

# TAXTALK

## AUTOMOBILE BENEFITS AND DEDUCTIONS

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### HIGHLIGHTS

*Company cars - employees may want to reimburse employer by February 14, 2010 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 - no changes for 2010.*

Specific income tax rules and regulations define the tax benefits with respect 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. However, travel first from an employee's home to a customer or a business destination that is not the employee's normal place of employment, and then to the office, is considered to be for employment purposes. Also, travel at the end of the day to a customer, and then to home is considered to be for employment 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 relates to the personal use of the automobile.

Operating costs include all expenses of running<sup>1</sup> an automobile such as gas, oil, repairs (net of any insurance reimbursement), maintenance, licences, and insurance.

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

### CONTENTS

Taxable Benefits - Employer-Provided Automobiles.....	1
Planning to Reduce Operating Cost Benefits .....	2
Should the Company or the Employee Buy/Lease the Automobile? .....	3
General Overview of Rules where the Employee Provides an Automobile .....	4
Automobile Rates for 2010 .....	6

<sup>1</sup> Operating costs do not include parking, capital cost allowance, lease payments or interest.

### Standby Charge Benefit

For **corporate-owned** automobiles, the standby charge is computed at 2%<sup>2</sup> of the actual cost (including Provincial Sales Tax (PST) and GST)<sup>3</sup> 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)<sup>3</sup> and the automobile was made available for 365 days in 2009, then the standby charge would be \$7,200 (2% x \$30,000 x 12).

For **corporate-leased** automobiles, the standby charge is computed at 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, if in 2009 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 the year would be reduced from \$7,200 to \$2,880 (\$30,000 x 2% x 12 x 8,000/20,004 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 2009 operating cost benefit is computed at 24 cents per personal-use kilometre<sup>4</sup>.

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

<sup>3</sup> Starting July 1, 2010, PST will be replaced by the Ontario Harmonized Sales Tax (HST). The rate for Ontario HST will be 8% which is the same rate presently used for the PST. Corporations that are considered Large Businesses (generally those making taxable supplies > \$10 million), will be subject to a temporary recapture of certain input tax credits, including input tax credits on specified road vehicles and the related fuel and parts.

<sup>4</sup> The 2009 benefit is calculated at 21 cents per personal-use kilometre for employees principally employed in selling or leasing automobiles.

However, where the employee's annual business-related use **exceeds 50%** of total use **and** the employee **notifies the employer in writing by December 31, 2009**, the operating cost benefit can be calculated as one-half of the standby charge (before any reimbursements for the standby charge).

The operating cost benefit may be reduced by any reimbursement made by the employee by February 14<sup>th</sup> of the following year to his or her employer for the operating costs.

For example, assume a company car costs \$35,000 (including PST and GST)<sup>3</sup>, and in 2009 personal use is 15,000 kilometres, total use is 35,000 kilometres, and the employee reimburses the employer \$500 for the operating cost benefits.

In this case, the employee's standby charge for 2009 is \$6,300 (\$35,000 x 2% x 12 x 15,000/20,004 km)<sup>5</sup>. As outlined above, there are two options for calculating the operating costs benefit:

- Option 1 is based on the per kilometre rate. The result is \$3,100 (15,000 km x 24 cents/km - \$500 reimbursement).
- Option 2 is based on the standby charge. The result is \$2,650 ([(\$6,300 standby charge x 50%]) - \$500 reimbursement).

In this example, the employee has a lower taxable benefit with Option 2.

As detailed in our Year End Tax Planning TaxTalk, an employee **was required to notify, in writing, his or her employer by December 31, 2009**, 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 2009 repayments, by February 14, 2010. In some cases, it may be prudent for the employee to **repay the full personal-use operating costs by February 14, 2010**.

<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.

For example, assume the following:

Total kilometres driven by employee in 2007	45,000
Personal kilometres – 2/3	30,000
Business kilometres – 1/3	15,000

The employer pays \$1,500 for car insurance, (including PST)<sup>6</sup>. All other operating costs (fuel, repairs, licensing etc.) are paid by the employee.

In these circumstances, the following result will occur:

Calculated taxable benefit at 24 cents per personal kilometre (30,000 km x 24 cents/km) <sup>7</sup>	(A)	\$ 7,200
Actual personal advantage that employee received (30,000/45,000 x \$1,500)	(B)	<u>1,000</u>
Phantom Benefit	(A - B)	<u>\$6,200</u>

Approximate personal tax on phantom benefit:

- at 40% marginal rate,	<u>\$2,480</u>
- at 46.41% (2009 top marginal rate),	<u>\$2,880</u>

Thus, if the employee does **not** pay \$1,000<sup>8</sup> to the employer by February 14, 2010, he or she will be liable for the higher personal tax based on the operating cost taxable benefit calculated at 24 cents per kilometre or \$7,200. This result would be unfair to the employee.

To avoid this injustice, the employee could, in our example, pay \$1,000 to his or her employer **by February 14, 2010**. The overall cash savings to the employee would be \$1,880 to \$2,340<sup>9</sup> using the assumed range of marginal tax rates of the employee as indicated above, (i.e., 40% to 46.41%).

In our example above, it is assumed that the employer only 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.

<sup>6</sup> To be replaced by a special Ontario tax on insurance when HST commences on July 1, 2010.

<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 \$7,200 taxable benefit, resulting in a tax savings of approximately \$3,340 (applying the top marginal rate of 46.41% for 2009). The net savings to the employee is the tax savings of \$3,340 less the \$1,000 cash outlay, resulting in net savings of \$2,340.

It is important to note that **all** of the personal-use operating costs must be reimbursed by February 14, 2010 for the operating cost benefit to be reduced.

For example, if the personal-use advantage is subsequently determined to exceed \$1,000, and only \$1,000 is reimbursed by February 14, 2010, the taxable benefit attracting tax would be \$6,200 (\$7,200 less \$1,000 reimbursed).

The reimbursement with respect to operating costs **must be made to the employer**. 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).

To determine whether or not a repayment should be made by February 14, 2010, the net cost to the employee of the reimbursement required to eliminate the operating cost benefit from income should be compared to the income tax payable on the operating cost benefit, before any reimbursement is made by the employee.

### Should the Company or the Employee Buy/Lease the Automobile?<sup>11</sup>

The current standby charge rules make company cars more attractive in certain situations.

#### 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.

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

<sup>11</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 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.

Before changes to the standby charge rules, it was generally more beneficial<sup>12</sup> for the owner-manager to buy an automobile personally and be reimbursed for the 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 of 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:

- 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.
- Where business/employment use is *less than 50%*, then personal ownership or a personal lease is the generally preferred decision.
- Where business/employment use is *between 50 and 90%*, the conclusion as to whether the company or the employee<sup>13</sup> should purchase or lease the car will depend on the facts in each case.

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 cost of financing, the percentage of personal use, the amount of personal kilometres driven, the total kilometres driven, and the personal and corporate income tax rates.

The comments above provide only general guidelines. It is not possible to review all variations, and therefore there may be instances where the guidelines do not apply. Accordingly, each situation should be considered based

<sup>12</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>13</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.

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 when 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/HST<sup>3</sup> implications for the employee and the employer. Option 3 will subject the employee and the employer to a different income tax and GST/HST<sup>3</sup> consequence.

### **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 52 cents per kilometre for the first 5,000 of employment-related kilometres in the year and 46 cents per kilometre for employment-related kilometres over 5,000<sup>14</sup>.
- The **employee cannot deduct** his or her actual automobile expenses on the employee's personal income tax return.

<sup>14</sup> These limits apply to the 2009 calendar year. For 2010, there is no change in the per km rates.

*GST/HST<sup>3</sup> Rules*

- The employer can claim an input tax credit (ITC) for the allowance paid (5/105 or 13/113 of the amount paid for 2009).
- 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.
- 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 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 2009) by the employer for an accountable advance paid will be restricted to the 52/46 cents per kilometre limits, as outlined above for Option 1.
- The **employee cannot deduct** the actual automobile expenses on the employee's personal tax return.

*GST/HST<sup>3</sup> Rules*

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

**Option 3 - Flat Periodic Automobile Allowances***Income Tax Rules*

- Flat periodic amounts<sup>15</sup> received are **not** considered 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>16</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/HST<sup>3</sup> Rules*

- The employer **cannot** claim an ITC 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 both the employer and employee.

<sup>15</sup> For instance, a fixed monthly amount that is not linked to business/employment-related kilometres driven.

<sup>16</sup> To deduct expenses, the employee must receive a Form T2200 from their employer.

### Automobile Rates for 2010

	<b>2010</b>	2009
	<b>\$</b>	<b>\$</b>
Cost Limit in Ontario	<b>30,000</b>	30,000
(plus GST & PST or HST)	<b>33,900</b>	33,900
MSLP Limit (Cost/.85)	<b>39,882</b>	39,882
Monthly Lease Limit in Ontario	<b>800</b>	800
(plus GST & PST or HST)	<b>904</b>	904
Monthly Interest Limit	<b>300</b>	300
Maximum Deductible Cents per km		
1st 5,000 km	<b>52¢</b>	52¢
Km in excess of 5,000	<b>46¢</b>	46¢
Standby Operating Expense Income Inclusion		
All other employees	<b>24¢</b>	24¢
Persons employed in selling automobiles	<b>21¢</b>	21¢

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.

Offices: 10 Bay Street, Suite 600  
(Bay Street and Queen's Quay)  
Toronto, Ontario M5J 2R8

Phone: (416) 362-0515  
Fax: (416) 362-0539

8501 Mississauga Rd, Suite 100  
(Steeles Avenue and Mississauga Road)  
Brampton, Ontario L6Y 5G8

Phone: (905) 451-4788  
Fax: (905) 451-3299

*TaxTalk is prepared by our Tax Group (taxtalk@mgca.com)*