INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Index (UIL) No.: 280F.04-03
CASE-MIS No.: TAM-102354-08

Director, Field Operations -

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayer =
Nationality =
Parent =
Distributor =
Brand A =
Brand B =
Department =
Rate A =
Rate B =
Rate C =
Date =
X =
Y =
Z =

ISSUE(S):

Whether Taxpayer is regularly engaged in the business of leasing automobiles, such that the automobiles leased under Taxpayer's employee vehicle leasing program are exempt under section 280F(c)(1) of the Internal Revenue Code from the depreciation limitations in sections 280F(a) and (b).

CONCLUSION:

The facts demonstrate that contracts to lease automobiles under the employee vehicle leasing program are entered into with some frequency over a continuous period of time, and are not occasional or incidental leasing activity. Therefore, under section 280F(c)(1) of the Code, the automobiles leased under the Taxpayer's employee vehicle leasing program constitute listed property leased by a person regularly engaged in the business of leasing such property, and the provisions of sections 280F(a) and (b), including the depreciation limitations therein, do not apply to the automobiles.

FACTS:

Parent is a Nationality conglomerate that manufactures, sells, and leases automobiles worldwide through various subsidiaries.

Taxpayer, a wholly-owned subsidiary of Parent, is a holding company that conducts Parent's manufacturing, research and development, sales, public relations, and marketing operations in the United States, Canada, and Mexico. Parent's retail leasing and financing operations in the United States are conducted by a different Parent subsidiary.

Distributor is a member of Taxpayer's affiliated group. Distributor is engaged in the wholesale distribution of newly-manufactured Brand A and Brand B automobiles, trucks, industrial equipment, and related replacement parts and accessories throughout the continental United States. Distributor also exports automobiles and related parts and accessories to Europe, Asia, and elsewhere.

Distributor administers an employee vehicle leasing program under which it leases Brand A and Brand B automobiles solely to Distributor employees, Distributor retirees, and Distributor affiliates. Except in the case of a retiree, the leases terminate automatically if the lessee ceases to be employed by Distributor or an affiliate. The leases are solely for the personal use of the automobile by the lessees and do not involve use of the automobile in the employee's employment-related activities for Distributor, and the leased automobile may not be used for hire or commercial purposes. Distributor generally does not enter into automobile leases outside of the program.

Distributor enters into a nine-page formal lease agreement with the lessee for every automobile leased under the program. These automobile leases have a lease term of one to three years. The leased vehicles are registered and titled in the name of Distributor, and all registration fees, insurance, and maintenance costs are paid by Distributor. The lessee pays for gasoline, oil, and fluids, and is responsible for a $Z deductible under the insurance coverage maintained on the vehicle by Distributor. An early termination fee is charged by Distributor if the employee defaults on the lease.

Distributor's employee base represents an extremely low credit risk due to lease payments being automatically deducted from payroll, and the program does not entail any advertising costs, dealer commissions, or collection fees. Consequently, the lease terms offered under the program are more favorable than the lease terms offered to the general public by other Parent affiliates. The employee lease cost depends on the vehicle model leased, and is designed to return to Distributor the wholesale price that Distributor charges to dealers for that model. The monthly lease cost is based on the length of the lease; the monthly rate is Rate A for a one-year lease, Rate B for a two-year lease, and Rate C for a three-year lease.

Distributor has operated the employee vehicle leasing program for several years, and enters into several thousand leases per year under the program. As of Date, Distributor had X automobiles under lease to employees, retirees, and affiliates.

The program is administered by Distributor's Department, overseen by a national manager. The Department is comprised of a staff of approximately Y employees, including four managers, and is configured into groups responsible for customer relations, administration (including accounting and billing), asset management, safety administration, and operations.

LAW AND ANALYSIS:

Section 167(a) of the Code allows as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear of property used in a trade or business or of property held for the production of income. Section 168(a) provides that, generally, the depreciation deduction provided by section 167(a) for any tangible property shall be determined using the applicable depreciation method, the applicable recovery period, and the applicable convention. Typically, automobiles are depreciated using the 200 percent declining balance method over a period of five years using the half-year convention.

Section 280F of the Code defines, and is applicable to, a class of property designated as "listed property". Section 280F(d)(4)(A) provides that, subject to certain exceptions, listed property means any passenger automobile, any other property used as a means of transportation (e.g., a bus, boat, or airplane), any property of a type generally used for purposes of entertainment, recreation, or amusement, any computer

or peripheral equipment, and any cellular telephone (or other similar telecommunications equipment). Enacted as part of the Tax Reform Act of 1984, section 179, 1984-3 (Vol.1) C.B. 221, section 280F was designed to reduce two specific abuses of the tax system by business taxpayers by deferring a portion of the depreciation deduction for listed property to later years in certain cases.

First, with regard only to passenger automobiles (one of the several classes of property included in listed property), Congress sought to discourage the purchase of expensive business vehicles in cases where a more economical vehicle would be suitable. In the Joint Committee on Taxation Staff (the "Joint Committee") report, Congress explained that the full benefit of accelerated depreciation should be available for the necessary costs of purchasing an automobile for business purposes, but that the extra expense of a luxury automobile provides a tax-free personal emolument that Congress believed should not qualify for accelerated depreciation because the extra expense would not add to the productivity that accelerated depreciation was designed to encourage. Joint Committee on Taxation Staff, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 98th Cong., 2d Sess. 559 (1984).

Section 280F(a) of the Code (the "annual depreciation limitation") accomplishes this objective by limiting depreciation deductions (and other cost recovery deductions, such as the expense deduction under section 179) for passenger automobiles to specific dollar amounts for each year of the depreciation period (indexed for inflation in subsequent years under section 280F(d)(7)).

Second, with regard to all types of listed property (not simply passenger automobiles), Congress sought to limit the use of accelerated depreciation for such property where there is excessive personal use by business owners and their employees. The Joint Committee explained that Congress was concerned about the use of accelerated depreciation with respect to automobiles and other property used primarily for personal or investment use rather than in the conduct of a trade or business, and that the incentive of accelerated depreciation was not designed to subsidize the purchase of personal property that is used incidentally or occasionally in the taxpayer's business. Joint Committee on Taxation Staff, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 98th Cong., 2d Sess. 559 (1984).

To this end, Congress enacted section 280F(b)(1) of the Code (the "predominant use limitation"), which provides that if any listed property is not predominantly used in a qualified business use for any taxable year, the deduction allowed under section 168 with respect to such property for such taxable year and any subsequent taxable year shall be determined under section 168(g) (relating to the alternative depreciation system, which provides only straight-line depreciation). Section 280F(b)(3) clarifies that property shall be treated as predominantly used in a qualified business use for any taxable year if the business use percentage for such taxable year exceeds 50 percent.

Section 280F(d)(6)(B) defines the term "qualified business use" as generally meaning any use in a trade or business of the taxpayer.

Section 280F(c)(1) of the Code provides that section 280F does not apply to any listed property leased or held for leasing by any person regularly engaged in the business of leasing such property. Section 1.280F-5T(a) of the Income Tax Regulations restates this rule, specifically referencing both the annual depreciation limitation and the predominant use limitation. The Conference Report states that the limits are instead applied to the lessee (under tables prescribed by the Secretary) by denying a deduction for the percentage of the lease payments that is substantially equivalent to the effect as if the restrictions were placed on the lessor. H.R. Rep. No. 861, 98th Cong., 2d Sess. 1025 (1984), 1984-3 (Vol. 2) C.B. 279.

Section 1.280F-5T(c) of the regulations states that, for purposes of section 1.280F-5T(a), a person shall be considered regularly engaged in the business of leasing listed property only if contracts to lease such property are entered into with some frequency over a continuous period of time. The determination shall be made on the basis of the facts and circumstances in each case, taking into account the nature of the person's business in its entirety. Occasional or incidental leasing activity is insufficient. For example, a person leasing only one passenger automobile during a taxable year is not regularly engaged in the business of leasing automobiles. In addition, an employer that allows an employee to use the employer's property for personal purposes and charges the employee for the use of the property is not regularly engaged in the business of leasing with respect to the property used by the employee.

At issue in this technical advice memorandum is whether the automobiles leased under the Taxpayer's employee vehicle leasing program are exempt from the annual depreciation limitation by virtue of section 280F(c)(1) of the Code. Under that section, if the Taxpayer is "regularly engaged in the business of leasing automobiles", as clarified by section 1.280F-5T(c) of the regulations, the automobiles in the employee vehicle leasing program are excluded from the operation of any provision of section 280F.

The field has conceded that Taxpayer is regularly engaged in its leasing operations. No implication has been raised that the leases involved in the employee vehicle leasing program are anything other than bona fide leases, notwithstanding that the lease rates are below fair market rates.

Section 1.280F-5T(c) of the regulations states that a person shall be considered regularly engaged in the business of leasing listed property only if contracts to lease such property are entered into with some frequency over a continuous period of time. Further, whether a taxpayer is regularly engaged in the business of leasing listed property is determined on the basis of the facts and circumstances of the case, taking into account the nature of the taxpayer's business in its entirety. In discussing this requirement, the regulation states that occasional or incidental leasing is not sufficient to

trigger the exclusion under section 280F(c)(1) of the Code. The regulation then gives examples of occasional or incidental leasing.

The technical advice submission contains discussion concerning whether the Taxpayer is in the trade or business of leasing automobiles, and whether the employee vehicle leasing program can be shown to operate at a profit. However, section 1.280F-5T(c) of the regulations provides a clear definition of "regularly engaged in the business of leasing" for purposes of section 280F(c)(1) of the Code that does not require a separate trade or business of leasing automobiles, and does not require a determinable profit motive for the activity. Instead, for purposes of section 280F(c)(1), the clear definition of "regularly engaged in the business of leasing" under section 1.280F-5T(c) requires that the contracts to lease listed property be entered into with some frequency over a continuous period of time and that the nature of the taxpayer's business in its entirety be taken into account in making this factual determination in each case. Therefore, for purposes of section 280F(c)(1), it is sufficient that the leasing activity is substantial with a reasonable connection to the overall business activities of the taxpayer.

In the instant case, the Taxpayer's business operations obtain a number of benefits from the leasing activity, including moving automobiles out of inventory and advertising its brand through putting additional Brand A and Brand B vehicles on the road. These benefits are reasonably and clearly related to the operation of the Taxpayer's primary business of selling Brand A and Brand B automobiles, and support the position that Taxpayer is engaged in the business of leasing automobiles.

While conceding that the Taxpayer's leasing operations are regular (i.e., the contracts are entered into with some frequency over a continuous period of time), the Director has asserted that the employee vehicle leasing program is incidental to the Taxpayer's overall business of selling automobiles and, as such, is not within the exclusion under section 280F(c)(1) of the Code.

The phrase "occasional or incidental" in §1.280F-5T(c) of the regulations is drawn directly from the Joint Committee explanation that the incentive of accelerated depreciation was not designed to "subsidize the purchase of personal property that is used incidentally or occasionally in the taxpayer's business", and its use in the regulations was meant to expand on the meaning of the phrase "entered into with some frequency over a continuous period of time" rather than to create a separate requirement. This meaning is illustrated by the example in the next sentence of the regulation, which states that a person leasing only one automobile during a taxable year is not regularly engaged in the business of leasing automobiles (presumably because the single lease constitutes occasional or incidental leasing).

The term "incidental" looks to whether the leasing activity is significant in relation to the overall business activities of the taxpayer, is reasonably related to those activities,

and is exercised in a planned and deliberate manner. Given that the Taxpayer's employee vehicle leasing program is administered by Y full-time employees, it is clear that the program is significant, planned and deliberate, and is not incidental.

In the analysis section of the technical advice memorandum request, the Director posits that the Taxpayer is not entitled to depreciation deductions for the automobiles leased under the employee vehicle leasing program because, pursuant to section 280F(d)(6)(C)(i)(III) of the Code, provision of the use of listed property (in this case, the purported excess between the lease rate and a fair market lease rate) to an employee (other than a five percent or greater owner or related party) of a taxpayer is not considered qualified business use by the taxpayer if an amount is not included in the employee's income for such use.

The rule enunciated in section 280F(d)(6)(C)(i)(III) of the Code relates to whether a particular portion of an employer's use of listed property may be counted as "qualified business use" for purposes of the predominant use limitation under section 280F(b) (i.e., the determination of whether the taxpayer is eligible for accelerated depreciation under section 168(a) rather than straight-line depreciation under section 168(g)). As established in the analysis above, the Taxpayer is regularly engaged in the business of leasing automobiles, and therefore section 280F, including section 280F(b), does not apply to the automobiles offered for lease under the employee vehicle leasing program.

CAVEAT(S):

This Technical Advice Memorandum does not address (i) the issue of whether the Taxpayer is required to treat as compensation to the employee for both income tax and employment tax purposes any difference between the rate paid by employees under the employee vehicle leasing program and the annual lease value, or (ii) whether any issues relating to substantiation of business use arise under section 274 of the Code as a consequence of a portion of the use of the automobile by an employee being so treated.

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