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INTERNAL REVENUE SERVICE
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CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR AREA COUNSEL,
CC:SB:

FROM: Chief, Employment Tax Branch 1
Tax Exempt and Government Entities
CC:TEGE:EOEG:ET1

SUBJECT: Employment Taxes - Taxable Year

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LEGEND

Taxpayer =
Area X = area
Y =
Year A = taxable year

ISSUE

Whether the arrangement Taxpayer established to reimburse certain expenses of its employee drivers qualifies as an accountable plan under section 62(c) of the Internal Revenue Code during Year A.

CONCLUSION

The arrangement Taxpayer established to reimburse certain expenses of its employee drivers does not qualify as an accountable plan under section 62(c) of the Internal Revenue Code during Year A.

FACTS

Taxpayer is a company in the business of providing messenger and delivery service in Area X. Taxpayer used drivers to provide these courier services to its clients in Year A. The drivers owned the vehicles that they used when performing their duties for Taxpayer. These drivers were all classified by Taxpayer as employees. The drivers all had scheduled daily routes. Each driver proceeded to a set location each day and picked up packages to be delivered elsewhere on the driver's scheduled daily route. Each driver could also make additional pickups and deliveries which were not on the driver's scheduled route. These deliveries were called "on demand" deliveries. The "on demand" deliveries were deliveries made per requests made by clients to the Taxpayer which were communicated to the driver during his route deliveries. A driver could sometimes combine or "double up" deliveries for different clients on the same route.

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Taxpayer maintained _____ for at least one driver.¹ The _____ contained daily summaries of the number of packages delivered, locations of picked up and delivered packages, the times packages were delivered on the driver's scheduled delivery route, and type of the deliveries. No mileage was recorded on these sheets. The _____ also recorded " _____ " deliveries that are telephoned in during the day and were then routed to the driver during his scheduled delivery route. The " _____ " delivery information was added to the bottom of the _____.

Taxpayer also maintained _____ on many, if not all, of its drivers. The _____ listed client names, locations of delivered packages, and type of deliveries. These _____ also contained information on the amount charged to each client and the commission earned by the driver on each delivery. The _____ did not provide information on the number or weight of packages delivered. No mileage was reported on these documents.

_____ were also kept by the Taxpayer.² These forms showed pickup and delivery locations, pieces delivered, client signatures and times.

Charges made by Taxpayer to customers for deliveries were based upon a rate chart that listed prices under the following categories: _____, _____, standard, priority, and _____. The _____ price for distances up to _____ miles was calculated by multiplying the miles traveled times _____ ¢ plus \$ _____. For distances greater than _____ miles, the cost per mile was raised to \$ _____. The _____ price was equal to _____ % of the _____ price and was not available for distances over _____ miles. The standard price was equal to _____ % of the _____ price and was not available for deliveries over _____ miles. The priority price was equal to _____ times the _____ price. The charge for _____ was set at \$ _____. Additional charges were also made based on the weight of packages for long distance deliveries. The total amount charged a customer by Taxpayer for any one job was called a tag rate. If a driver "doubled up" deliveries, each client was still charged for the full tag rate.

¹ Taxpayer had one driver who made deliveries in the _____ area. The remainder of Taxpayer's drivers were based in _____ and only made deliveries in that area. Pursuant to Service requests for documentation, Taxpayer provided _____ on the deliveries made by the driver who made deliveries in the _____ area and _____ on the deliveries made by nine other _____ based drivers.

² _____ were only kept on deliveries made by _____ based drivers.

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The mileage figures used by the Taxpayer to calculate tag rates charged to clients was roughly based upon the mileage distance between pickup and delivery locations.³ The mileage figure for any delivery was estimated by Taxpayer using a zone system. The entire delivery area was divided into zones and the mileage distance from the center of a pickup zone to the center of the delivery zone was used as the mileage figure by the Taxpayer to calculate a tag rate for any delivery.

Income was earned by drivers on a commission basis. Commission rates varied on a driver by driver basis. Generally, a driver was paid % of the tag rate for each package delivered as a commission. The commissions earned by a driver were set out in . were made on a weekly basis. These reports showed a driver's name and employee number, a code representing each delivery made by the driver, the type of delivery, the amount that the client was charged for each delivery, the driver's commission rate, and the driver's actual commission on each delivery. Generally, the total commission earned by and paid to a driver was allocated % to wages and % to equipment rental.

Taxpayer acquired company Y prior to year A. The employee handbook of Y was in effect for Taxpayer during Year A. The handbook stated that employees were to be paid on a commission basis and that this amount was to be allocated % to wages and % to equipment rental. The handbook also stated that employees did not have to provide mileage logs to their employer, but should keep logs for their individual income tax returns. Lease agreements were also executed between the Taxpayer and each driver which provided that % of each driver's commission was for the lease of that driver's vehicle.

Taxpayer had no formal written accountable plan, nor did it have any formal written plan addressing reimbursement of the driver expenses. No specific mileage expense records were kept by the drivers. Nor were mileage records provided to Taxpayer by the drivers prior to the drivers receiving payments for deliveries made. Instead, Taxpayer relies upon reconstructed mileage records based upon the employee routes as sufficient evidence of an accountable plan. Specifically, Taxpayer used its and to reconstruct its mileage records.

After the end of Year A, Taxpayer issued a Form W-2 to each driver for the amount of the commissions (generally %) that Taxpayer paid to that driver as wages and a Form 1099 for the remaining amount of the commissions. The

³ Mileage figures were only one of several factors used by the Taxpayer to calculate tag rates.

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Taxpayer did not treat the amounts reported on the Form 1099 as wages subject to employment taxes. Taxpayer contends that the Form 1099 amounts represented rental of each driver's vehicle, or a reimbursement of mileage expenses.

LAW AND ANALYSIS

I.R.C. § 62

Employee reimbursement or other expense allowance arrangements are governed by section 62 of the Internal Revenue Code (the Code). Section 62 generally defines "adjusted gross income" as gross income minus certain ("above-the-line") deductions. Section 62(a)(2)(A) allows an employee an above-the-line deduction for expenses paid by the employee, in connection with his or her performance of services as an employee, under a reimbursement or other expense allowance arrangement with his employer.

Section 62(c) of the Code provides that an arrangement will not be treated as a reimbursement or other expense allowance arrangement for purposes of section 62(a)(2)(A) 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) gives the employee the right to retain any amount in excess of the substantiated expenses covered under the arrangement.⁴

Under section 1.62-2(c) of the Income Tax Regulations, a reimbursement or other expense allowance arrangement satisfies the requirements of section 62(c) if it meets the three requirements of business connection, substantiation, and

⁴ Section 62(c) of the Code was enacted by the Family Support Act of 1988, Pub. L. 100-485. Through enactment of section 67 of the Code by section 132 of the Tax Reform Act of 1986 (1986 Act), Pub. L. 99-514, 1986-3 C.B. (Vol. 1) 30, the Congress sharpened the distinction between the tax treatment of unreimbursed and reimbursed employee business expenses. Among other changes, unreimbursed business expenses plus other miscellaneous itemized deductions generally were made subject to a two percent floor. At the same time, the Congress decided to retain the above-the-line deduction treatment for reimbursements received by an employee pursuant to a reimbursement arrangement. This rationale for allowing the employee an above-the-line deduction to offset true reimbursement amounts does not apply in the case of nonaccountable plans. Under nonaccountable plans, the amount received by the employee from the employer is not determined by the actual amount of expenses incurred by the employee during the year.

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returning amounts in excess of expenses, set forth in paragraphs (d), (e), and (f), respectively, of section 1.62-2 (“the three requirements”).

If an arrangement meets the three requirements, all amounts paid under the arrangement are treated as paid under an “accountable plan.” Treas. Reg. § 1.62-2(c)(2)(i). Under section 1.62-2(c)(4), 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 sections 31.3121(a)-3, 31.3306(b)-2, and 31.3401(a)-4 of the Employment Tax Regulations, and section 1.6041-3(i) of the Income Tax Regulations.

On the other hand, section 1.62-2(c)(3)(i) of the Income Tax Regulations provides that if an arrangement does not satisfy one or more of the three requirements, all amounts paid under the arrangement are treated as paid under a “nonaccountable plan.” Amounts treated as paid under a nonaccountable plan are included in the employee’s gross income for the taxable year, must be reported as wages or other compensation to the employee on Form W-2, and are subject to withholding and payment of employment taxes. See section 1.62-2(c)(5) of the Income Tax Regulations, and sections 31.3121(a)-3(b)(2), 31.3306(b)-2(b)(2), and 31.3401(a)-4(b)(2) of the Employment Tax Regulations.

An arrangement meets the business connection requirement of section 1.62-2(d) of the Income Tax Regulations if it provides advances, allowances (including per diem allowances, allowances only for meals and incidental expenses, and mileage allowances), or reimbursements for business expenses that are allowable as deductions by Part VI (section 161 and the following), subchapter B, Chapter 1 of the Code, and that are paid or incurred by the employee in connection with the performance of services as an employee. Section 1.62-2(d)(3)(i) provides that the business connection requirement will not be satisfied if the payor arranges to pay an amount to an employee regardless of whether the employee incurs or is reasonably expected to incur business expenses described in paragraphs (d)(1) or (d)(2).

Section 1.62-2(e) of the Income Tax Regulations provides that the substantiation requirement is met if the arrangement requires each business expense to be substantiated to the payor (the employer, its agent, or a third party) within a reasonable period of time. An arrangement that reimburses business expenses governed by section 274(d) of the Code meets this requirement if the information submitted to the payor sufficiently substantiates the requisite elements of each expenditure or use. For example, when substantiating expenses for travel away from home, section 1.274-5T(b)(2) of the Temporary Income Tax Regulations

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requires that information sufficiently substantiating the amount, time, place, and business purpose of the expense must be submitted.

As for the third requirement that amounts in excess of expenses must be returned to the payor, the general rule of section 1.62-2(f) of the Income Tax Regulations provides that this requirement is met 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 the expenses substantiated.

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 section 62(c) and the regulation sections, all payments made under the arrangement will be treated as made under a nonaccountable plan.

Based on the facts presented, we conclude that the Taxpayer's arrangement failed the business connection, the substantiation, and the return of excess payments requirements for an accountable plan.

First, Taxpayer's arrangement failed to meet the business connection requirement of an accountable plan that payments must be for business expenses "that are allowable as deductions by Part VI (section 161 and the following), subchapter B, chapter 1 of the Code, and that are paid or incurred by the employee in connection with the performance of services as an employee of the employer." Treas. Reg. § 1.62-2(d)(1). If an employer pays an amount to the employee as a business expense regardless of whether the employee incurs, or is reasonably expected to incur, the business expense, the payment does not meet the business connection requirement. Treas. Reg. § 1.62(d)(3)(i). In this case, Taxpayer's reimbursed its drivers under its arrangement regardless of actual mileage or vehicle rental expenses incurred.

Second, Taxpayer's arrangement failed to meet the substantiation requirement of section 1.62-2(e) of the Income Tax Regulations. In order to meet the substantiation requirement, the drivers must submit to the Taxpayer information sufficient to substantiate the amount, time, use, and business purpose of the expense. In the present case, no specific mileage records were kept by the drivers nor were mileage records provided to the taxpayer by the drivers prior to the drivers receiving compensation. Additionally no records as to the specific rental value of the vehicles used by the drivers were kept. Taxpayer simply reimbursed expenses of each driver on the basis of a percentage of that driver's commissions which, in turn, were based upon the tag rates of packages delivered by that driver. The tag rates were based upon a number of factors including rough mileage estimates, set rates, weight of packages, and level of priority of the delivery. It was also possible

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for a driver to combine trips so that the driver would then be reimbursed based on two tag rates even though neither actual mileage nor mileage expenses doubled and even though neither the rental value of the driver's vehicle nor vehicle rental expenses doubled. Accordingly, the reimbursement payments made by the Taxpayer were not based upon substantiated actual mileage or vehicle rental expenses and the substantiation requirement of an accountable plan was not met. Taxpayer's reimbursements were solely based on commissions and tag rates which were only partially based on actual mileage.

Third, Taxpayer's arrangement failed to meet the return of excess payments requirement of section 1.62-2(f) of the Income Tax Regulations. The payments made under the arrangement bore no direct relationship to any mileage or rental expenses. Additionally, since the drivers were not required to substantiate their expenses, it was not possible to determine whether the reimbursement payments made were higher or lower than the expenses incurred.

Finally, we conclude that Taxpayer's plan is abusive under section 1.62-2(k) of the Income Tax Regulations and, therefore, all payments made under the arrangement will be treated as made under a nonaccountable plan. Section 1.62-2(k) states that if the reimbursement arrangement evidences a pattern of abuse of the rules of section 62(c), then all payments made under the arrangement will be treated as made under a nonaccountable plan. Taxpayer's reimbursement payments were not based solely on actual miles driven or mileage expenses incurred. Taxpayer's reimbursement payments were also not based at all on the rental value of drivers' vehicles nor vehicle rental expenses incurred. Rather the payments were based on other factors such as additional charges for rush deliveries and the weight of packages. We find this arrangement to be an abuse of section 62(c).

Revenue Ruling 68-624

Employers typically rely on Rev. Rul. 68-624, 1968-2 C.B. 424 as authority for designating a portion of an employee's compensation as a rental payment and excluding that amount from wages. The question raised in Rev. Rul. 68-624, is what percentage of the total amount paid by a corporation for the use of a truck and the services of a driver is allocatable as wages of the driver for FICA purposes. The facts specify that the corporation hires a truck and driver to haul stone from its quarry to its river loading dock at a fixed amount per load and allocates one-third of the amount paid the employee as wages and two-thirds as payment for the use of the truck. The ruling holds that an allocation of the amount paid to an individual when the payment is for both personal services and the use of equipment must be governed by the facts in each case. If the contract of employment does not specify

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a reasonable division of the total amount paid between wages and equipment, a proper allocation may be arrived at by reference to the prevailing wage scale in a particular locality for similar services in operating the same class of equipment or the fair rental value of similar equipment.

Although Rev. Rul. 68-624, has not been obsoleted, we believe it should not be relied upon to exclude rental payments for equipment from wages. The analysis in Rev. Rul. 68-624 is incomplete under current law because it does not consider whether the rental payments are paid under an accountable plan. Under current law, the rental payments can be excluded from wages only if they are paid under an accountable plan. An employment contract that merely allocates compensation between wages and rentals will not satisfy the requirements of I.R.C. § 62(c). To exclude employee reimbursements or other expense allowance payments from wages an employer must establish an accountable plan.

CASE LAW

In Shotgun Delivery, Inc. v. United States, 85 F.Supp. 2d 962 (N.D. Cal. 2000), the court found that the plaintiff's expense reimbursement arrangement with its employees was not an accountable plan within the meaning of section 62(c) of the Code because it did not meet the business connection requirement. Under its arrangement, the plaintiff Shotgun Delivery, Inc. (Shotgun) reimbursed its drivers for expenses incurred in using the drivers' own vehicles regardless of actual miles driven or expenses incurred. Shotgun charged its customers based on distance, time required for delivery, waiting time, and weight. The total amount a customer was charged for any one job was called the tag rate. On certain deliveries Shotgun would double-up, in that if there were several requests for pick-up and delivery in the same cities, then Shotgun would charge each customer for the full distance between the pick-up and delivery locations while only being required to use a single driver to make the one trip. Shotgun would also charge an additional amount for overweight items or rush deliveries.

Shotgun's drivers were paid via two separate checks. The first check was a wage check for hours worked. The second check was considered reimbursement of expenses and was 40% of the tag rate less the wage check. Shotgun did not withhold income tax or employment taxes for the second check. The court agreed that the plaintiff's reimbursement program did not meet the business connection requirement because Shotgun's reimbursement arrangement reimbursed its drivers regardless of actual mileage driven or expenses incurred. On this basis, the court determined that Shotgun's reimbursement arrangement was not a valid accountable plan under I.R.C. § 62(c).

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In this case, under the analysis set out in Shotgun, Taxpayer's reimbursement program failed to meet the business connection requirement. Taxpayer's reimbursement payments to each driver were equal to % of the commission paid to that driver for the deliveries that the driver made. The commission paid to each driver was a percentage of the tag rate charged to the client. The commission rate paid to the drivers varied from driver to driver dependent upon the agreement that they reached with the Taxpayer. Generally the commission was % of the tag rate charged to the client. However, neither the commissions, commission rates, nor the tag rates were based solely upon or directly correlate with mileage or rental expenses.

Taxpayer's drivers, like the drivers in Shotgun Delivery, could double-up on deliveries with no correlating reduction in the amount of reimbursed expenses received by the drivers for these deliveries. Under its arrangement, Taxpayer reimbursed its drivers for the expenses incurred by its drivers regardless of actual miles driven by the drivers, mileage expenses incurred by the drivers, rental value of drivers' vehicles, or vehicle rental expenses incurred. Under these facts and pursuant to the decision in Shotgun Delivery, Taxpayer's reimbursement arrangement did not meet the business connection requirement of an accountable plan.

Another case, Trans-Box Systems, Inc. v. United States, 84 AFTR2d (RIA) 6479 (N.D. Cal. 1998), aff'd without published opinion, 86 AFTR2d (RIA) 5015 (9th Cir. June 2, 2000), involved the issue of whether a reimbursement arrangement utilized by a courier service qualified as an accountable plan for purposes of I.R.C. § 62(c). In Trans-Box, the District Court for the Northern District of California found that plaintiff Trans-Box Systems, Inc. (Trans-Box) failed to meet the substantiation and return of excess payments requirements for an accountable plan. Trans-Box hired drivers to pick up and deliver documents and packages overnight. Some of the drivers used their personal vehicles (owner-operators.) All of the owner-operators signed a standard lease with Trans-Box and were given a runsheet which set a fixed time for completion of standard routes. The drivers were not required to maintain expense reports, but simply requested compensation if a route took more time than that set out in the runsheet. Trans-Box paid the owner-operators a fixed wage of \$8.95 per hour, 45% of which Trans-Box paid as taxable wages and the remaining 55% was paid as vehicle expenses. Trans-Box argued that the vehicle expenses were paid pursuant to an accountable plan.

The court found that Trans-Box failed to meet the substantiation requirement for an accountable plan because the drivers were not required to substantiate their expenses and, even though the drivers recorded their mileage for each route, Trans-Box paid its drivers a fixed wage, which bore no relation to the mileage

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recorded. The court also found that Trans-Box failed to meet the return of excess payments requirement for an accountable plan because the payments bore no relationship to the expenses reimbursed and because it was impossible for Trans-Box to tell whether the fixed sums that Trans-Box paid were higher or lower than the expenses incurred.

In this case, using the analysis set out in Trans-Box, Taxpayer's reimbursement arrangement failed to meet the substantiation and the return of excess payments requirements. Taxpayer based its payments upon factors other than the expenses being reimbursed and, thus, its payments did not correlate to these expenses. The payments were based upon commissions and tag rates which bore little relation to the expenses being reimbursed. Additionally, Taxpayer's drivers were not required to substantiate their expenses. Thus it is not possible to determine the extent that the reimbursement payments made by the Taxpayer equaled the expenses incurred. Under these facts and pursuant to the decision in Trans-Box, Taxpayer's reimbursement arrangement did not meet the substantiation and the return of excess payments requirements for an accountable plan.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

Based on our analysis, we are of the opinion that Taxpayer's plan does not constitute an accountable plan. The plan does not meet the business connection, substantiation, or the return of excess payments requirements of accountable plans under I.R.C. § 62(c). In addition, we believe that the Taxpayer's arrangement evidences a pattern of abuse of the rules of section 62(c) and section 1.62-2(k) of the Income Tax Regulations. Therefore, all amounts paid under the arrangement are subject to withholding and payment of employment taxes.

We also note that whether Taxpayer's reimbursement arrangement qualifies as an accountable plan under I.R.C. § 62 may involve issues of fact that fall within a jury's purview. The Eleventh Circuit recently decided in Trucks, Inc. v. United States, 234 F.3d 1340 (11th Cir. Dec. 11, 2000) that if a taxpayer produces sufficient evidence to show a genuine dispute over the reasonableness of its decision that expense reimbursements were paid under an accountable per diem allowance arrangement, that the issue of whether the reimbursement arrangement qualifies under I.R.C. § 62 is a factual determination, that comes within a jury's purview.

If you have any further questions, please call Suzanne Tank at (FTS) (202) 622-6040.

By: _____

MICHAEL A. SWIM
Chief, Employment Tax Branch1
Office of Division Counsel/Associate Chief
Counsel (Tax Exempt and Government
Entities)