



Close Doesn't Count—Accountable Plan Rulings
Podcast of November 25, 2006



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Why §62(c) Is Neither Horseshoes Nor Hand Grenades...

There wasn't a lot of news on the tax front this week, as the IRS and courts had a short week readying for the Thanksgiving holiday. So this week we look back at a ruling that came out a short while ago that revisited accountable plans and compare that with a ruling from a year ago. Taken together, these rulings make it clear that the IRS has concerns about employers taking liberties with various issues with regard to accountable plans under §62(c). It would appear the IRS is attempting to signal that they expect employers to strictly follow the requirements under §62(c) if they want to exclude payments from employee's W-2s.

The 2005 ruling dealt with a "tool allowance" plan, while the more recent ruling deals with a trucking company that made use of a per diem arrangement, but failed to include

excess reimbursements in income. In both cases, the IRS made it clear that the *entire* amount of the payments under the plan had to be included in income.

Revenue Ruling 2006-56

ISSUE

Whether, under an expense allowance arrangement which has no mechanism or process to determine when an allowance exceeds the amount that may be deemed substantiated and which routinely pays allowances in excess of the amount that may be deemed substantiated without requiring actual substantiation of all expenses or repayment of the excess amount, the failure to treat the excess allowances as wages for employment tax purposes causes all payments made under the expense allowance arrangement to be treated as made under a nonaccountable plan.

FACTS

Taxpayer is an employer of long-haul truck drivers in the transportation industry. Taxpayer uses a monthly payroll period and compensates its drivers for their services on a mileage basis. For 2006, Taxpayer pays its drivers compensation of X cents-per-mile driven during each month. Taxpayer reports the compensation on the drivers' Forms W-2 and treats the compensation as wages for Federal Insurance Contributions Act (FICA) tax, Federal Unemployment Tax Act (FUTA) tax, and Federal income tax withholding purposes (collectively, "employment taxes").

Taxpayer also reimburses its drivers for meal and incidental expenses (M&IE) paid or incurred while traveling away from home during the monthly payroll period. Taxpayer reimburses its drivers for these expenses through an allowance for each day the driver is away from home for Taxpayer's business. For 2006, the allowance is Y cents-per-mile driven. Taxpayer's industry commonly used this cents-per-mile driven method before December 12, 1989.

Taxpayer establishes the Y cents-per-mile rate based on its expectation of the amount of daily M&IE that will be paid or incurred, and its expectation of the average number of daily miles driven during the payroll period. Taxpayer bases its expectations on reliable industry data and on Taxpayer's own data from recent years. Based on Taxpayer's specific methodology and data, Taxpayer's projected allowance is reasonably calculated not to exceed the drivers' anticipated daily M&IE.

Taxpayer requires its drivers to provide logs to substantiate the time, place, and business purpose of the travel away from home for each day (or partial day). Taxpayer does not require its drivers to substantiate the amount of actual M&IE. Instead, for its drivers' substantiation of the amount of M&IE paid or incurred by the drivers, Taxpayer relies on administrative guidance published annually by the Internal Revenue Service under which the amount of ordinary and necessary business expenses of an employee for M&IE paid or incurred while traveling away from home is deemed substantiated when the employer provides a per diem allowance to cover the expenses. The guidance applicable for per diem allowances paid to an employee on or after October 1, 2005, with respect to travel away from home on or after October 1, 2005, is Rev. Proc. 2005-67, 2005-2 C.B. 729.

For 2006 Taxpayer elects to treat \$52 per day as the federal M&IE rate for all localities of travel pursuant to section 4.04 of Rev. Proc. 2005-67. Thus, for 2006, \$52 or less per day of M&IE paid or incurred by a driver while traveling away from home may be deemed substantiated. The allowances paid by Taxpayer to many of its drivers for M&IE incurred on travel away from home during the monthly payroll period routinely exceed \$52 per day, even when computed on a monthly basis pursuant to the periodic rule provided in section 4.04 of Rev. Proc. 2005-67.

Taxpayer requires its drivers to return any amounts paid to them for M&IE with respect to days they were not away from home on business travel. Taxpayer does not require drivers to return the portion of the allowance paid for days they were away from home on business travel that exceeds the \$52 per day that may be deemed substantiated.

Neither the policies nor actual practices of Taxpayer's expense allowance arrangement include any process for tracking the amount of the cents-per-mile M&IE allowance paid to each driver on a per diem basis, nor is there any mechanism in place to determine when the allowances exceed the amount of expenses that may be deemed substantiated under Rev. Proc. 2005-67. Taxpayer does not treat the excess allowances over \$52 per day as wages for withholding or employment tax purposes and does not report the excess allowances as wages on the drivers' Forms W-2.

LAW AND ANALYSIS

Section 62(a)(2)(A) of the Internal Revenue Code provides that, for purposes of determining adjusted gross income, an employee may deduct certain business expenses paid by the employee in connection with the performance of services as an employee of the employer under a reimbursement or other expense allowance arrangement.

Section 62(c) provides that, for purposes of § 62(a)(2)(A), an arrangement will not be treated as a reimbursement or other expense allowance arrangement if (1) the arrangement does not require the employee to substantiate the expenses covered by the arrangement to the person providing the reimbursement, or (2) the arrangement provides the employee the right to retain any amount in excess of the substantiated expenses covered under the arrangement.

Section 1.62-2(c)(1) of the Income Tax Regulations provides that a reimbursement or other expense allowance arrangement satisfies the requirements of § 62(c) if it meets the requirements of business connection, substantiation, and returning amounts in excess of substantiated expenses. If an arrangement meets these requirements, all amounts paid under the arrangement are treated as paid under an accountable plan. See § 1.62-2(c)(2). Amounts treated as paid under an accountable plan are excluded from the employee's gross income, are not reported as wages or other compensation on the employee's Form W-2, and are exempt from the withholding and payment of employment taxes. See § 1.62-2(c)(4). Conversely, if the arrangement fails any one of these requirements, amounts paid under the arrangement are treated as paid under a nonaccountable plan and are included in the employee's gross income, must be reported as wages or other

compensation on the employee's Form W-2, and are subject to withholding and payment of employment taxes. See § 1.62-2(c)(3) and (5).

With regard to the business connection requirement, under § 1.62-2(d)(3)(ii) an arrangement providing a per diem allowance that is computed on a basis similar to that used in computing the employee's wages or other compensation (such as the number of hours worked, miles traveled, or pieces produced) meets the business connection requirement only if, on December 12, 1989, the per diem allowance was identified by the payor either by making a separate payment or by specifically identifying the amount of the per diem allowance, or a per diem allowance computed on that basis was commonly used in the industry in which the employee is employed.

With regard to the substantiation requirement, pursuant to Rev. Proc. 2005-67, the amount of M&IE that is deemed substantiated for each calendar day is equal to the lesser of the per diem allowance for that day or the amount computed at the federal M&IE rate. See section 3.01(3) of Rev. Proc. 2005-67. Under these rules, employees must continue to actually substantiate the elements of time, place, and business purpose relating to the travel expenses. See section 7.01 of Rev. Proc. 2005-67. Section 4.04 of Rev. Proc. 2005-67 provides special rules for the transportation industry under which \$52 per day may be treated as the federal M&IE rate and the amount deemed substantiated may be computed on a periodic basis (but not less frequently than monthly) rather than daily.

For purposes of the return of excess requirement, § 1.62-2(f)(2) permits the Commissioner to prescribe rules under which an arrangement that provides a per diem allowance is treated as satisfying the requirement of returning amounts in excess of expenses so long as the allowance is reasonably calculated not to exceed the amount of the employee's expenses and the employee is required to return any portion that relates to days of travel not substantiated. However, the portion of the allowance that exceeds the amount deemed substantiated will be treated as paid under a nonaccountable plan, must be reported as wages or other compensation, and is subject to withholding and payment of employment taxes. See § 1.62-2(c)(5).

Section 1.62-2(h)(2)(i)(B)(1) provides that if a payor pays a per diem allowance that meets the requirements of § 1.62-2(c)(1), the portion, if any, of the allowance that relates to days of travel substantiated in accordance with § 1.62-2(e) and that exceeds the amount of the employee's expenses deemed substantiated for the travel pursuant to rules prescribed under § 274(d) and the relevant regulations is treated as paid under a nonaccountable plan. Such amount is wages subject to withholding and payment of employment taxes. See § 1.62-2(c)(5). See also §§ 31.3121(a)-3(b)(1)(ii), 31.3306(b)-2(b)(1)(ii), and 31.3401(a)-4(b)(1)(ii) of the Employment Tax Regulations.

Section 1.62-2(k) provides that if a payor's reimbursement or other expense allowance arrangement evidences a pattern of abuse of the rules of § 62(c) and the regulations thereunder, all payments made under the arrangement are treated as made under a nonaccountable plan. Thus, these payments are included in the employee's gross income,

are reported as wages or other compensation on the employee's Form W-2, and are subject to withholding and payment of employment taxes. See § 1.62-2(c)(5), and (h)(2).

If an arrangement satisfies all three requirements of an accountable plan, but an allowance is paid under the arrangement that exceeds the amount that may be deemed substantiated, no actual substantiation is provided for the M&IE covered by the allowance, and the excess allowance is not returned, the excess allowance is treated as wages. See § 1.62-2(h)(2)(B)(1). However, if the facts and circumstances evidence a pattern of abuse of the rules of § 62(c) and the regulations thereunder, including the rule to treat excess allowances as wages, all payments made under the arrangement are treated as wages. See § 1.62-2(k).

Under the facts set forth above, the arrangement to reimburse Taxpayer's drivers for M&IE paid or incurred while traveling away from home meets the business connection requirement. Taxpayer is permitted to compute a per diem allowance based upon the number of miles driven during the payroll period as that method was commonly used in Taxpayer's industry before December 12, 1989.

For purposes of satisfying the substantiation requirements of § 1.62-2(e) for 2006, Taxpayer relies on the deemed substantiation rules provided in Rev. Proc. 2005-67, including the special rules for the transportation industry found in section 4.04 of Rev. Proc. 2005-67.

With respect to the return of excess requirement, the regulations and Rev. Proc. 2005-67 permit Taxpayer to pay per diem allowances for M&IE paid or incurred while traveling away from home that exceed the deemed substantiated amount without requiring return of the excess. See § 1.62-2(f)(2) and section 7.02 of Rev. Proc. 2005-67. Under these rules, however, Taxpayer must take steps to ensure that the excess allowances are tracked and treated as wages subject to withholding and payment of employment taxes and reporting on Forms W-2.

In implementing its expense allowance arrangement for 2006, Taxpayer has not included any mechanism or process that tracks allowances and permits it to determine when the allowances paid to its drivers, computed on a per diem basis, exceed the \$52 per day that may be deemed substantiated. Taxpayer does not receive actual substantiation for the M&IE covered by the allowances. Taxpayer neither requires repayment of the excess allowances nor treats the excess allowances as wages for purposes of withholding and payment of employment taxes and reporting on Forms W-2.

As operated in 2006, Taxpayer's expense allowance arrangement routinely results in payment of excess allowances that are not repaid or treated as wages. Taxpayer's failure to track the excess allowances and its routine payment of excess allowances that are not repaid or treated as wages evidence a pattern of abuse under § 1.62-2(k). Although the excess allowances that have not been repaid or treated as wages may be small in comparison to the total allowance paid to an individual driver, to the amount that may be deemed substantiated for any given period of travel away from home, and to the

aggregate allowances paid to all of Taxpayer's drivers, Taxpayer's arrangement is neither structured nor operated to meet the requirements of the accountable plan regulations for per diem allowance arrangements. As a result, Taxpayer has more than a failure to account for a particular driver's excess allowance or excess allowances paid to drivers for a particular period of travel. Taxpayer's arrangement evidences a pattern of abuse of the accountable plan rules.

Accordingly, even if Taxpayer's expense allowance arrangement otherwise meets the business connection, substantiation, and return of excess requirements of an accountable plan for the allowances paid to Taxpayer's drivers up to the amount that may be deemed substantiated, all payments made under Taxpayer's expense allowance arrangement are treated as paid under a nonaccountable plan. Taxpayer must include all amounts paid under the arrangement to reimburse drivers' M&IE, not just the excess allowances, in the drivers' wages on Forms W-2 and must treat all these amounts as wages for the withholding and payment of employment taxes.

HOLDING

Where an expense allowance arrangement has no mechanism or process to determine when an allowance exceeds the amount that may be deemed substantiated and the arrangement routinely pays allowances in excess of the amount that may be deemed substantiated without requiring actual substantiation of all the expenses or repayment of the excess amount, the failure of the arrangement to treat the excess allowances as wages for employment tax purposes causes all payments made under the arrangement to be treated as made under a nonaccountable plan.

DRAFTING INFORMATION

The principal author of this revenue ruling is Ligeia M. Donis of the Office of Associate Chief Counsel (Tax Exempt & Government Entities). For further information regarding this revenue ruling, contact Ligeia M. Donis at (202) 622-0047 (not a toll-free call).

Revenue Ruling 2005-52

ISSUE

In the following situation, is the tool allowance paid by the employer to the employees paid under an accountable plan such that the payments are excluded from the employees' gross income and exempt from the withholding and payment of employment taxes?

FACTS

Employer operates an automobile repair and maintenance business. Employer hires service technicians to work in the business as employees. Employer requires these employees, as a condition of employment, to provide and maintain various tools needed for use in performing repair and maintenance services. Employer pays each employee an hourly wage. In addition, Employer pays each employee a set amount for each hour worked as a "tool allowance" to cover costs the employee incurs for acquiring and maintaining his tools.

Employer sets each employee's tool allowance annually by using a combination of data from a national survey of average tool expenses for automobile service technicians and specific information concerning tool-related expenses provided by the employee in response to an annual questionnaire completed by all service technicians who work for Employer. Employer does not reimburse expenses paid or incurred for listed property, as defined by § 280F(d) of the Internal Revenue Code (the Code), or depreciation expenses; thus, these expenses are not taken into account in calculating the amount of the annual tool allowance. Employer uses the data to project the employee's total annual tool expenses. Employer then uses a projection of the total number of hours the employee is expected to work during the year that will require the use of tools to convert the employee's estimated annual tool expenses into an hourly rate for the tool allowance. Thus, the hourly tool allowance is an estimate of the tool expense projected to be incurred per hour by the employee over the course of the coming year.

At the end of each pay period, each employee reports to Employer his hours worked requiring the use of tools. Employer multiplies the number of hours reported as worked requiring the use of tools by the employee's hourly rate for the tool allowance and pays the resulting amount to the employee in addition to compensation for services performed during the pay period. On a quarterly statement furnished to each employee, Employer reports: (1) the amount paid to the employee as a tool allowance during the quarter, and (2) the tool expenses estimated to be incurred in the quarter (i.e., the hours reported worked requiring the use of tools times the tool allowance). Employees are not required to provide any substantiation of expenses actually incurred for tools either before or after the quarterly reports are issued. Employer does not require employees to return any portion of the tool allowances that exceeds the expenses they actually incur either before or after the quarterly reports are issued.

LAW

Section 61 of the Code provides that gross income means all income from whatever source derived, including compensation for services, fees, commissions, fringe benefits, and similar items.

Section 62(a)(2)(A) of the Code and § 1.62-2(b) of the Income Tax Regulations provide that, for purposes of determining adjusted gross income, an employee may deduct certain business expenses paid by the employee in connection with the performance of services as an employee under a reimbursement or other expense allowance arrangement with his employer.

Section 62(c) provides that, for purposes of § 62(a)(2)(A), an arrangement will not be treated as a reimbursement or other expense allowance arrangement if (1) the arrangement does not require the employee to substantiate the expenses covered by the arrangement to the payor, or (2) the arrangement provides the employee the right to retain any amount in excess of the substantiated expenses covered under the arrangement.

Section 1.62-2(c)(1) of the regulations provides that a reimbursement or other expense allowance arrangement satisfies the requirements of § 62(c) if it meets the requirements of business connection, substantiation, and returning amounts in excess of substantiated expenses. If an arrangement meets these requirements, all amounts paid under the arrangement are treated as paid under an accountable plan. § 1.62-2(c)(2)(i). Amounts treated as paid under an accountable plan are excluded from the employee's gross income, are not required to be reported on the employee's Form W-2, and are exempt from the withholding and payment of income and employment taxes. § 1.62-2(c)(4).

If an arrangement does not satisfy one or more of these requirements, all amounts paid under the arrangement are treated as paid under a "nonaccountable plan." § 1.62-2(c)(3). Amounts treated as paid under a nonaccountable plan are included in the employee's gross income, must be reported as wages or other compensation of the employee's on Form W-2, and are subject to withholding and payment of income and employment taxes. § 1.62-2(c)(5).

Section 1.62-2(d)(1) provides that an arrangement meets the business connection requirements if it provides advances, allowances, or reimbursements only for business expenses that are allowable as deductions and are paid or incurred by the employee in connection with the performance of services as an employee of the employer. If, however, a payor arranges to pay an amount to an employee regardless of whether the employee incurs (or is reasonably expected to incur) bona fide employee business expenses, the arrangement does not satisfy the business connection requirements and all amounts paid under the arrangement are treated as paid under a nonaccountable plan. § 1.62-2(d)(3)(i).

Section 1.62-2(e)(1) provides that an arrangement meets the substantiation requirements if the arrangement requires each business expense to be substantiated to the payor in accordance with paragraph (e)(3), within a reasonable period of time. An arrangement for

those expenses meets the substantiation requirements of § 1.62-2(e)(3) if information submitted to the payor is sufficient to enable the payor to identify the specific nature of each expense and to conclude that the expense is attributable to the payor's business activity. Generally the employee must submit an expense account or other written statement to the employer showing the business nature and amount of the employee's expenses. See § 1.162-17(b)(4).

Revenue Procedure 2002-41, 2002-1 C.B. 1098, provides an optional expense substantiation rule applicable only to certain employers in the pipeline construction industry. If an eligible employer's arrangement to pay employee business expenses otherwise satisfies the business connection and return of excess requirements, and amounts paid under the arrangement do not exceed \$13.00 per hour, adjusted for inflation, an employee is deemed to have substantiated the expenses, and amounts paid under the arrangement are treated as paid under an accountable plan.

Section 1.62-2(f)(1) provides that an arrangement meets the return of excess requirements if the arrangement requires the employee to return to the payor within a reasonable period of time any amount paid under the arrangement in excess of substantiated expenses. Section 1.62-2(f)(2) provides authority for the Commissioner to issue rules, for per diem or mileage allowances only, under which an arrangement will be treated as satisfying the return of excess requirement even though the arrangement does not require the employee to return the portion of the allowance related to days or miles of travel substantiated but that exceeds the amount of the employee's expenses deemed substantiated pursuant to rules prescribed under § 274(d).

Section 1.62-2(g)(2)(ii) provides that if a payor provides employees with a periodic statement, no less frequently than quarterly, stating the amount, if any, paid under the arrangement that exceeds the expenses the employee has substantiated as required by the arrangement, and requesting the employee to substantiate any additional business expenses that have not yet been substantiated (whether or not such expenses relate to the expenses to which the original advance was paid) and/or to return any amounts remaining unsubstantiated within 120 days of the statement, an expense substantiated or an amount returned within that period will be treated as being substantiated or returned within a reasonable period of time.

Additionally, § 1.62-2(k) provides that if a payor's reimbursement or other expense allowance arrangement evidences a pattern of abuse of the rules of § 62(c) and the regulations thereunder, all payments made under the arrangement will be treated as made under a nonaccountable plan.

ANALYSIS

An amount paid by an employer to an employee to cover expenses incurred by the employee in the course of employment can be excluded from the employee's income and wages only if a particular Code section provides an exclusion for such amount or if the amount is paid under an accountable plan. No specific section of the Code excludes from

wages amounts paid to employees for acquiring and maintaining tools used in the performance of services as employees. Thus, to be excluded from wages, amounts paid to employees to cover expenses incurred to acquire or maintain such tools must be paid under a reimbursement or other expense allowance arrangement that meets the requirements of § 62(c).

An arrangement qualifies as an accountable plan only if it satisfies all three requirements set forth in the statute and regulations. An arrangement that fails to meet one or more of the three requirements will be treated as a nonaccountable plan.

The arrangement described in this revenue ruling fails to meet both the substantiation and the return of excess requirements and thus does not qualify as an accountable plan.

Although reasonable expectations for expenses can be used to establish that a plan meets the business connection requirement, satisfaction of the substantiation and return of excess requirements must be based on expenses actually incurred. The arrangement in the facts of this ruling does not require employees to substantiate the actual expenses they are incurring; rather the employees report their time worked requiring the use of tools, and Employer converts the hours into an amount treated as expenses incurred based on statistical data. Reporting hours worked requiring the use of tools is not the equivalent of substantiating actual expenses incurred. Employers may not substitute a reasonable estimate of expenses to be incurred based on statistical data and hours worked for the substantiation of actual expenses that is required by § 1.62-2(e)(3) absent explicit guidance permitting the use of such deemed substantiation. See, e.g., Rev. Proc. 2002-41.

Employer does not cure the absence of substantiation or return of excess by providing employees with the quarterly statement described in this revenue ruling. Employer does not require employees to provide substantiation of expenses actually incurred nor does Employer require employees to return any excess received within a reasonable period of time after receiving the quarterly statement. Thus, Employer is not providing a periodic statement within the meaning of § 1.62-2(g)(2)(ii).

Each of the accountable plan requirements must be independently satisfied. Thus, even if Employer required the employees to substantiate the actual amount of the expenses, and Employer treated any portion of the tool allowances they receive that exceeded substantiated expenses as additional wages, the arrangement would still not be an accountable plan. With the exception of circumstances where employee expenses are covered through a mileage or per diem allowance pursuant to § 1.62-2(f)(2), an arrangement is not an accountable plan if it includes amounts paid in excess of substantiated expenses in wages rather than requiring that they be returned. See § 1.62-2(f)(1); Rev. Proc. 2004-64, 2004-49 I.R.B. 898, (mileage allowances), or Rev. Proc. 2005-10, 2005-3 I.R.B. 341, (per diem allowances), or any successors.

HOLDING

The arrangement described in this revenue ruling is not an accountable plan. Therefore, the arrangement is a nonaccountable plan and all tool allowances paid under the

arrangement must be included in the employees' gross income, reported as wages on the employees' Forms W-2, and are subject to withholding and payment of federal employment taxes.

DRAFTING INFORMATION

The principal author of this revenue ruling is Joe Spires of the Office of Associate Chief Counsel (Tax Exempt & Government Entities). For further information regarding this revenue ruling, contact Jeanne Royal Singley at (202) 622-0047 (not a toll-free call).