

Tax strategies for business people stepping up to a new car

The decision of whether to trade in an old business car or try to sell it for cash generally should be based on factors such as the amount you can get on a sale versus a trade-in, and the time and bother a sale will entail. However, important tax factors also may affect your decision-making process. Here's an overview of the complex rules that apply to what appears to be a simple transaction, and some pointers on how to achieve the best tax results.

In general, the sale of a business asset yields a gain or loss depending on the net amount you receive from the sale and your basis for it. "Basis" is your cost for tax purposes and, if you bought the asset, usually equals your cost less the depreciation deductions you claim for the asset over the years. Under the tax-free swap rules, trading in an old business asset for a new, like-kind asset doesn't result in a current gain or loss, and the new asset's basis will equal the old asset's remaining basis plus any cash you paid to trade up. The rules generally are the same for business cars, with a couple of extra twists. Here are some pointers.

As a general rule, you should trade in your old business car if you used it exclusively for business driving, and its basis has been depreciated down to zero, or is very low. The trade-in often avoids a current tax. For example, if you sell your business car for \$9,000, and your basis in it is only \$7,000, you will have a \$2,000 taxable gain, but if you trade it in, a current tax is avoided. True, your basis in the new car will be lower than it would be if you bought it without a trade-in, but that doesn't necessarily mean lower depreciation deductions on the new car. Because of the so-called "luxury auto" annual depreciation dollar caps, your annual depreciation deductions on the new car may be the same whether you sold the old car or traded it in.

However, you should consider selling your old business car for cash rather than trading it in if you used it exclusively for business driving and depreciation on the old car was limited by the annual depreciation dollar caps. In this situation, your basis in the old car may exceed its value. If you sell the old car, you will recognize a loss for tax purposes. However, if you trade it in, you will not recognize the loss. By way of a simplified example, let's assume a business person bought a \$30,000 car several years back and used it 100% for business driving. Because of the annual depreciation dollar caps, she still has a \$16,000 basis in the car, which has a current value of \$14,500. Now, she wants to buy another \$30,000 car. If the old car is sold, a \$1,500 loss will be recognized (\$16,000 basis less \$14,500 sale price). If the old car is traded in for a new one, there will be no current loss. Of course, if the old car's value exceeds its basis, the tax-smart move is to trade it in and thereby avoid a gain.

You also may be better off selling your old business car for cash rather than trading it in, if you used the standard mileage allowance to deduct car-related expenses. For 2011, the allowance is 51¢ per business mile driven from Jan. 1, 2011 through June 30, 2011, and 55.5¢ per business mile driven from July 1, 2011 through Dec. 31, 2011. The standard mileage allowance has a built-in allowance for depreciation, which must be reflected in the basis of the car. The deemed depreciation is 22¢ for every business mile traveled during 2011. When it's time to dispose of a car, the

depreciation allowance may leave you with a higher remaining basis than the car's value. Under these circumstances, the car should be sold in order to recognize the loss.

Did you use your car partially for business, partially for personal use? The rules are more complicated in this situation, which can occur if you are self-employed, or an employee required to supply a car for business use.

If you sell the part-business, part-personal-use car, cost and depreciation must be allocated between the business and personal portions. Gain or loss on the business part is recognized; gain, but not loss, is recognized on the personal part.

If you trade in the part-business, part-personal-use car, a special basis rule applies for depreciation purposes only: The basis of the new car as computed under the normal trade-in rules is reduced by any difference between (1) the depreciation that would have been allowable had the old car been used 100% for business driving, and (2) the depreciation claimed for its actual business use.

Are you thinking of leasing a business car? The complex rules that apply to purchased business autos are one reason many businesses are leasing vehicles instead of buying them. You simply deduct the business/investment use portion of annual lease costs, and, if the vehicle is a "luxury" model, you add back to income during each lease year an income inclusion amount derived from an IRS table. For auto leases that begin during 2011, the auto is a "luxury" if the auto's fair market value exceeds \$18,500 (\$19,000 for certain trucks and vans treated as autos for purposes of the "luxury" auto rules). There are, however, a few special angles you should be aware of:

If you pay an additional sum up-front, it should be amortized over the life of the lease. Any refundable deposit required as part of the lease deal can't be deducted at all.