

# TAXTALK

## AUTOMOBILE BENEFITS AND DEDUCTIONS

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### HIGHLIGHTS

- **Company cars - employees may want to reimburse employer by February 14, 2006 for their automobile operating costs.**
- **Employee-owned/leased cars - how to compensate employees who use their car for employment/business purposes.**
- **Automobile limits and deductions - some changes for 2006.**

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Specific income tax rules and regulations define the tax benefits related to **employer-provided automobiles and the deductibility of automobile expenses**. The detailed rules are complex. This TaxTalk will:

- (i) outline the rules for employees who use an employer-provided automobile for personal use;
- (ii) discuss options to reimburse an employee for employment use of their automobile;
- (iii) discuss planning options and opportunities related to automobiles; and
- (iv) summarize the current income tax limits related to automobiles.

In computing benefits and deductions, it is critical to distinguish between **personal and business use**. In this regard, the Canada Revenue Agency's (CRA) viewpoint is that travel between an employee's residence and his or her regular place of work is considered to be **personal**, even if the employee may have to return to work after regular hours. Where the employee is on call, the CRA considers the primary purpose of such travel to be personal. Travel first from an employee's home to a customer or a business destination that is not the employee's normal place of business, and then to the office, is considered to be for business purposes.

### Taxable Benefits - Employer-Provided Automobiles

Where an employer provides an automobile to an employee, the employee receives a benefit with respect to their **personal use** of the automobile. This benefit is taxable to the employee. For income tax purposes, there are two components to this benefit calculation:

- a **standby charge benefit** based on the fact that the automobile is available for personal use; and
- an **operating cost benefit** based on the portion of the operating costs paid by the employer that relate to the personal use of the automobile.

Operating costs include all expenses of an automobile such as gas, oil, repairs (net of any insurance reimbursement), maintenance, licences, and insurance.

Employer-paid parking costs are not considered to be operating costs for this purpose, but any benefit received by an employee that is related to employer-paid parking is included in taxable income.<sup>1</sup>

The employer is liable for Goods and Services Tax (GST), based on the employee's standby charge and operating cost benefits.

### ***Standby Charge Benefit***

For **corporate-owned** automobiles, the standby charge is computed as 2 percent<sup>2</sup> of the actual cost (including Provincial Sales Tax (PST) and GST) of the automobile to the employer for each month that the automobile was made available to the employee (or related person) in the year.

For example, if the cost of an automobile was \$30,000 (including PST and GST) and the automobile was made available for 365 days in 2005, then the standby charge would be \$7,200 (2% x \$30,000 x 12).

For **corporate-leased** automobiles, the standby charge is computed as two-thirds of the lease payments (including PST and GST, but excluding insurance paid to the lessor).

The standby charge is reduced where the automobile is used primarily (50% or more) for business or employment purposes **and** the personal kilometres do not exceed 1,667 kilometres per month (20,004 kilometres for the year).

For example, where the automobile referred to above was used at least 50% for business **and** the personal-use kilometres were 8,000 kilometres for the year, the standby charge benefit for 2005 would be

<sup>1</sup> Any benefit received by an employee related to employer-paid parking is to be included in taxable income under paragraph 6(1)(a) of the Income Tax Act.

<sup>2</sup> For employees principally employed in selling or leasing automobiles, the 2 percent rate is decreased to 1.5 percent per month, based on the *average cost* of all automobiles purchased by the employer in the year.

reduced from \$7,200<sup>3</sup> to \$2,880 ( $\$30,000 \times 2\% \times 12 \times 8,000/20,004 \text{ km}$ ).

The standby charge benefit is also reduced by employee reimbursements in the calendar year, other than those reimbursements related to operating costs.

### ***Operating Cost Benefit***

The second taxable benefit related to an employer-provided automobile is referred to as the operating cost benefit.

Where an employer provides an automobile to an employee and the employer pays part or all of the operating expenses, the employee receives a taxable benefit related to the personal-use portion of the operating costs. In general, the 2005 operating cost benefit is computed at 20 cents per personal kilometre.<sup>4</sup>

However, where the employee's annual business-related use **exceeds 50%** of total use **and** the employee **notifies the employer in writing**, the operating cost benefit can be calculated as one-half of the standby charge (before any reimbursements for the standby charge) less any reimbursement made by the employee to his or her employer for the operating costs benefit.

For example, assume a company car costs \$35,000 (including PST and GST), personal use is 15,000 kilometres, and total use is 35,000 kilometres. In this case, the employee's standby charge for 2005 is \$6,300 ( $\$35,000 \times 2\% \times 12 \times 15,000/20,004 \text{ km}$ <sup>5</sup>). The employee reimburses the employer \$500 for the operating cost benefits.

<sup>3</sup> Note that under legislation prior to 2003, there would have been no reduction in the standby charge since personal use was not less than 10% of total use. This change in the law represented a potential significant tax savings to employees with employer-provided automobiles.

<sup>4</sup> The operating cost benefit is calculated at 20 cents per personal-use kilometre (17 cents for employees principally employed in selling or leasing automobiles).

<sup>5</sup> Since the personal-use kilometres are 15,000 out of 35,000 total kilometres driven, the automobile use is primarily for business (>50%), and the employee can elect to have the operating cost benefit computed at one-half of the standby charge benefit.

As outlined above, there are two options for calculating the operating costs benefit. Option 1 is based on the per kilometre rate. In this case, the result is \$2,500 (15,000 km x 20 cents/km less \$500 reimbursement). Option 2 is based on the \$6,300 standby charge. The result is \$2,650 [(6,300 x 50%) - \$500]. In this example, the employee is better off with Option 1.

As detailed in our Year End Tax Planning TaxTalk,<sup>6</sup> an employee **was required to notify, in writing, his or her employer by December 31, 2005**, if they wanted their operating cost benefit to be computed at one-half of the standby charge benefit.

**Planning to Reduce Operating Cost Benefits**

As indicated, the amount of the operating cost benefit is reduced by amounts repaid by the employee to the employer for the actual personal operating costs paid by the employer.

In determining the amount of employer repayment, repayments made within 45 days of the calendar year are taken into account, i.e., for 2005, by February 14, 2006. In some cases, it may be prudent for the employee to **repay the full personal-use operating costs by February 14, 2006**.

For example, assume the following:

Total kilometres driven by employee in 2005	45,000
Personal kilometres - 2/3	30,000
Business kilometres - 1/3	15,000

The employer pays \$1,500 for car insurance, (including PST). All other operating costs (fuel, repairs, licensing etc.) are paid by the employee.

<sup>6</sup> For more information, please refer to TaxTalk 2005 Issue 3, Year End Tax Planning 2005.

In these circumstances, the following result will occur:

Calculated taxable benefit at 20 cents per personal kilometre (30,000 km x \$0.20/km) <sup>7</sup>	\$6,000 (A)
Actual personal advantage that employee received (30,000/45,000 x \$1,500)	<u>1,000 (B)</u>
Phantom Benefit (A - B)	<u>\$5,000</u>
Personal tax payable on phantom benefit	
- at 46.41% (2005 top marginal rate), approximately	<u>\$2,320</u>
- at 40% marginal rate, approximately	<u>\$2,000</u>

Thus, if the employee does **not** pay \$1,000<sup>8</sup> to the employer by February 14, 2006, he or she will be liable for the higher personal tax based on the operating cost taxable benefit calculated at 20 cents per kilometre or \$6,000. This result would be unjust to the employee.

To avoid this injustice, the employee could, in our example, pay \$1,000 to his or her employer **by February 14, 2006**. The overall cash savings to the employee would range from \$1,400 to \$1,785<sup>9</sup> using the assumed marginal tax rates of the employee as indicated above, (i.e., 40% or 46.41%).

In our example above, we assumed that the employer paid the insurance for the automobile. Similar results may arise from any other operating expenses paid by the employer, such as gas or repairs and maintenance.

It is important to note that **all** of the personal-use operating costs must be reimbursed or the operating cost benefit will be calculated at the 20 cents per personal kilometre rate less the actual repayment made for 2005.

<sup>7</sup> Since personal use exceeds 50% in this example, the employee cannot elect to have the operating cost benefit computed at one-half of the standby charge.

<sup>8</sup> The \$1,000 represents the personal portion of the operating expenses paid by the employer, i.e., 2/3 of \$1,500.

<sup>9</sup> Payment of the \$1,000 would remove the \$6,000 taxable benefit, resulting in a tax savings of approximately \$2,785 (applying the top marginal rate of 46.41% for 2005). The net savings to the employee is the tax savings of \$2,785 less the \$1,000 cash outlay, resulting in net savings of \$1,785.

For example, if the personal-use advantage is subsequently determined to exceed \$1,000, and only \$1,000 is reimbursed by February 14, 2006, the taxable benefit attracting tax would be \$5,000 (\$6,000 less \$1,000 reimbursed). In addition, if the employee pays a third party in respect of costs of operating the employer-provided automobile, the payments do **not** reduce the operating cost benefit.

Consideration could be given to paying additional salary to the employee to enable him or her to make the repayment. For example, an additional salary of \$1,000 could assist the employee<sup>10</sup> to repay the personal portion of the automobile operating costs paid by the employer, generally without any net cash cost to the employer, (i.e., the employee would pay the \$1,000 back to the employer as a reimbursement).

For employees who have a personal-use percentage that is less than 50 percent of total use, it is possible that their taxable benefit for operating costs may be reportable at less than 20 cents per kilometre, since, in these circumstances, the employee has the option of computing their taxable benefit at one-half of the standby charge.<sup>11</sup>

In these cases, to determine whether or not a repayment should be made by February 14, 2006, a comparison should be made of the tax otherwise payable on the benefit as computed under this method to the cash payment required by the employee to remove the taxable benefit from income.

### **Should the Company or the Employee Buy/Lease the Automobile?<sup>12</sup>**

The current standby charge rules (applicable to years after 2002) make company cars more attractive in certain situations.

<sup>10</sup> The employee would incur personal tax on the additional \$1,000 of salary.

<sup>11</sup> As outlined above, the standby charge is generally calculated as 2 percent per month of the original capital cost, or 2/3 of the lease costs of the automobile.

<sup>12</sup> Keep in mind that there are two decisions to be made when buying or leasing an automobile for business use. The first decision concerns whether it is better to lease or (borrow to) buy. The second decision is whether to have the company or the employee lease or buy the car.

### *For Employees*

In many cases where the automobile is used at least 50% for employment purposes, the standby charge benefit to the employee will be reduced, which will lead to reduced tax being paid by the employee.

### *For Owners who are Employees*

For owner-managers the issue of whether to have the company buy or lease the car is still uncertain and will depend on the facts and circumstances of each case.

Under the previous standby charge rules, it was more beneficial in most cases<sup>13</sup> for owner-managers to buy an automobile personally and be reimbursed for their business-use, rather than have the corporation buy the automobile and make it available to the owner-manager.

Under the current standby charge rules, corporate ownership may be preferred in more instances than before. Any analysis to compare personal vs. corporate ownership would need to compare after-tax cash flow of the two options.

Some general comments can be made to provide a form of guidance in this area:

1. Where business/employment use is *90% or more*, and personal kilometres are relatively low, then a corporate-owned or corporate-leased automobile will generally lead to higher after-tax cash flow.
2. Where business/employment use is *less than 50%*, then personal ownership or a personal lease is the generally preferred decision.
3. Where business/employment use is *between 50 and 90%*, the conclusion as to whether the company or the employee<sup>14</sup> should purchase or lease the car will depend on the facts in each case.

<sup>13</sup> For many, under the previous rules, it was difficult to access the reduced standby charge, due to the high percentage of business-use kilometres required (at least 90%) and the low number of personal kilometres allowed ( $\leq 12,000$  kilometres).

<sup>14</sup> It should be noted that personal ownership, where the employee is reimbursed with a tax-free allowance [as discussed below] is generally much easier to administer than corporate ownership.

There is no general rule of thumb that applies to each case, and the difference in after-tax cash flow between corporate or personal ownership can be significant in some cases.

Factors that must be taken into account in an analysis of this ownership/leasing issue include the following: the purchase or lease cost of the car, the percentage of personal use, the amount of personal kilometres driven, the total kilometres driven, and the personal and corporate tax rates.

We must stress that the comments above provide only general guidelines. We could not review all variations, and therefore there may be instances where the guidelines do not apply. Accordingly, each situation should be considered based on its own set of facts - i.e., no decision should be made based solely on the general guidelines presented herein.

### General Overview of Rules Where the Employee Provides an Automobile

The above discussion has outlined rules and planning opportunities where an **employer** provides an employee with an automobile that is used for personal purposes.

Different tax rules apply where an **employee uses his or her own automobile** in performing their duties of employment. In these cases, the employer may compensate the employee for use of the automobile by one or a combination of the following options:

1. kilometre-based allowance,
2. reimbursement and/or accountable advance, or
3. flat periodic allowance.

Options 1 and 2 will lead to the same income tax and GST implications for the employee and the employer. Option 3 will subject the employee and the employer to a different income tax and GST consequences.

#### Option 1 - Kilometre-Based Allowances

CRA considers an allowance to mean any periodic or other payment that an employee receives from an employer, in addition to salary or wages, without having to account for its use.

#### Income Tax Rules

- A *reasonable* allowance based on kilometres driven for employment purposes by an employee is **not a taxable benefit** to the employee. The employee is responsible to keep track of their employment related kilometres.
- The deduction by the employer for the non-taxable allowance is restricted to \$0.45/km for the first 5,000 of employment-related kilometres in the year and \$0.39/km for employment-related kilometres over 5,000.<sup>15</sup>
- The **employee cannot deduct** his or her actual automobile expenses on the employee's personal income tax return.

#### GST Rules

- The employer can claim an Input Tax Credit for the allowance paid (7/107 of the amount paid).
- The employee **cannot** claim a GST rebate because the automobile expenses are not being claimed as a deduction.

#### Option 2 - Reimbursements and/or Accountable Advances

A **reimbursement** means a payment by an employer to an employee to repay the employee for amounts spent by the employee on the employer's business. An **accountable advance** means an amount given to an employee for expenses to be incurred by the employee on the employer's business and to be accounted for by the production of vouchers and the return of any amount not so spent.

#### Income Tax Rules

- Reimbursements and accountable advances are **not taxable** to an employee, provided that they do not relate to the employee's personal expenses.

<sup>15</sup> These limits apply to the 2005 calendar year. For 2006, the per kilometre limits are increased as outlined below - see "Automobile Rates for 2006".

- CRA's administrative position is that where payments in the nature of accountable advances are made to an employee for automobile expenses, they will **not be** required to be included in the employee's income, provided that **all** of the following conditions are met:
  1. there is a pre-established per-kilometre rate;
  2. the rate and the advance are **reasonable** in the circumstances;
  3. there must be a reconciliation to actual kilometres traveled for business/employment purposes no later than the earlier of the calendar year-end or, where an employee ceases to be employed during the year, at the time the employment ceases. At that time, if the employee was overpaid, the excess amount must be returned by the employee to the employer. If, on the other hand, the employee was underpaid, the deficiency must be made up by the employer (Note: simply reporting any excess on the employee's T4 supplementary will not be acceptable); **and**
  4. no other provisions of the Income Tax Act apply to require the inclusion of the advance in income.
- The deduction (for 2005) by the employer for an accountable advance paid will be restricted to the \$0.45/\$0.39 per km limits, as outlined above for Option 1.
- The **employee cannot deduct** the actual automobile expenses on the employee's personal tax return.

#### *GST Rules*

- The employer can claim an Input Tax Credit for the receipts and accountable advances paid.
- The employee **cannot** claim a GST rebate because the automobile expenses are not being claimed.

### **Option 3 - Flat Periodic Automobile Allowances**

#### *Income Tax Rules*

- Flat periodic amounts<sup>16</sup> received are **not** considered to be reasonable and accordingly are **taxable** to an employee and are subject to income tax withholding by the employer at source.
- The employee may deduct automobile expenses related to employment on their personal income tax return.<sup>17</sup> To be deductible, certain conditions must be met and the expenses must be reasonable in the circumstances and supportable by vouchers. The vouchers need not be filed with the employee's income tax return; however, they must be retained for examination upon request by CRA.
- The allowance paid by the employer is fully deductible, even if it is above the per kilometre limits.

#### *GST Rules*

- The employer **cannot** claim an Input Tax Credit on a flat monthly allowance paid.
- The employee can claim a GST rebate because the flat monthly allowance paid is taxable and the employee may be able to claim automobile expenses on the employee's personal tax return.

As can be seen, this option creates more tax reporting for the employer and employee.

### **Automobile Rates for 2006**

In our discussion above, we have outlined the tax rules related to employer and employee-provided automobiles. The rules provide rates and limits to compute employee benefits and deductions, and employer deductions. There have been changes to the operating cost benefit amounts and the per kilometre limits deductions for 2006.

<sup>16</sup> For instance, a fixed monthly amount that is not linked to business/employment-related kilometres driven.

<sup>17</sup> To deduct expenses, the employee must receive a Form T2200 from their employer.

### Benefits for Employer-Provided Automobile

The operating cost benefit applicable for personal driving of an employer-provided automobile is 22 cents (2005 - 20 cents) per personal kilometre (and 19 cents (2005 - 17 cents) for employees principally employed in selling or leasing automobiles), applicable to kilometres driven on or after January 1, 2006. These rates reflect operating costs only, and are in addition to the basic benefit amount for having an employer-owned or leased automobile available for personal use (i.e., the standby charge).

### Limits on Deductions

For 2006, the per kilometre deduction by an employer for allowances paid to an employee increases to 50 cents (2005 - 45 cents) per business kilometre for the first 5,000 kilometres and 44 cents (2005 - 39 cents) on each additional business kilometre.

For some cars, such as automobiles with special features, a reasonable (i.e., tax-free to the recipient) allowance may in fact be higher than these general amounts; however, in these cases, although the higher allowance may be "reasonable" and thus tax-free to the employee, the employer's allowable expense deduction is restricted to the 50/44 cent per kilometre limits.

To illustrate, if an employee drives his car 10,000 kilometres for business use and receives a 55 cent per kilometre allowance, the \$5,500 allowance can be received tax-free by the employee; however, the tax deduction of the allowance to the employer would be based on the 50/44 cent limits and would be \$4,700.

The Income Tax Act provides limits on the deductibility of various expenses relating to passenger automobiles. The deduction for capital cost allowance (CCA), interest and lease costs are subject to the following limits, which have **not changed** for the 2006 calendar year:

- the ceiling for the addition to the undepreciated capital cost pool when acquiring a new passenger automobile remains at \$30,000, plus PST and GST;
- the limit on tax deductible leasing costs remains at \$800 per month, plus PST and GST, effective for leases entered into after 2002;<sup>18</sup>
- the maximum allowable interest deduction for amounts borrowed to purchase an automobile remains at \$300 per month for funds borrowed after 2002.

<sup>18</sup> A separate restriction limits deductible lease costs where the manufacturer's list price (when new) of the automobile exceeds the \$30,000 capital cost ceiling. Further, large up-front lump-sum payments or refundable deposits can also restrict an automobile lease deduction.

A memorandum of this nature cannot be all-encompassing and is not intended to replace professional advice. Its purpose is to highlight tax planning possibilities and identify areas of possible concern. Anyone wishing to discuss the contents or to make any comments or suggestions about this TaxTalk is invited to contact one of our offices.

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