Congress Misfires on SUV Loophole

By Professor Andrew Pike

The Internal Revenue Code (IRC) provides special tax treatment for purchasers of gas-guzzling, jumbo Sports Utility Vehicles (SUVs). Congress had the opportunity to remedy this situation when it considered tax legislation in 2004, but it did not do so. Instead, it enacted a limited measure that retains excessive, (albeit reduced) tax benefits for the affluent few who feel the need to acquire a Hummer-class vehicle.

Why would Congress create an incentive that is limited to some of the most luxurious, high-cost, and least fuel-efficient vehicles on the road? The simple answer is that Congress never enacted an IRC provision that either requires, or explicitly encourages, taxpayers to purchase these gas-guzzlers. Rather, it has enacted several sensible provisions which, when considered together, produce a seemingly incongruous set of incentives due to the complexities of the IRC and the interplay of unrelated provisions.

This article discusses the creation of the SUV tax break and examines: (1) the special tax benefits available for motor vehicle purchasers, (2) the IRC's cost recovery provisions that govern the tax treatment of new equipment that is purchased for business use, (3) the limitations that Congress enacted to prevent what it perceived as excessive tax benefits claimed with respect to luxury automobiles, (4) the incentives that Congress created in 2003 to encourage small businesses to invest in new business equipment, (5) how the interaction of these provisions created the unanticipated SUV tax break, and (6) how Congress responded to the SUV loophole in the American Jobs Creation Act of 2004.[1]

Special Tax Benefits Available for Motor Vehicle Purchasers

Prior to the enactment of the American Jobs Creation Act of 2004, purchasers of the least fuel-efficient SUVs could receive a tax deduction. However, this deduction was not available to all who purchased an SUV. Rather, only those who purchased a Hummer-class behemoth for use in a business could benefit. Thus, this tax benefit was available primarily to doctors, lawyers and small businesses owners –folks who receive a salary need not apply.

Unlike the $2,000 deduction available to those who purchase hybrids,[2] the tax break for an SUV purchase may have equalled the full cost of the vehicle, up to a maximum of $100,000. The tax deduction for SUV purchasers is not explicitly stated; rather, it results from the interplay of several statutory provisions governing the tax treatment of equipment purchased for use in a business.

Tax Treatment of Equipment Purchased for Use in a Business

One of the cornerstone principles of the U.S. income tax system is that taxpayers must report their income on an annual basis.[3] The IRC incorporates three broadly applicable principles that are fundamental to measuring income on an annual basis.

First, a business' income for any given year should reflect all income generated during the year as well as the costs incurred in producing this income. This "matching principle" is reflected in numerous statutory provisions. For example, taxpayers must use a specific "method of accounting" that governs the timing of income and deductions.[4] In addition, taxpayers are permitted to deduct an expense only in the year in which the expense is "paid or incurred."[5]

> "Why would Congress create an incentive that is limited to some of the most luxurious, high-cost, and least fuel-efficient vehicles on the road?"

Second, the IRC generally provides that a business may not deduct any capital expenditure in the year in which the expenditure incurs. A capital expenditure represents the cost of acquiring an asset that will last substantially beyond the end of the taxable year.[6] The capitalization requirement was created to prevent serious distortions in the calculation of a taxpayer's annual income. Absent this requirement, the cost of an asset would be treated as a cost of producing income in the year in which the taxpayer acquires an asset. A mismatching of income and costs results to the extent that the asset generates income in future years.

Third, consistent with the matching principle, taxpayers are allowed depreciation deductions.[7] Depreciation represents the decline in value of a business asset that takes place in any given year. This economic cost represents one of the costs that the taxpayer incurs to generate his income for that year.

Although the depreciation deduction is an essential feature of an income tax, Congress has used the depreciation provisions of the IRC to provide economic subsidies for businesses. For many years, taxpayers have been allowed to claim depreciation on an accelerated basis. This acceleration generates a "time value of money" benefit for a business: the larger deductions in the first years in which an asset is owned reduces the business' tax liability in those years. Although this is offset by the effect of smaller depreciation deductions allowed in later years, the "time value of money" benefit is significant.

There are several distinct factors that contribute to the acceleration of depreciation deductions:

- ***Taxpayers may use short "useful lives" for purposes of depreciation.*** For example, the cost of a business asset that remains productive in a business for nine years may be fully deducted over a five-year period rather than over its nine-year economic lifespan.[8]
- ***Depreciation deductions are "front-loaded."*** Under the depreciation rules in effect since 1981, taxpayers may utilize accelerated methods of depreciation for assets other than real property.[9] As a result, more than half of the cost of a business asset may be deducted as depreciation during the first half of the asset's useful life.[10]
- ***Congress enacted explicit front-loading provisions***: In 2002 and 2003, Congress increased the extent to which depreciation deductions are front-loaded. For assets acquired after September 10, 2001, taxpayers were allowed to deduct 30 percent of an asset's cost in the year in which it was first used in business. In 2003, Congress increased the additional first-year depreciation deduction to 50 percent of an asset's cost.[11] An asset's remaining cost is depreciated under the general accelerated depreciation rules. The 50 percent first-year deduction applies to most tangible personal property acquired after May 5, 2003, and before January 1, 2005.
- ***Congress allowed "small businesses" to deduct the full cost of business assets.*** In 1981, Congress enacted IRC section 179. This provision allows taxpayers to deduct the cost of certain types of business assets in the year in which the asset is acquired. Initially, taxpayers could deduct up to $5,000 pursuant to this section, but Congress repeatedly increased the maximum deduction, thereby scheduling the increase to reach $25,000 in 2003. In 2003, Congress again increased the maximum deduction to $100,000.[12]

Limitations on Tax Benefits Claimed with Respect to Automobiles

THE BUSINESS USE OF AUTOMOBILES raises several tax policy concerns that are not applicable to other types of business assets. First, an automobile provides a driver with a certain amount of personal satisfaction. Particularly when the car is exceptionally luxurious (e.g., a Rolls Royce, Bentley or high-end Mercedes Benz) or unusually sporty (e.g., a Ferrari or Lamborghini), the personal rewards are likely to exceed the business benefits from the car's operation.

Second, a driver may use an automobile to satisfy both business and personal needs. To the extent that an asset is used for non-business purposes, no depreciation deduction is allowed. For example, consider a situation in which an automobile is used 60 percent for business with the remaining 40

percent attributable to personal use. In this case, the taxpayer must reduce his or her otherwise allowable depreciation deductions by 40 percent.[13]

It is difficult to determine the extent to which use of a luxury or sports car satisfies the personal needs of the employee/driver, as opposed to satisfying the business needs of the employer. It is also difficult for the Internal Revenue Service to determine the extent of a taxpayer's non-business use of an automobile since it is virtually impossible to verify how a car is used during an entire year.

In response to these concerns, Congress enacted IRC section 280F, which limits the amount of depreciation deductions a taxpayer may claim with respect to automobiles used for business purposes. Section 280F contains explicit dollar limits on the amount of depreciation deductions allowed in any given year.[14]

In addition to the limitations on the magnitude of depreciation deductions contained in section 280F, taxpayers were

able to take advantage of the additional first-year depreciation deductions. As mentioned above, Congress increased the front-loading of depreciation deductions. Through the end of 2004, taxpayers were able to deduct 50 percent of an asset's cost in the year in which the taxpayer first uses the asset in his or her business. For passenger vehicles subject to section 280F, however, Congress limited the amount of additional first-year depreciation that taxpayers may claim.[15] When combined with the section 280F limitations on depreciation deductions, a business' first-year depreciation was limited to $10,610. During the first three years of ownership, the aggregate depreciation deductions could not exceed $18,260 and subsequent annual depreciation deductions are limited to $1,675 per year thereafter.[16]

> "Any taxpayer who claims to have used one of these SUVs entirely for business may deduct 60 percent of his or her cost during the first calendar year of ownership."

The following example demonstrates the effect of the section 280F limitations. A business paid $60,000 in 2004 for an automobile. Assuming that the taxpayer uses the automobile solely for business, he or she would be entitled to the additional first-year deduction of $30,000 if the section 280F limitations were not applicable. Under the general depreciation provisions, the taxpayer would be allowed to deduct $6,000 in that year, with deductions of $9,600 and $5,760 in the following two years.[17] For the first three years of business use, the aggregate deductions would total $51,360. Under section 280F, the taxpayer's deductions are limited to $18,260 during that three-year period.

It is important to note that section 280F applies only to passenger automobiles. Congress defined a "passenger automobile" as any four-wheeled vehicle manufactured primarily for use on public streets, and which is rated at 6,000 pounds gross vehicle weight or less.[18] At the time section 280F was enacted, few, if any, automobiles manufactured primarily for routine passenger use had a rated gross vehicle weight of more than 6,000 pounds. This definition effectively distinguished passenger vehicles, which are subject to these limitations, and delivery vans and other trucks, which are used in business and by farmers.

In subsequent years, the permissible depreciation allowed with respect to automobiles did not change. Rather, the market for automobiles underwent a transformation. Specifically, Americans developed a love affair with the SUV. Initially, the largest and best selling SUV was the "mid-sized" Ford Explorer. Although the 2005 model has a gross vehicle weight of 5,880 pounds, the Explorer is still characterized as a passenger vehicle.

For many Americans, the mid-sized SUV was not large enough. The automobile manufacturers developed larger, and substantially heavier, SUVs that surpassed 6,000 pounds and thereby avoid classification as a passenger vehicle. American consumers came to love the Cadillac Escalade, the Lexus LX-470, and that armored personnel carrier in civilian clothing, the Hummer H1. The Lexus tips the scales at 6,860 pounds, the Escalade weighs in at 7,000 pounds, and the Hummer H1 is 10,300 pounds.[19] The owners of these super-sized vehicles avoided the depreciation limits in section 280F because their SUV's weight exceeded the 6,000-pound limit.

Then Congress Created the SUV Tax Break

At this point, it is apparent that different depreciation regimes applied to cars and SUVs. Section 280F classifies most cars, minivans, pick-up trucks, and small to medium sized SUVs as "passenger vehicles." Taxpayers who use these vehicles in their businesses were able to claim, at most, $18,260 in depreciation during the first three calendar years of the vehicle's use in business.

The ultra-large SUVs, however, are not "passenger vehicles," and taxpayers who acquire them may claim depreciation deductions under the generally applicable depreciation rules. Any taxpayer who used one of these SUVs entirely for business was allowed to deduct 60 percent of his or her cost during the first calendar year of ownership. Clearly, owners of these SUVs enjoy preferential tax treatment compared to the owners of smaller passenger vehicles, who may claim depreciation only to the extent permitted under section 280F.

Moreover, section 179 permits certain small and moderate size businesses to deduct the cost of depreciable equipment and machinery, rather than capitalize those costs. As discussed above, the maximum deduction permitted under this section was scheduled to reach $25,000 in 2003.

In 2003, Congress created the ultimate SUV tax break when it increased the maximum amount that taxpayers could deduct under section 179 from $25,000 to $100,000.[20] Again, Congress made no explicit reference to SUVs when it enacted this change.[21] Rather, it focused on the fact that section 179 "lowered the cost of capital," which it believed would lead small businesses to "invest in more equipment and employ more workers," and would "reduce depreciation recordkeeping requirements with respect to expensed property."[22]

Notwithstanding Congress' intent, the change had an unanticipated consequence. At last, a small business that pur-

chased a heavyweight, luxurious, and high-priced SUV could deduct the full cost of the vehicle if it was used entirely for business purposes. A small business that used an ultra-large SUV could deduct up to $100,000 of the vehicle's cost immediately, pursuant to section 179, with the remainder of the cost deductible under the generally applicable accelerated depreciation provision discussed above.[23]

Daily newspapers and the financial press reported, with outrage, about the "three-ton SUV loophole,"[24] and hundreds of articles appeared from coast-to-coast. In October, Congress responded to this outrage as part of the American Jobs Creation Act of 2004 ("the Act"). Prior to the Act, the $100,000 limitation in section 179 was to expire at the end of 2005. In section 201 of the Act, Congress created a two-year extension of the provision. To deal with the SUV loophole, section 910 of the Act provides: "The cost of any sport utility vehicle for any taxable year which may be taken into account under this section shall not exceed $25,000."[25]

Evaluation of Congressional Action

AFTER READING CONGRESSIONAL COMMITTEE REPORTS and the popular press, one might conclude that Congress has closed the SUV loophole. For example, a recent story in the *Wall Street Journal* carried the headline, "SUV Tax Break for Business Is Likely to End," and reported that Congress would either "scrap the tax break, or limit it so that it applies only to people who have legitimate business uses for these vehicles."[26] This is wrong.

The 2004 Act's amendment to section 179 creates a $25,000 limit to the amount that a small business may deduct when it purchases a vehicle with a gross weight of between 6,000 and 14,000 pounds.[27] This provision is applicable to any SUV placed in service after October 22, 2004. The effect of the revised section 179 limitation is illustrated in the following examples. First, assume that a taxpayer acquires a super-sized SUV that costs $70,000 prior to January 1, 2005. Assume further that the SUV meets the requirements of section 179 and is used solely for business purposes. The taxpayer then may deduct:

- $25,000 under section 179
- $22,500 of additional first-year depreciation deduction
- the remaining cost of $22,500 as depreciation. In the first year of business use, the taxpayer may deduct $4,500 with the remaining $18,000 deductible over the next five years.

This example demonstrates that Congress created a year-end window for taxpayers seeking to obtain substantial tax benefits from the purchase of jumbo SUVs in 2004. The purchaser in this example may deduct $52,000 in the year that the SUV is acquired.

As mentioned above, the additional first year depreciation allowance contained in section 168(k) expired at the end of 2004. Unless Congress reinstates this provision, beginning in 2005, small business owners who acquire jumbo SUVs will be allowed smaller, but still substantial, tax benefits. Assume that a taxpayer acquires a super-sized SUV that costs $70,000 in 2005, that the SUV meets the requirements of section 179 and that it is used solely for business purposes. The taxpayer then may deduct:

- $25,000 under section 179
- the remaining cost of $45,000 as depreciation. In the first year of business use, the taxpayer may deduct $9,000 with the remaining $36,000 deductible over the next five years.

Although the first-year tax deductions are reduced to $36,000, they remain substantial, and much greater than would be obtained if the SUV were classified as a passenger vehicle for purposes of section 280F.

These examples demonstrate that Congress has not eliminated the SUV tax break. It has merely reduced the magnitude of the unjustified tax benefits. Business taxpayers were able to deduct more than 70 percent of the cost of an SUV purchased before the end of 2004 and more than approximately 50 percent of the cost for purchases occurring thereafter.

Conclusion

THE ORIGINAL SUV TAX BREAK resulted from the interaction of the following seemingly unrelated tax provisions:

- Congress attempted to draw a line between motor vehicles commonly used for personal use and those used overwhelmingly for business when it enacted section 280F. This provision draws the line at 6,000 pounds. Although accurate during the mid-1980s, the line became inadequate to serve its intended purpose because the market for automobiles changed.
- Congress decided to provide some tax relief for small businesses. When Congress increased the amount that small businesses could deduct under section 179, it created the SUV tax break, and when Congress increased the limit to $100,000, the SUV loophole became a subject of popular outrage.

The complexity of the IRC makes it likely that unintended consequences will arise. These consequences are more likely to occur when Congress uses the tax law to provide economic incentives for investment rather than provide an accurate measure of income. In the case of the SUV tax break, many professionals and small business owners claimed excessive tax deductions when they improperly overstated the extent of their business use of these vehicles.

Congress's failure to close the SUV loophole is inexcusable. The loophole was widely known and the solution was simple. Congress should have amended section 280F and changed the definition of the term "passenger vehicle" to cover Hummer-class SUVs. The failure to enact this change reinforces the notion that Congress is unwilling to remove any tax break – no matter how meritless the tax break may be. BLB

Professor Andrew D. Pike is Associate Dean for Academic Affairs and Professor of Law at American University's Washington College of Law. Prior to his academic career, he served as Associate Tax Legislative Counsel in the Office of Tax Policy of the United States Department of the Treasury. He has been a consultant to the Internal Revenue Service, the Congressional Joint Committee on Taxation and the Congressional Research Service. In addition, Professor Pike has provided assistance to several of the republics of the former Soviet Union concerning the reform of the tax laws and the systems of tax administration in these countries. Professor Pike received his academic degrees from the University of Pennsylvania Law School and Swarthmore College.

ENDNOTES: *Andrew Pike*

[1] H.R. 4520, 108th Cong. (2004) (enacted).

[2] *See* I.R.C. § 179A (2004) (providing a special deduction for taxpayers who purchase an automobile that employs hybrid technology. Purchasers may deduct up to $2,000. Typically, these hybrid vehicles incorporate innovative technology that results in superior fuel economy and extremely low levels of pollutants).

[3] I.R.C. § 441 (2004).

[4] I.R.C. § 446 (2004); Treas. Reg. §1.446-1 (2004).

[5] I.R.C. § 162 (2004).

[6] I.R.C. § 263 (2004); Treas. Reg. § 1.263(a)-2(a) (2004).

[7] I.R.C. §§ 168 (for tangible property), 197 (for certain intangible assets) (2004) (Assets such as land are not depreciable because they are deemed to have an unlimited economic life).

[8] I.R.C. § 168(e)(1).

[9] I.R.C. §§ 168(b)(1) and (2).

[10] Rev. Proc. 87-56, 1987-2 C.B. 674, Table 1.

[11] I.R.C. § 168(k)(1)(4) and (4) (2004).

[12] I.R.C. § 179(b) (2004) (Pub L. No. 108-27, Sec. 202(a)-(e) amended this section in 2003 by reducing the benefit if the taxpayer's investment in business assets in the year exceeds specified levels. For 2003, the benefits were eliminated if a taxpayer's investment exceeded $500,000).

[13] BORIS I. BITTKER, ET AL., FEDERAL INCOME TAXATION OF INDIVIDUALS 14-9 (2d ed. 1995) at 14-9. *See also* Treas. Reg. 1.179-1(d) (1992).

[14] In 1984, Congress also enacted a requirement that taxpayers maintain contemporaneous records of their business and non-business use of automobiles. Pub. L. 98-369, § 179(b)(1). Following a public outcry against these provisions, this requirement was repealed retroactively.

[15] H.R. REP. NO. 108-94 (2003). This amount is not increased to reflect inflation.

[16] *See* Rev. Proc. 2004-20, 2004-13 I.R.B. 642. § 280F(a)(1)(C)(ii) provides that the generally applicable depreciation limitations are tripled for passenger vehicles propelled primarily by electricity.

[17] *See* I.R.C. § 168, Rev. Proc. 87-57, 1987-2 C.B. 687. This example assumes that the taxpayer uses the automobile solely for business.

[18] I.R.C. § 280F(d)(5). For automobiles, the weight limit is based upon the vehicle's unloaded gross vehicle weight. The statutory definition utilizes "gross vehicle weight" with respect to trucks and vans. Unlike the weight used for passenger automobiles, the gross weight for trucks and vans includes the weight of vehicle options, passengers, cargo and gas. 2004-5 Fed. Tax Rep. (CCH) ¶ 15,108.022.

[19] All vehicle weights are obtained for 2005 vehicles from www.edmunds.com. For a list of the super-sized SUVs that avoid the "passenger vehicle" designation, *see* 2004-5 Fed. Tax Rep. (CCH) ¶ 15,108.022.

[20] Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, sec. 202 117 Stat. 752.

[21] Although the committee reports discussing this provision do not discuss the treatment of SUVs, some members of Congress were aware of, and objected to, the differential treatment of the ultra-large SUVs and other passenger vehicles. On January 30, 2003, Senator Boxer introduced S.265, which would have amended section 280F. This proposed legislation would have expanded the definition of "passenger vehicle" to include SUVs weighing up to 14,000 pounds. Excluded from this definition, however, were vehicles incorporating features that made it unlikely that the vehicle would be used for significant non-business purposes.

[22] H.R. REP. NO. 108-94 at 25 (2003).

[23] To the extent that the cost of machinery and equipment exceeds this limit, the taxpayer is allowed to deduct the remaining cost through the allowance for depreciation. *See* IRS Publication 946, *How To Depreciate Property* at 17 *available at* www.irs.gov/publications/p946/chol.html/#d0e1587. If the business purchased other equipment during the year, the taxpayer might not be able to deduct the entire cost in the year of purchase.

[24] *See, e.g.*, Mark K. Solheim, *Heavy Metal*, 57 KIPLINGER'S PERSONAL FINANCE 107 (2003) *available at* 2003 WL 2058001; Al Kamen, Editorial, *A Hummerdinger of a Tax Loophole*, WASH. POST, Sept. 26, 2003 at A25, *available at* 2003 WL 62218281.

[25] American Jobs Creation Act of 2004, § 910.

[26] Neal E. Boudette and Karen Lundegaard, *SUV Tax Break For Businesses Is Likely to End*, THE WALL ST. J., Oct. 7, 2004 at D6. *available at* 2003 WL 62218281.

[27] American Jobs Creation Act of 2004, § 910. This amendment does not apply to vehicles with: (1) seating for more than nine passengers, (2) with a cargo bed of at least six feet in interior length, or (3) which is structured as a delivery van. *See* § 179(b)(6)(B)(ii), as amended by American Jobs Creation Act of 2004.