobile is the projected amount for which it could be sold at the end of the retention period after being driven the retention mileage. The Service will accept the following safe harbor residual

values for a standard automobile computed as a percentage of the standard automobile cost:

<i>Retention period</i>	<i>Residual value</i>
2-year	70 percent
3-year	60 percent
4-year	50 percent

.03 FAVR allowance in lieu of operating and fixed costs.

(1) A reimbursement computed using a FAVR allowance is in lieu of the employee's deduction of all the operating and fixed costs paid or incurred by an employee in driving the automobile in connection with the performance of services as an employee of the employer, except as provided in section 9.06 of this revenue procedure. Items such as depreciation (or lease payments), maintenance and repairs, tires, gasoline (including all taxes thereon), oil, insurance, license and registration fees, and personal property taxes are included in operating and fixed costs for this purpose.

(2) Parking fees and tolls attributable to an employee driving the standard automobile in connection with the performance of services as an employee of the employer are not included in fixed and operating costs and may be deducted as separate items. Similarly, interest relating to the purchase of the standard automobile may be deducted as a separate item, but only to the extent that the interest is an allowable deduction under § 163.

.04 Depreciation.

(1) A FAVR allowance may not be paid with respect to an automobile for

which the employee has (a) claimed depreciation using a method other than straight-line for its estimated useful life, (b) claimed a § 179 deduction, (c) claimed the special depreciation allowance under § 168(k), or (d) used ACRS under former § 168 or MACRS under current § 168. If an employee uses actual costs for an owned automobile that has been covered by a FAVR allowance, the employee must use straight-line depreciation for the automobile's remaining estimated useful life (subject to the applicable depreciation deduction limitations under § 280F).

(2) Except as provided in section 8.04(3) of this revenue procedure, the total amount of the depreciation component for the retention period taken into account in computing the periodic fixed payments for that retention period may not exceed the excess of the standard automobile cost over the residual value of the standard automobile. In addition, the total amount of the depreciation component may not exceed the sum of the annual § 280F limitations on depreciation (in effect at the beginning of the retention period) that apply to the standard automobile during the retention period.

(3) If the depreciation component of periodic fixed payments exceeds the limitations in section 8.04(2) of this revenue procedure, that section will be treated as satisfied in any year during which the total annual amount of the periodic fixed payments and the periodic variable payments made to an employee driving 80 percent of the annual business mileage of the standard automobile does not exceed the amount obtained by multiplying 80 percent of the annual business mileage of the standard automobile by the business standard mileage rate for that year (under section 5.01 of

the applicable revenue procedure).

(4) The depreciation included in each periodic fixed payment portion of a FAVR allowance paid with respect to an automobile will reduce the basis of the automobile (but not below zero) in determining adjusted basis as required by § 1016. See section 8.07(2) of this revenue procedure for the requirement that the employer report the depreciation component of a periodic fixed payment to the employee.

.05 FAVR allowance limitations.

(1) A FAVR allowance may be paid only to an employee who substantiates to the payor for a calendar year at least 5,000 miles driven in connection with the performance of services as an employee of the employer or, if greater, 80 percent of the annual business mileage of that FAVR allowance. If the employee is covered by the FAVR allowance for less than the entire calendar year, these limits may be prorated on a monthly basis.

(2) A FAVR allowance may not be paid to a control employee (as defined in § 1.61-21(f)(5) and (6), excluding the \$100,000 limitation in paragraph (f)(5)(iii)).

(3) An employer may not pay a FAVR allowance if at any time during a calendar year a majority of the employees covered by the FAVR allowance are management employees.

(4) An employer may not pay a FAVR allowance to any employee unless at all times during a calendar year at least five employees in total are covered by FAVR allowances provided by the employer.

(5) A FAVR allowance may be paid only with respect to an automobile

(a) owned or leased by the employee receiving the payment, (b) the cost of which, as a new vehicle (whether or not purchased new by the employee), was at least 90 percent of the standard automobile cost taken into account for purposes of determining the FAVR allowance for the first calendar year the employee receives the allowance with respect to that automobile, and (c) the model year of which does not differ from the current calendar year by more than the number of years in the retention period.

(6) A FAVR allowance may not be paid with respect to an automobile leased by an employee for which the employee has used actual expenses to compute the deductible business expenses of the automobile for any year during the entire lease period. For a lease commencing on or before December 31, 1997, the "entire lease period" means the portion of the lease period (including renewals) remaining after that date.

(7) The insurance cost component of a FAVR allowance must be based on the rates charged in the base locality for insurance coverage on the standard automobile during the current calendar year without taking into account rate-increasing factors such as poor driving records or young drivers.

(8) A FAVR allowance may be paid only to an employee whose insurance coverage limits on the automobile with respect to which the FAVR allowance is paid are at least equal to the insurance coverage limits used to compute the periodic fixed payment under that FAVR allowance.

.06 *Employee reporting.* Within 30 days after an employee's automobile is initially covered by a FAVR allowance, or is again covered by a FAVR allowance if

coverage has lapsed, the employee by written declaration must provide the payor with the following information: (a) the make, model, and year of the employee's automobile, (b) written proof of the insurance coverage limits on the automobile, (c) the odometer reading of the automobile, (d) if owned, the purchase price of the automobile or, if leased, the price at which the automobile is ordinarily sold by retailers (the gross capitalized cost of the automobile), and (e) if owned, whether the employee has claimed depreciation with respect to the automobile using any of the depreciation methods prohibited by section 8.04(1) of this revenue procedure or, if leased, whether the employee has computed deductible business expenses with respect to the automobile using actual expenses. The information described in (a), (b), and (c) of the preceding sentence also must be supplied by the employee to the payor within 30 days after the beginning of each calendar year that the employee's automobile is covered by a FAVR allowance.

.07 Payor recordkeeping and reporting.

(1) The payor or its agent must maintain written records setting forth (a) the statistical data and projections on which the FAVR allowance payments are based, and (b) the information provided by the employees pursuant to section 8.06 of this revenue procedure.

(2) Within 30 days of the end of each calendar year, the employer must provide each employee covered by a FAVR allowance during that year with a statement that, for automobile owners, lists the amount of depreciation included in each periodic fixed payment portion of the FAVR allowance paid during that calendar year and

explains that by receiving a FAVR allowance the employee has elected to exclude the automobile from the Modified Accelerated Cost Recovery System pursuant to § 168(f)(1). For automobile lessees, the statement must explain that by receiving the FAVR allowance the employee may not compute the deductible business expenses of the automobile using actual expenses for the entire lease period (including renewals). For a lease commencing on or before December 31, 1997, the "entire lease period" means the portion of the lease period (including renewals) remaining after that date.

.08 Failure to meet section 8 requirements. If an employee receives a mileage allowance that fails to meet one or more of the requirements of section 8 of this revenue procedure, the employee may not be treated as covered by any FAVR allowance of the payor during the period of the failure. Nevertheless, the expenses to which that mileage allowance relates may be deemed substantiated using the method described in sections 5, 9.01(1), and 9.02 of this revenue procedure to the extent the requirements of those sections are met.

SECTION 9. APPLICATION

.01 If a payor pays a mileage allowance in lieu of reimbursing actual transportation expenses incurred or to be incurred by an employee, the amount of the expenses that is deemed substantiated to the payor is either:

(1) for any mileage allowance other than a FAVR allowance, the lesser of the amount paid under the mileage allowance or the applicable standard mileage rate in section 5.01 of this revenue procedure multiplied by the number of business miles substantiated by the employee; or

(2) for a FAVR allowance, the amount paid under the FAVR allowance less the sum of (a) any periodic variable rate payment that relates to miles in excess of the business miles substantiated by the employee and that the employee fails to return to the payor although required to do so, (b) any portion of a periodic fixed payment that relates to a period during which the employee is treated as not covered by the FAVR allowance and that the employee fails to return to the payor although required to do so, and (c) any optional high mileage payments.

.02 If the amount of transportation expenses is deemed substantiated under the rules provided in section 9.01 of this revenue procedure, and the employee actually substantiates to the payor the elements of time, place (or use), and business purpose of the transportation expenses in accordance with paragraphs (b)(2) (travel away from home) and (b)(6) (listed property, which includes passenger automobiles and any other property used as a means of transportation) of § 1.274-5T, and paragraph (c) of § 1.274-5, the employee is deemed to satisfy the adequate accounting requirements of § 1.274-5(f) as well as the requirement to substantiate by adequate records or other sufficient evidence for purposes of § 1.274-5(c). See § 1.62-2(e)(1) for the rule that an arrangement must require business expenses to be substantiated to the payor within a reasonable period of time.

.03 An arrangement providing mileage allowances will be treated as satisfying the requirement of § 1.62-2(f)(2) with respect to returning amounts in excess of expenses as follows:

(1) For a mileage allowance other than a FAVR allowance, the

requirement to return excess amounts will be treated as satisfied if the employee is required to return within a reasonable period of time (as defined in § 1.62-2(g)) any portion of the allowance that relates to miles of travel not substantiated by the employee, even though the arrangement does not require the employee to return the portion of the allowance that relates to the miles of travel substantiated and that exceeds the amount of the employee's expenses deemed substantiated. For example, assume a payor provides an employee an advance mileage allowance of \$97 based on an anticipated 200 business miles at 48.5 cents per mile (at a time when the business standard mileage rate is 44.5 cents per mile), and the employee substantiates 120 business miles. The requirement to return excess amounts will be treated as satisfied if the employee is required to return the portion of the allowance that relates to the 80 unsubstantiated business miles (\$38.80) even though the employee is not required to return the portion of the allowance (\$4.80) that exceeds the amount of the employee's expenses deemed substantiated under section 9.01 of this revenue procedure (\$53.40) for the 120 substantiated business miles. However, the \$4.80 excess portion of the allowance is treated as paid under a nonaccountable plan as discussed in section 9.05.

(2) For a FAVR allowance, the requirement to return excess amounts will be treated as satisfied if the employee is required to return within a reasonable period of time (as defined in § 1.62-2(g)), (a) the portion (if any) of the periodic variable payment received that relates to miles in excess of the business miles substantiated by the employee, and (b) the portion (if any) of a periodic fixed payment that relates to a period during which the employee was not covered by the FAVR allowance.

.04 An employee is not required to include in gross income the portion of a mileage allowance received from a payor that is less than or equal to the amount deemed substantiated under section 9.01 of this revenue procedure, provided the employee substantiates in accordance with section 9.02. See § 1.274-5T(f)(2)(i). In addition, that portion of the allowance is treated as paid under an accountable plan, is not reported as wages or other compensation on the employee's Form W-2, and is exempt from withholding and payment of employment taxes. See § 1.62-2(c)(2) and (c)(4).

.05 An employee is required to include in gross income the portion of a mileage allowance received from a payor that exceeds the amount deemed substantiated under section 9.01 of this revenue procedure, provided the employee substantiates in accordance with section 9.02 of this revenue procedure. See § 1.274-5T(f)(2)(ii). In addition, the excess portion of the allowance is treated as paid under a nonaccountable plan, is reported as wages or other compensation on the employee's Form W-2, and is subject to withholding and payment of employment taxes. See § 1.62-2(c)(3)(ii), (c)(5), and (h)(2)(i)(B).

.06 If an employee's substantiated expenses are less than the employee's actual expenses, the following rules apply:

(1) Except as otherwise provided in section 9.06(2) of this revenue procedure with respect to leased automobiles, if the amount of the expenses deemed substantiated under the rules provided in section 9.01 of this revenue procedure is less than the amount of the employee's business transportation expenses, the employee

may claim an itemized deduction for the amount by which the business transportation expenses exceed the amount that is deemed substantiated, provided the employee substantiates all the business transportation expenses, includes on Form 2106, Employee Business Expenses, the deemed substantiated portion of the mileage allowance received from the payor, and includes in gross income the portion (if any) of the mileage allowance received from the payor that exceeds the amount deemed substantiated. See § 1.274-5T(f)(2)(iii). However, for purposes of claiming this itemized deduction, substantiation of the amount of the expenses is not required if the employee is claiming a deduction that is equal to or less than the applicable standard mileage rate multiplied by the number of business miles substantiated by the employee minus the amount deemed substantiated under section 9.01 of this revenue procedure. The itemized deduction is subject to the 2-percent floor on miscellaneous itemized deductions provided in § 67.

(2) An employee whose business transportation expenses with respect to a leased automobile are deemed substantiated under section 9.01(1) of this revenue procedure (relating to an allowance other than a FAVR allowance) may not claim a deduction based on actual expenses under section 9.06(1) unless the employee does so consistently beginning with the first business use of the automobile after December 31, 1997. An employee whose business transportation expenses with respect to a leased automobile are deemed substantiated under section 9.01(2) of this revenue procedure (relating to a FAVR allowance) may not claim a deduction based on actual expenses.

.07 An employee may deduct an amount computed pursuant to section 5.01 of this revenue procedure only as an itemized deduction. This itemized deduction is subject to the 2-percent floor on miscellaneous itemized deductions provided in § 67.

.08 A self-employed individual may deduct an amount computed pursuant to section 5.01 of this revenue procedure in determining adjusted gross income under § 62(a)(1).

.09 If a payor's reimbursement or other expense allowance arrangement evidences a pattern of abuse of the rules of § 62(c) and the regulations thereunder, all payments under the arrangement will be treated as made under a nonaccountable plan. Thus, the payments are included in the employee's gross income, are reported as wages or other compensation on the employee's Form W-2, and are subject to withholding and payment of employment taxes. See § 1.62-2(c)(3), (c)(5), and (h)(2).

SECTION 10. WITHHOLDING AND PAYMENT OF EMPLOYMENT TAXES

.01 The portion of a mileage allowance (other than a FAVR allowance), if any, that relates to the miles of business travel substantiated and that exceeds the amount deemed substantiated for those miles under section 9.01(1) of this revenue procedure is subject to withholding and payment of employment taxes. See § 1.62-2(h)(2)(i)(B).

(1) In the case of a mileage allowance paid as a reimbursement, the excess described in section 10.01 of this revenue procedure is subject to withholding and payment of employment taxes in the payroll period in which the payor reimburses the expenses for the business miles substantiated. See § 1.62-2(h)(2)(i)(B)(2).

(2) In the case of a mileage allowance paid as an advance, the excess

described in section 10.01 of this revenue procedure is subject to withholding and payment of employment taxes no later than the first payroll period following the payroll period in which the business miles with respect to which the advance was paid are substantiated. See § 1.62-2(h)(2)(i)(B)(3). If some or all of the business miles with respect to which the advance was paid are not substantiated within a reasonable period of time and the employee does not return the portion of the allowance that relates to those miles within a reasonable period of time, the portion of the allowance that relates to those miles is subject to withholding and payment of employment taxes no later than the first payroll period following the end of the reasonable period. See § 1.62-2(h)(2)(i)(A).

(3) In the case of a mileage allowance that is not computed on the basis of a fixed amount per mile of travel (for example, a mileage allowance that combines periodic fixed and variable rate payments, but that does not satisfy the requirements of section 8 of this revenue procedure), the payor must compute periodically (no less frequently than quarterly) the amount, if any, that exceeds the amount deemed substantiated under section 9.01(1) of this revenue procedure by comparing the total mileage allowance paid for the period to the standard mileage rate in section 5.01 of this revenue procedure multiplied by the number of business miles substantiated by the employee for the period. Any excess is subject to withholding and payment of employment taxes no later than the first payroll period following the payroll period in which the excess is computed. See § 1.62-2(h)(2)(i)(B)(4).

(4) For example, assume an employer pays its employees a mileage

allowance at a rate of 48.5 cents per mile (when the business standard mileage rate is 44.5 cents per mile). The employer does not require the return of the portion of the allowance that exceeds the business standard mileage rate for the business miles substantiated (4 cents). In June, the employer advances an employee \$242.50 for 500 miles to be traveled during the month. In July, the employee substantiates to the employer 400 business miles traveled in June and returns \$48.50 to the employer for the 100 business miles not traveled. The amount deemed substantiated for the 400 miles traveled is \$178 and the employee is not required to return \$16. No later than the first payroll period following the payroll period in which the 400 business miles traveled are substantiated, the employer must withhold and pay employment taxes on \$16.

.02 The portion of a FAVR allowance, if any, that exceeds the amount deemed substantiated for those miles under section 9.01(2) of this revenue procedure is subject to withholding and payment of employment taxes. See § 1.62-2(h)(2)(i)(B).

(1) Any periodic variable rate payment that relates to miles in excess of the business miles substantiated by the employee and that the employee fails to return within a reasonable period, or any portion of a periodic fixed payment that relates to a period during which the employee is treated as not covered by the FAVR allowance and that the employee fails to return within a reasonable period, is subject to withholding and payment of employment taxes no later than the first payroll period following the end of the reasonable period. See § 1.62-2(h)(2)(i)(A).

(2) Any optional high mileage payment is subject to withholding and payment of employment taxes when paid.

SECTION 11. EFFECTIVE DATE

This revenue procedure is effective for (1) deductible transportation expenses paid or incurred on or after January 1, 2006, and (2) mileage allowances or reimbursements paid to an employee or to a charitable volunteer (a) on or after January 1, 2006, and (b) with respect to transportation expenses paid or incurred by the employee or charitable volunteer on or after January 1, 2006.

SECTION 12. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2004-64, as modified by Announcement 2005-71, is superseded.

DRAFTING INFORMATION

The principal author of this revenue procedure is John Roman Faron of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Mr. Faron at (202) 622-4930 (not a toll-free call).