

Part I

Section 62. – Adjusted Gross Income Defined

Rev. Rul. 2004-1

ISSUE

Whether a mileage allowance for local transportation expenses computed on a basis similar to that used in computing a courier's compensation may be treated as paid under an accountable plan so that it will be excluded from the courier's gross income and exempt from the withholding and payment of employment taxes.

FACTS

1. Situation One

Employer, a courier company, hires employee drivers to deliver packages locally. Drivers must own or lease an automobile (including vans, pickups, or panel trucks) for use in connection with the performance of services as couriers. When delivering packages, drivers incur the ordinary and necessary expenses of operating an automobile.

Employer charges customers for deliveries based on location, time of day, expedited service (if requested), mileage between pickup and delivery, size and weight of a package, and other factors. This per package charge is referred to as the "tag rate." The mileage component of the tag rate is computed as though each package were delivered separately. However, drivers often pick up multiple packages from one location, deliver multiple packages to another location, and travel overlapping routes between and among customers. Consequently, the tag rate may not accurately reflect the transportation expenses incurred with respect to a particular package.

Employer pays drivers a commission equal to X percent of the tag rate as compensation for services. Additionally, employer pays drivers a mileage allowance equal to Y percent of the tag rate to cover the expenses of operating their automobiles. Because the mileage allowance is computed based on a percentage of the tag rate, the mileage rate (cents per mile) paid with respect to any particular package varies depending on the number of miles traveled.

Employer determines the percentage of the tag rate paid as a mileage allowance annually and the percentage remains fixed throughout the calendar year. The percentage paid as a mileage allowance is based on employer's review of a sample of documents submitted by drivers (including receipts, logbooks, and invoices) reflecting the drivers' operating and fixed costs. Employer pays the mileage allowance only with respect to miles traveled while delivering packages.

Employer requires that, on a monthly basis, each driver provide information sufficient to substantiate the number of business miles traveled. Employer multiplies the number of miles traveled times the business standard mileage rate (as published by the Commissioner) to calculate the amount of travel expenses deemed substantiated. Employer subtracts the amount deemed substantiated from the mileage allowance paid and reports the excess as wages on the driver's Form W-2.

2. Situation Two

The facts are the same as in Situation One except employer pays drivers a commission equal to Z percent of the tag rate reduced by a mileage allowance equal to the number of miles traveled multiplied by the business standard mileage rate. Thus, drivers always receive Z percent of the tag rate, but the amount treated as a mileage allowance varies based on the number of business miles traveled and subsequently substantiated by drivers.

LAW

Section 61 of the Internal Revenue 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) 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 section 62(a)(2)(A), an arrangement will in no event 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, and (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 section 62(c) if it meets the requirements of business connection, substantiation, and returning amounts in excess of expenses. If an arrangement meets these requirements, all amounts paid under the arrangement are treated as paid under an accountable plan. 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 section 1.62-2(c)(4). Conversely, amounts treated as paid under a nonaccountable plan 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 section 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 that 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) deductible 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. See section 1.62-2(d)(3)(i); see also section 1.62-2(j), example (1) which describes the payment of a fixed amount as either compensation or travel allowance and concludes that the arrangement does not satisfy the business connection requirements.

Section 1.62-2(e)(2) provides that an arrangement reimbursing use of a passenger automobile meets the substantiation requirements if information sufficient to satisfy the substantiation requirements of section 274(d) is submitted to the payor. Section 274(d) provides that no deduction shall be allowed under section 162 with respect to any listed property (including passenger automobiles and any other property used as a means of transportation) unless the taxpayer complies with certain substantiation requirements. Section 1.274-5(g) grants the Commissioner the authority to prescribe rules relating to mileage allowances for ordinary and necessary expenses of using a vehicle for local transportation. Pursuant to this grant of authority the Commissioner may prescribe rules under which such allowances, if in accordance with reasonable business practice, will be regarded as (1) equivalent to substantiation of the amount of such transportation expenses, and (2) satisfying the requirements of an adequate accounting to the employer of the amount of such expenses. The Commissioner annually publishes a revenue procedure establishing a business standard mileage rate taxpayers may use to substantiate the amount of the deductible costs of operating an automobile for business purposes. See, for example, Rev. Proc. 2003-76, 2003-43 I.R.B. 924 (or any successor.) A taxpayer must nonetheless actually substantiate the elements of time, use, and business purpose relating to the expenses.

Section 1.62-2(f) provides that an arrangement meets the return requirements if it 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. However, section 1.62-2(f)(2) provides that a reimbursement or other expense allowance arrangement that provides mileage allowances for ordinary and necessary expenses of local travel will be treated as satisfying the return of excess requirements even though the arrangement does not require the employee to return the portion of such an allowance that relates to the miles of travel substantiated and that exceeds the amount of the employee's expenses deemed substantiated. This exception applies only if the allowance is paid at a rate for each mile of travel that is reasonably calculated not to exceed the amount of the employee's expenses or anticipated expenses and the employee is required to return to the payor within a reasonable period of time any portion of such allowance which relates to miles of travel not substantiated.

In Shotgun Delivery, Inc. v. United States, 269 F.3d 969 (9th Cir. 2001), a courier company paid its drivers a commission equal to 40 percent of the tag rate. The commission was allocated between compensation paid at the minimum wage and a variable mileage reimbursement. The district court found that "because Shotgun's tag rates were not based solely on distance traveled, and since Shotgun drivers could double up on deliveries, Shotgun's reimbursement arrangement, was in fact, reimbursing its drivers in a manner not correlated to expenses Shotgun's employees incurred or were reasonably likely to incur." Shotgun Delivery, Inc. v. United States, 85 F.Supp. 2d 962, 965 (N.D. Cal. 2000.) Consequently, the district court concluded that Shotgun's reimbursement arrangement failed to meet the business connection requirements and held that the mileage reimbursements were paid under a nonaccountable plan. In affirming the district court's holding, the Ninth Circuit observed that such arrangements blur "the fundamental distinction between taxable compensation and tax-exempt reimbursement which underpins this entire aspect of the tax system" and concluded that "requiring a demonstrable connection to actual business expenses prevents companies from improperly sheltering otherwise taxable compensation under the guise of reimbursement." Shotgun Delivery, 269 F.3d at 974.

ANALYSIS

1. Situation One

In Situation One the mileage allowance meets the business connection requirements of section 1.62-2(d). The mileage allowance is paid with respect to deductible employee business expenses reasonably expected to be incurred by the drivers. Employer reviews a sample of receipts, logbooks, and invoices annually to estimate the drivers' operating and fixed costs and, correspondingly, to set the percentage of the tag rate paid as a mileage allowance. Although the mileage allowance is computed on a basis similar to that used in computing the driver's compensation and, consequently, is paid at a variable mileage rate, the percentage of the tag rate paid as a mileage allowance remains fixed throughout the calendar year. Unlike the reimbursements at issue in Shotgun Delivery, Inc. v. United States, 269 F.3d 969 (9th Cir. 2001), the mileage allowance in Situation One is paid with respect to expenses reasonably expected to be incurred and does not vary inversely with the commission based on the number of hours worked.

Similarly, in Situation One the mileage allowance meets the substantiation requirements of section 1.62-2(e). Specifically, the drivers are required to substantiate monthly the time, use, and business purpose, i.e., the number of business miles traveled, relating to their use of an automobile while delivering packages. In lieu of substantiating the actual amount of the driver's deductible transportation expenses, an amount is deemed substantiated equal to the number of miles traveled multiplied by the business standard mileage rate. An allowance paid with respect to ordinary and necessary transportation expenses that is reasonably calculated not to exceed the amount of anticipated expenses and is paid at a flat rate or stated schedule constitutes a mileage allowance

pursuant to section 1.274-5(g) and the rules promulgated thereunder. See Rev. Proc. 2003-76. While the mileage allowance in Situation One is paid at a variable mileage rate, it is nonetheless computed based on a fixed percentage of the tag rate and is considered paid at a flat rate or stated schedule. Thus, drivers are deemed to have substantiated expenses at the business standard mileage rate with respect to each mile of travel actually substantiated.

Finally, in Situation One the mileage allowance meets the return of excess requirements of section 1.62-2(f). Employer intends to pay the mileage allowance only with respect to miles of travel substantiated by the drivers. Consequently, drivers are not required to return the portion of the mileage allowance exceeding the amount of expenses deemed substantiated. See section 1.62-2(f)(2).

Having met the business connection, substantiation, and return of excess requirements of section 1.62-2(c)(1), the portion of the mileage allowance that is not in excess of the expenses deemed substantiated may be treated as paid under an accountable plan in accordance with section 62(c). Such amounts are excluded from the drivers' gross income and are exempt from the withholding and payment of employment taxes. The portion of the mileage allowance that is in excess of the expenses deemed substantiated is treated as paid under a nonaccountable plan. These amounts must be included in the drivers' gross income and are subject to the withholding and payment of employment taxes.

2. Situation Two

In Situation Two the reimbursement arrangement does not meet the business connection requirements of section 1.62-2(d). A variable allocation between commission and mileage allowance ensures that each driver receives Z percent of the tag rate regardless of the amount of deductible employee business expenses incurred by the driver. A bona fide reimbursement arrangement must preclude the recharacterization as a mileage allowance of amounts otherwise payable as a commission. See section 1.62-2(j), example (1); see also H. R. Conf. Rep. No. 998, 100th Cong., 2d Sess. 202-206 (1988). Consequently, the reimbursement arrangement in Situation Two is treated as a nonaccountable plan, and all amounts paid under the plan must be included in the drivers' gross income and are subject to the withholding and payment of employment taxes.

HOLDING

Under the circumstances set forth in Situation One, a mileage allowance for local transportation expenses computed on a basis similar to that used in computing a courier's compensation may be treated as paid under an accountable plan. The portion of the mileage allowance that is not in excess of the expenses deemed substantiated is excluded from the courier's gross income and is exempt from the withholding and payment of employment taxes. However, the portion of the mileage allowance that is in excess of the expenses deemed substantiated is treated as paid under a

nonaccountable plan, must be included in the courier's gross income, and is subject to the withholding and payment of employment taxes. Under the circumstances set forth in Situation Two, a variable allocation between commission and mileage allowance does not meet the business connection requirements. Consequently, the reimbursement arrangement is treated as a nonaccountable plan, and all amounts paid under the plan must be included in the drivers' gross income and are subject to the withholding and payment of employment taxes.

DRAFTING INFORMATION

The principal author of this revenue ruling is Neil D. Shepherd of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this revenue ruling contact Neil D. Shepherd (202) 622-6040 (not a toll-free call).