

WEST VIRGINIA LEGISLATURE
Legislative Post Audit Division

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**Denny Rhodes
Director**

January 12, 2015

The Honorable William Cole, President
West Virginia State Senate
Post Audits Subcommittee, Co-Chair
Room 229 M, Building 1
State Capitol Complex
Charleston, WV 25306

The Honorable Timothy Armstead, Speaker
West Virginia House of Delegates
Post Audits Subcommittee, Co-Chair
Room 228 M, Building 1
State Capitol Complex
Charleston, WV 25306

Dear Mr. President and Mr. Speaker:

The Legislative Post Audit Division is currently conducting a performance audit of the Division of Highways (DOH). The audit includes a review of employee commuting in state vehicles. After review of DOH policies and in consultation with Legislative Services legal counsel, the Legislative Auditor has determined that the current method utilized by DOH for calculating the taxable fringe benefit for employees commuting in state vehicles is incorrect.

As a fringe benefit to employment, DOH issues vehicles to some employees for commuting. For tax purposes, DOH uses the "Commuting Rule" as described in IRS Publication 15-B as a means to calculate the taxable fringe benefits for withholding and reporting taxes. The Commuting Rule has four requirements which all must be met if an employer is going to utilize the rule. The requirements are paraphrased as follows:

1. The employee is required to commute in the employer provided vehicle.
2. A written policy is established that prohibits personal use of the vehicle.
3. The employee doesn't use the vehicle for personal reasons other than commuting and *de minimis* personal use.

4. The employee is not an elected official or an employee who equals or exceeds Federal Government Executive Level wages.

It appears DOH meets three of these requirements. The requirement that is not met is the first requirement listed. DOH does not **require** its employees to commute in a state assigned vehicle. In fact, DOH requires employees to acknowledge that the use of a state vehicle for commuting is optional. Each employee assigned a state vehicle is required to sign the West Virginia Division of Highways Policy Acknowledgement Statement which states in part:

I certify that my use of a vehicle is completely optional, that it is a matter of my personal choice, and that the agency does not require me to use a vehicle for commuting. (Emphasis Added)

Additionally, a June 29, 2012 DOH memo to staff entitled "Assignment and Use of Transportation Vehicles" states:

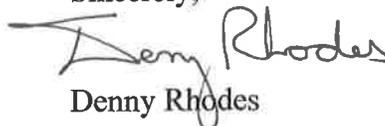
Use of the State vehicle is at the employee's option and is provided solely for the convenience of the employee. (Emphasis Added)

Since DOH policies and procedures state that employees are not required to commute in a state vehicle (if provided) and is for the convenience of the employee, the use of the IRS Commuting Rule is not correct. Thus, the Legislative Auditor recommends the following:

The Legislative Auditor recommends that the Division of Highways discontinue the use of the Commuting Rule for state employees commuting in a state assigned vehicle. Additionally, the Division should seek guidance from the IRS to determine the appropriate value of the taxable fringe benefits allotted to Division of Highways employees, and the appropriate steps the IRS requires to correct the submission of taxable fringe benefits for commuting in the previous tax years.

Future audits will attempt to quantify the effect that the incorrect use of the Commuting Rule has on state government and the Division of Highways.

Sincerely,



Denny Rhodes

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MEMO

To: Mike Jones, Audit Manager
From: Sarah Rogers, Counsel
Subject: DOH Legal Opinion- Commuting Rule- IRS Publication 15B
Date: August 25, 2015

I. Questions Presented

1. Do DOH policy statements,¹ concerning vehicles as fringe benefits, disqualify the DOH and DOH employees from using “the Commuting Rule?”²
2. If DOH misapplied the Commuting Rule to determine the value of commuting vehicles on information returns, what are the legal repercussions to DOH or the State? Can employees file suit against DOH for damages?

II. Short Answer

1. DOH policy statements indicate that DOH-provided commuting vehicles do not qualify for the Commuting Rule.
2. If the DOH under-calculated the value of commuting vehicles while preparing information returns, DOH employees may have underpaid their individual income taxes and could become liable for back taxes, interest and penalties. The DOH could also face penalties for providing incorrect information returns. In addition, the DOH may have under calculated payroll taxes and could be liable for penalties, interest and back-taxes for underpaying payroll taxes. It is highly unlikely that employees could recover damages in a lawsuit against the DOH for misapplying the Commuting Rule.

III. Facts

¹“Policy statements” refers to the “Highways Policy Acknowledgement Statement” as well as the DOH’s “Assignment and Use of Transportation Vehicles Policy,” dated June 29, 2012. This memo combines the first two questions presented in your Request for Legal Opinion, because the legal analysis is the same for both policy statements.

²The “Commuting Rule” refers to the special valuation procedure of 26 CFR § 1.61-21, discussed in IRS Publication 15B.

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As a fringe benefit to employment, the Department of Highways (DOH) issues vehicles to some employees for commuting to and from the workplace. To determine the value of these fringe benefits for withholding taxes and preparing information returns,³ the DOH uses a fringe benefit valuation procedure called “the Commuting Rule.” The Commuting Rule is an exception to the Internal Revenue Code’s general requirement that the value of an employer-provided vehicle for income tax purposes is equal to the vehicle’s fair market rental value during a taxable year. Under the Commuting Rule, a taxpayer may instead calculate the value of an employer-provided commuting vehicle by multiplying the number of commuting trips that the taxpayer traveled in a vehicle during a taxable year by \$1.50. However, the Commuting Rule is only available under certain circumstances,⁴ including that “[f]or bona fide noncompensatory business reasons, **the employer requires the employee to commute to and/or from work in the vehicle** [. . .]” 26 CFR 1.61-21 (**emphasis added**). Presumably, DOH employees simply enter the information that the DOH reports on their W-2 forms into their personal income tax returns and pay income tax on commuting vehicles at the rates permitted under the Commuting Rule.

According to a recent Post Audit inquiry, the DOH has several written policies which indicate that the DOH does not require employees to drive DOH-provided vehicles and thus, the Commuting Rule does not apply. Before the DOH issues an employee a commuting vehicle, the DOH requires the employee to sign a West Virginia Division of Highways Policy Acknowledgment Statement, which states:

I certify that my **use of a vehicle is completely optional**, that it is a matter of **my personal choice**, and that **the agency does not require me to use a vehicle** for commuting.

(**emphasis added**). In addition, the DOH’s Assignment and Use of Transportation Vehicles Policy, dated June 29, 2012, covers employee use of commuting vehicles and states:

Use of the State vehicle is at the **employee’s option** and is provided solely for the **convenience of the employee**.

(**emphasis added**).

Because these written policies state that the DOH does *not* require employees to commute in DOH vehicles, the Post Audit Division is concerned that DOH and DOH employees’ may be underreporting the value of commuting vehicles to the IRS. When the Commuting Rule does not apply, a taxpayer must include the fair rental value of an employer-provided vehicle in the taxpayer’s income. The fair rental value of a vehicle is most likely higher than the value of a vehicle under the Commuting Rule, meaning that DOH employees may be underpaying their income taxes and the DOH may be issuing incorrect information returns and underpaying payroll taxes.

³ “Information returns” include documents like W-2s and 1099s.

⁴ There are five requirements, but only the requirement quoted above is at issue in this memorandum.

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IV. Legal Discussion

- a. DOH's written policies indicate that the Commuting Rule does not apply to DOH-provided commuting vehicles.**

Whether the Commuting Rule applies to an employer-provided vehicle is a factual question. As noted above, the Treasury Regulations set out specific factors that must be present before a taxpayer may apply the Commuting Rule for income tax reporting purposes. For the Commuting Rule to apply, the following five factors must be present:

- (i) The vehicle is owned or leased by the employer and is provided to one or more employees for use in connection with the employer's trade or business and is used in the employer's trade or business;**
- (ii) For bona fide noncompensatory business reasons, the employer requires the employee to commute to and/or from work in the vehicle;**
- (iii) The employer has established a written policy under which neither the employee, nor any individual whose use would be taxable to the employee, may use the vehicle for personal purposes, other than for commuting or de minimis personal use (such as a stop for a personal errand on the way between a business delivery and the employee's home);**
- (iv) Except for de minimis personal use, the employee does not use the vehicle for any personal purpose other than commuting; and**
- (v) The employee required to use the vehicle for commuting is not a control employee of the employer (as defined in paragraphs (f) (5) and (6) of this section).**

26 CFR 1.61-21 (Emphasis and spaces added).

As explained above, two DOH policies state that DOH-provided commuting vehicles are entirely optional and that the DOH does *not* require employees **“to commute to and/or from work” in employer provided vehicles.** Id. If DOH policy statements are accurate, the “Commuting Rule” clearly does not apply to DOH-provided vehicles and the plain language of the Treasury Regulations instead requires DOH employees to include the fair rental value of vehicles in their income for tax reporting purposes. 26 CFR 1.61-21(d).

- b. If the DOH undervalues employee fringe benefits on information returns, DOH employees may face penalties, interest and back taxes for underpaying personal income taxes and the DOH may face penalties for issuing incorrect information returns.**

Misapplying the Commuting Rule to DOH-provided vehicles may lead to negative tax consequences for the DOH and for DOH employees. Presumably, DOH employees simply enter

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the information on DOH-provided W-2 forms into their tax returns, and pay income taxes based on the information in those forms. Therefore, if the DOH is misapplying the Commuting Rule to undercalculate employee income on information returns, DOH employees are likely to rely on these information returns and underpay their personal income taxes. As a result, the IRS may audit DOH employees and assess penalties, interest and back taxes against them. *See* 26 U.S.C. 6622(b).

It is highly unlikely that the DOH could become liable to taxpayers for the cost of penalties, interest or back taxes resulting from reliance on DOH information returns. The Internal Revenue Code generally places the legal responsibility for paying the correct amount of individual income tax solely on the individual taxpayer. *See* 26 U.S.C. 6622. In addition, there has not been a singly legal decision reported from any jurisdiction of the United States, holding an employer liable for an employee's reliance on an incorrect information return. If a West Virginia taxpayer were to file a negligence lawsuit against the DOH for issuing incorrect information returns, the DOH would likely have an immunity defense to such a claim.⁵ *See* W. Va. Const. Art. VI, § 35.

However, if the DOH is understating its employee's income by misapplying the Commuting Rule to value fringe benefits, the DOH could face IRS penalties for providing incorrect information returns to employees. The Internal Revenue Code requires employers to furnish employees with correct information on "information return" forms, such as W-2s and 1099s. *See* 26 U.S.C §§ 6041-6050W. The IRS may assess penalties against an employer who fails to provide correct information on those forms. *See* 26 U.S.C § 6722.

c. The DOH may be underpaying payroll taxes and could be liable to the IRS for back taxes, penalties and interest.

Federal law requires employers to pay numerous payroll taxes, part of which are deducted from an employee's wages and part of which are paid by the employer based on the employee's wages.⁶ If the DOH is undercalculating the value of employee fringe benefits by misapplying the Commuting Rule and thus, undercalculating employee income, the DOH may be undercalculating and underpaying payroll taxes as well. If the DOH is underpaying payroll taxes, the IRS could assess penalties, interest and back taxes against the DOH for underpaying payroll taxes.⁷

V. Conclusion

The DOH's written policies regarding employer-provided vehicles indicate that those vehicles do not qualify for Commuting Rule valuation. Unless the DOH policies change to meet

⁵ This would depend on several in-depth factual inquires, including whether the State has liability insurance which a court would deem to "waive" immunity in this instance.

⁶ "Payroll taxes" includes taxes, such as social security taxes [26 U.S.C. §§ 3101, 3102]; Federal Insurance Contribution Act Taxes [26 U.S.C. § 3111] and federal unemployment taxes [26 U.S.C. § 3301].

⁷ Generally, as to additions to the tax and additional amounts, *see* 26 U.S.C. §§ 6651-6659; 6651-6659A; as to assessable penalties, *see* 26 U.S.C 1954 §§ 6671-6674; 6671-6674.

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the requirements of the Commuting Rule, the DOH should instead include the fair rental value of commuting vehicles as income on employee W-2s and any other information returns. Otherwise, DOH employees may rely on incorrect W-2s when filing tax returns and may become liable for back taxes, interest and tax penalties for underpaying personal income taxes. The DOH could also face penalties for provided incorrect information returns. The DOH should also calculate payroll taxes by including the fair rental value of commuting vehicles in employee wages to avoid liability for back taxes, interest and penalties for underpaying payroll taxes.