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to: Mark H. Howard
Senior Counsel (Salt Lake City)
(Small Business/Self-Employed)

from: Janine Cook
Branch Chief, Employment Tax Branch 1 (Exempt Organizations/Employment
Tax/Government Entities)
(Tax Exempt & Government Entities)

subject:

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =
Promoter =

ISSUES

Whether amounts paid by Taxpayer to its employee service technicians as purported reimbursements for the use of the technicians' tools under the Taxpayer's tool plan may be excluded from wages for employment tax purposes as amounts paid under an accountable plan?

FACTS

Taxpayer's employee service technicians (Technicians) are required to provide their own tools as a condition of employment. The tools used may range from simple wrenches to sophisticated power tools and computer analysis equipment. Prior to the years at issue, Technicians had been compensated solely on an hourly wage basis, with no specific amount attributed to the provision of tools or other factors related to their employment qualifications. In late 2002, Promoter approached Taxpayer regarding implementation of the Promoter's program (Tool Plan) as a tax savings opportunity related to the reimbursement of Technicians' tool expenses without requiring Taxpayer to pay to the Technicians any additional cash over their hourly wages.

Taxpayer completed a number of forms to permit the Promoter to determine projected tax savings and to enroll in the Tool Plan. As part of this enrollment process, Technicians were asked to estimate their tool inventory value.

From the estimates and other information provided by Taxpayer, such as the hourly wage rate of each eligible Technician, Promoter then compiled a benefit analysis for Taxpayer to determine projected Taxpayer savings. However, Promoter increased each estimated inventory value by \$2000 to reflect an estimate of the Promoter's administrative fee that would be charged to each Technician and treated as an expense covered by the Tool Plan. Once Taxpayer chose to implement the Tool Plan in early 2003, eligible Technicians could participate at their option by completing and signing an enrollment form. The plan materials state that to become a Tool Plan participant, a Technician must average a minimum of 20 hours of employment per week and have a minimum of \$1,000 worth of "qualifying expenses."¹

After receiving a Technician's enrollment form, Promoter notified the Technician of his acceptance as a plan participant and the amount of the Tool Benefit he would receive, if any. The Technician's Tool Benefit amount was based on the information provided on the enrollment form, as described further below.

In 2003, 2004, and part of 2005, the enrollment form asked the Technician to list the tools the Technician was "required to provide, hold liability insurance for, keep, and maintain for purposes of [the Technician's] job" and to provide the cost of each category of tools. Technicians were asked to sign the form, which included a statement that "the information contained here is accurate to the best of my knowledge and, if required, full substantiation can be provided." Although the enrollment form asked the Technician to

¹ The Tool Plan materials state that "all tools required as a condition of employment, all ordinary and necessary trade and business expenses incurred by the employee in furtherance of his employer's business, such as uniforms, safety clothing and gear, training and certification, travel and lodging to obtain training and certification, insurance on tools, and maintenance of tools, equipment, and uniforms, etc., interest paid on tools, personal property taxes paid on tools, and the replacement cost of tools lost, stolen, or damaged" may be claimed as employee business expenses. We are not certain how these non-tool expenses were claimed by the Technician and incorporated into the Tool Plan.

sign a statement that “I only use the above listed tools/equipment for my employer’s business related activities,” Taxpayer has not provided any evidence that it verified whether the tools listed by a Technician were actually required for or used in the Technician’s employment with Taxpayer.

The enrollment form did not ask for any information regarding date of acquisition of the tools in order to determine when the listed cost may have been paid. The enrollment form asked the Technician for information regarding any depreciation taken by the Technician for the listed tools. Other Tool Plan materials indicated that Taxpayer may have asked Technicians whether any prior reimbursements had been received for such tools. However, Taxpayer has not provided any evidence that the Technician provided this information or that Taxpayer made any attempt to otherwise determine if Technician had recovered any tool cost through depreciation or previous reimbursement.²

Promoter’s materials stated that the Tool Plan asked for receipts or documentation related to the acquisition of the tools, if available, however, Taxpayer has not provided any evidence that it ever requested or obtained this documentation or otherwise determined if precise cost information was available. Promoter claims that it asked each Technician to fill out a form to permit Promoter to access each Technician’s tool purchase records, if any, from certain tool companies. For the 11 technicians involved with the plan in 2003 through 2005, only four of these forms were identified. Therefore, the information provided by the Technician on the enrollment form appears to be the only documentation of the Technician’s tool expenses.³ Promoter updated its records of the Technician’s initial Tool Inventory estimate to reflect the tool costs listed on the form.⁴

In late 2005 the enrollment form changed and was supplemented with an extensive tool inventory list with prices for each tool that could be purchased from certain specific tool companies. The price lists were generally 3 years old. The tool inventory list had another column for the Technician to list tools acquired from other companies.

² Promoter has stated that its procedure was to ask each Technician to either provide copies of the prior four year’s tax returns or sign a Form 4506T which would allow Promoter to access tax return information from the IRS to verify whether the Technician had previously claimed a tax deduction based on the tools listed on the Tool Inventory as either an itemized deduction on Form 1040, Schedule A, or a business expense deduction on schedule C. However, neither Taxpayer nor Promoter has provided any evidence that it obtained signed Forms 4506T or the tax return information.

³ We understand that the Technicians may have submitted pictures of their tools to attempt to document their Tool Inventory estimates or subsequent lists of tools on enrollment forms. We do not know the relevance placed by Taxpayer or Promoter on these pictures to establish the values or costs of Technicians’ Tool Inventories.

⁴ However, we understand that for one or more Technicians enrolled in the Plan, Taxpayer has not provided any evidence that the Taxpayer ever updated the Technician’s initial estimate of tool inventory with tool cost information that would have been listed on an enrollment form if one was completed by the Technician.

Promoter instructed the Technician to go through the list and insert the number of each tool he had available for use at the place of employment at that time. Promoter multiplied the number of tools by the price on the list to estimate the cost of the Technician's Tool Inventory.⁵ Promoter then updated its records of the Technician's initial Tool Inventory estimate with the Tool Inventory as determined by the enrollment form and the tool inventory list the Technician had completed.

As with the previously used enrollment form, the new enrollment form did not ask for any information regarding date of acquisition of the tools or previous cost recovery through depreciation or prior reimbursement. The new enrollment form asked the Technician to sign only that "I will be asked to provide substantiation for *future* expenses on a quarterly basis, which will also be reimbursed through [Promoter]." [Emphasis added.] Furthermore, while Promoter's materials stated that the Tool Plan asked for receipts or documentation related to the acquisition of the tools, if available, Taxpayer has not provided any evidence that it ever requested or obtained any additional documentation for those expenses. The prices listed on the tool inventory list were the only documentation of the Technician's tool expenses for any tools listed on the form.

Promoter charged a two-part fee for setting up and administering the Tool Plan. Promoter charged Taxpayer a flat fee per Technician (\$50 per Technician joining the Plan) when the Technician signed up. Promoter also charged the Technician an administrative fee of 10%⁶ of the computed value of the Technician's Tool Inventory as derived from the enrollment form. The 10% amount was added to the Technician's Tool Inventory to arrive at the Total Tool Dollar Amount.⁷

The Tool Plan then calculated the Technician's Tool Benefit based on the Total Tool Dollar amount (i.e., the Tool Inventory plus 10%). The Tool Benefit was paid to the Technician as an hourly reimbursement rate (Tool Rate) over a determined number of reimbursement hours. As a formula, the computation was as follows:

$$\bullet (\text{Tool Inventory} + 10\% \text{ fee}) / \text{Tool Rate} = \text{reimbursement hours.}$$

The Tool Plan determined the Tool Rate as a fixed dollar amount per hour for each Technician. The starting point was 35% of the Technician's current hourly wage, although under the Tool Plan the Tool Rate could not exceed \$8.00 per hour, or an amount that when recharacterized from the Technician's hourly wages left an hourly

⁵ Promoter's materials reference the Technician's ability to modify the price listed if necessary. We note also that some of Promoter's materials refer to information establishing the "value" of the Technician's tool inventory.

⁶ In states that do not have an income tax, the Promoter administrative fee was 8% of the computed value of Technician's tool inventory, to reflect the reduced tax savings for employees who enrolled in the Tool Plan in those states versus states that did have an income tax.

⁷ By increasing the Technician's Tool Inventory by 10% and then calculating its 10% of the new Total Tool Dollar amount, the Promoter effectively receives a 11% fee of the Tool Inventory amount.

wage below the legal minimum wage. For example, the Tool Rate for a Technician receiving compensation of \$20 per hour would be 35% of \$20, or \$7.

The number of reimbursement hours for which the Technician would receive the calculated Tool Rate was based on the formula above. The Technician received the Tool Rate for each hour worked until the reimbursement rate times such hours equaled the Technician's Tool Inventory plus the 10% fee, or the Total Dollar Amount.

To pay the Tool Benefit, Taxpayer divided the Technician's compensation into two components: the hourly wage and the hourly Tool Rate. The sum of the two components equaled the Technician's previous hourly wage. Once the Total Dollar Amount was paid via the Tool Rate over the number of reimbursement hours, the portion of the Technician's hourly wage that had been recharacterized as a Tool Rate immediately reverted back to part of the hourly wage, so that the Technician always received the same gross wages. The tax savings promoted by the Tool Plan resulted from treating the Tool Rate portion as nontaxable.

More specifically, once a Technician enrolled in the Tool Plan, Taxpayer began making two payments at the end of each pay period. Taxpayer issued one check to the Technician at the reduced hourly wage rate and treated this amount as wages and withheld income taxes and Federal Insurance Contributions Act (FICA) tax on the amount reported. Taxpayer made the second payment each pay period to Promoter based on the determined Tool Rate; Taxpayer treated this check as not subject to income tax withholding or FICA tax for the employer or the employee. Promoter took its fee of 10% of the Total Dollar Amount out of the remitted funds and paid the balance to the Technician as the Tool Benefit. Promoter did not treat such amount as wages subject to FICA tax or income tax withholding. Accordingly, the recharacterized hourly rate was treated as nontaxable income, including the portion paid to the Promoter as the fee. Technicians continued to receive the same amount per hour as they did before the implementation of the Tool Plan, but it was split into two portions, one treated as wages and the other treated as nontaxable reimbursement for tool expenses and the Tool Plan's administrative fee.

Technicians could increase their Total Tool Dollar Amount or again participate in the Tool Plan after receiving full reimbursement of their original Total Tool Dollar Amount if they purchased additional tools and submitted a "Tool Purchase Quarterly Update" form. Unlike the costs or prices provided on the original enrollment forms, the new tool expenses included on the Tool Purchase Quarterly Update forms required the attachment of receipts or invoices for the expenses listed. Promoter added these tool purchases to any balance of the Technician's previously computed Tool Inventory which had not yet been reimbursed. As the amount paid to a Technician as a Tool Benefit approached the Total Tool Dollar Amount, Promoter informed Taxpayer. The letter indicated how many pay periods were left for payment of the Tool Rate for the calculated reimbursement hours; if the number was "0," the letter also stated, "make

sure that you do not take any more Tool Plan deduction until further notified. The technician should return to their [sic] regular pay.”

Generally, a Technician continued to receive his Tool Benefit until he had received an amount equal to his Total Tool Dollar Amount or until he quit. However, the records provided by Taxpayer indicate that some Technicians received amounts as Tool Benefit in excess of their Total Tool Dollar Amounts. Taxpayer has not shown that it required the Technicians to repay any excess reimbursements received or that it included these amounts on Forms W-2.⁸

Promoter asserts that if a Technician terminated employment, he forfeited the ability to obtain reimbursement of the remaining balance on his Tool Inventory. However, as a payment made on an hourly basis, such “forfeiture” was consistent with the simultaneous cessation in the payment of hourly wages upon termination.

At the end of 2005, six new Technicians and two Technicians who had received prior reimbursements were signed up for the Tool Plan with benefits starting in January of 2006. The Tool Plan had been modified to treat the tool reimbursements as a “lump sum” pre-tax deduction from the technicians’ pay check. The Tool Benefits would no longer be based upon the number of actual hours worked during a particular pay period. The “lump sum” deduction was determined as follows. The total hourly wage rate was multiplied by 35% to arrive at the Tool Rate (same as before). This rate was then multiplied by a set 80 hours per pay period to determine the pre tax “lump sum” deduction. The Total Tool Dollar Amount (beginning tool inventory for the Technician plus the 10% administrative fee, same as above) was divided by the “lump sum” amount to determine how many pay periods the Technician’s benefit would last. Therefore, each “lump sum” deduction and Tool Benefit payment to the employee would be exactly the same for each pay period. Taxpayer would issue a check each pay period to Promoter for the total of the “lump sum” payment determined for the Technicians currently receiving benefits. Promoter would issue a Tool Benefit check to each Technician after deducting its 10% administrative fee. The remainder of the prior wage amount was paid to Technician by Taxpayer and treated as taxable wages.

LAW

Section 61 of the Internal Revenue Code defines gross income as all income, from whatever source derived. Section 62 defines adjusted gross income as gross income minus certain identified deductions. 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 § 62(a)(2)(A), an arrangement will not be treated as a reimbursement or other expense allowance

⁸ Although the correct reporting of excess amounts would be on a Form W-2, we also note that neither Taxpayer nor Promoter reported such amounts on a Form 1099.

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 on the employee's Form W-2, and are exempt from 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).

The business connection, substantiation, and return of excess requirements under § 1.62-2(d), (e), and (f), apply on an employee-by-employee basis. The failure of one employee to substantiate his expenses would not cause reimbursements to other employees to be treated as made under a nonaccountable plan. Namyst v. Commissioner, T.C. Memo 2004-263 (2004), aff'd, 435 F.3d 910 (8th Cir. 2006); § 1.62-2(i).

Business Connection Requirement

Section 1.62-2(d)(1) provides that an arrangement satisfies the business connection requirement if it provides advances, allowances, or reimbursements only for business expenses that are allowable as deductions by part VI, 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. Thus, not only must an employee pay or incur a deductible business expense, but the expense must arise in connection with the employment. If an employer reimburses a deductible tool expense that the employee paid or incurred prior to employment, the reimbursement arrangement does not meet the business connection requirement. Further, if an employer pays an advance or allowance based on an approximation of value or hypothetical expenses, regardless of whether the employee incurs (or is reasonably expected to incur) the type of deductible business expenses described above, the reimbursement arrangement does not meet the business connection requirement.

"Paid or incurred" requires that there be an actual expense, not fair rental value or use, or some other intangible figure, with which the advance, allowance or reimbursement is associated. In the case of an advance or allowance, the payment by the employer may

precede the incurring or payment of the specific expense by the employee, assuming the substantiation requirements are met in a timely manner, as discussed further below.

Section 1.62-2(d)(3)(i) provides that if a payor arranges to pay an amount to an employee regardless of whether the employee incurs (or is reasonably expected to incur) deductible business expenses or other bona fide expenses related to the employer's business, the arrangement does not satisfy the business connection requirement and all amounts paid under the arrangement are treated as paid under a nonaccountable plan. A payor arranges to pay an amount to an employee regardless of whether the employee is reasonably expected to incur bona fide business expenses by supplementing the wages of those employees not receiving the reimbursement (so that the same gross amount is paid regardless of the characterization), by reducing the wage payment in light of expenses incurred and paying the same or similar amount as reimbursement allowance to the employee, or by routinely paying a reimbursement allowance to an employee who has not incurred bona fide business expenses. Section 1.62-2(j) Example 1 illustrates a violation of the § 1.62-2(d)(3)(i) reimbursement requirement by the payment of wages in lieu of a reimbursement allowance to an employee who has not incurred bona fide business expenses. The example provides that Employer S pays its engineers \$200 a day. On those days that an engineer travels away from home on business for Employer S, Employer S designates \$50 of the \$200 as paid to reimburse the engineer's travel expenses. Because Employer S would pay an engineer \$200 a day regardless of whether the engineer was traveling away from home, the arrangement does not satisfy the reimbursement requirement of paragraph § 1.62-2(d)(3)(i). Thus, no part of the \$50 Employer S designated as a reimbursement is treated as paid under an accountable plan. Rather, all payments under the arrangement are treated as paid under a nonaccountable plan. Employer S must report the entire \$200 as wages or other compensation on the employees' Form W-2 and must withhold and pay employment taxes on the entire \$200 when paid.

If a plan serves to recharacterize as a reimbursement allowance amounts previously paid as wages, amounts paid under it will not be treated as paid under an accountable plan. Such recharacterization violates the business connection requirement of § 1.62-2(c) because the employees receive the same amount regardless of whether expenses are incurred, the only difference being the ratio of the amount treated as taxable wages to the amount treated as nontaxable reimbursement.⁹ Consequently, all reimbursement allowances paid under the plan must be treated as paid under a nonaccountable plan, must be included in the employee's gross income, and must be reported as wages for FICA tax, FUTA tax, and income tax withholding purposes. The recharacterization as a reimbursement allowance of amounts previously paid as wages violates the business

⁹ See also Rev. Rul. 2004-1, 2004-1 C.B. 325. In Rev. Rul. 2004-1 the Service concluded, in relevant part, that a reimbursement arrangement that subtracted a mileage allowance (calculated at the standard business mileage rate) from the driver's set commission rate and treated only the remaining commission as wages failed the business connection requirement. The variable allocation between commission and mileage allowance in essence recharacterized as mileage allowance amounts otherwise payable as commission.

connection requirement of § 1.62-2(c) regardless of whether the employee actually incurs (or is reasonably expected to incur) deductible business expenses related to the employer's business.

The prohibition against wage recharacterization does not preclude an employer's prospective alteration of its compensation structures to include reimbursements of substantiated expenses, as long as such amounts, however identified or denominated, are only paid if qualifying expenses are incurred and substantiated. The presence of wage recharacterization is based on the totality of facts and circumstances so that temporary alterations in compensation structures may in reality be invalid attempts to temporarily shift a portion of an employee's taxable compensation for services into a nontaxable reimbursement with the intent or expectation to shift it back once a certain amount is paid purportedly tax-free.

Substantiation Requirement

Section 1.62-2(e)(1) provides that an arrangement meets the substantiation requirement if it requires each business expense to be substantiated to the payor in accordance with paragraph (e)(2) or (e)(3) of the section, whichever is applicable, within a reasonable period of time. Section 1.62-2(g)(1) provides that what constitutes a reasonable period of time depends on the facts and circumstances of each arrangement.

Section 1.62-2(e)(2) provides that an arrangement that reimburses expenses governed by § 274(d), meets the requirements of § 1.62-2(e)(2) if information sufficient to satisfy the substantiation requirements of § 274(d) and the regulations thereunder is submitted to the payor. Section 274(d) applies to "listed property" under § 280F(d)(4). Most tools are not listed in § 280F(d)(4). The list is limited to items such as property used for transportation including an automobile, computer or peripheral equipment as defined in §168(i)(2)(B), and cellular telephone or similar telecommunications equipment. No deduction is allowed for an expense associated with such property under § 274(d)(4), and any "reimbursement" of the expense must be treated as wages subject to withholding and payment of employment taxes, unless the taxpayer establishes by adequate records or by sufficient evidence corroborating the taxpayer's own statement (A) the amount of the expense, (B) the time and place of the use of the subject property, (C) the business purpose of the expense, and (D) the business relationship to the person using the property.

Section 1.62-2(e)(3) provides that an arrangement that reimburses business expenses not governed by § 274(d) meets the requirements of § 1.62-2(e)(3) if information is submitted to the payor 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 activities. The section further provides that each of the elements of an expenditure or use must be substantiated to the payor, and that it is not sufficient for an employee to merely aggregate expenses into broad categories or to report individual expenses through the use of vague, non-descriptive terms.

Section 1.62-2(e)(3) references §1.162-17, which provides substantiation rules for employee business expenses. Section 1.162-17(b) provides that an employee need not report on his tax return expenses for travel, transportation, entertainment, and similar purposes paid or incurred by him solely for the benefit of his employer for which he is required to account and does account to his employer and which are charged directly or indirectly to the employer, or for which the employee is paid through advances, reimbursements, or otherwise, provided the total amount of such advances, reimbursements, and charges is equal to such expenses. Section 1.162-17(b)(4) provides that to “account” as used in this section means to submit an expense account or other required written statement to the employer showing the business nature and the amount of all the employee’s expenses broken down into broad categories such as transportation, meals and lodging while away from home overnight, entertainment expenses, and other business expenses.

The Tax Court addressed the substantiation requirements for an accountable plan in Namyst v. Commissioner, in which it stated:

The substantiation rules for business expense deductions under sections 162 and 274(d) are incorporated by section 1.62-2(e)(1) through (3), Income Tax Regs., for the purpose of determining whether a reimbursement arrangement constitutes an accountable plan.

Taxpayers must satisfy record keeping and substantiation requirements for tax benefits they claim. See § 1.6001-1(a). Such records must show a sufficient business connection. Chong v. Commissioner, T.C. Memo 2007-12. Deductions are provided as a matter of legislative grace and the taxpayer has the burden of proving entitlement to them. New Colonial Ice Co. v. Helvering, 292 U.S. 435 (1934). When the evidence shows that the taxpayer incurred a deductible expense, but the taxpayer does not have evidence of the exact amount, a court can allow an approximate amount. Cohan v. Commissioner, 39 F.2d 540 (2nd Cir. 1930). However, before the court will apply the “Cohan rule,” the record must contain sufficient evidence for the court to conclude that the taxpayer incurred a deductible expense, rather than a nondeductible personal expense, in at least the amount allowed. Williams v. United States, 245 F.2d 559, 560 (5th Cir. 1957); Vanicek v. Commissioner, 85 T.C. 731, 742-743 (1985); Deihl v. Commissioner, T.C. Memo 2005-287. In applying the Cohan rule, a court is free to disregard testimony of a taxpayer if the testimony is not credible evidence that a deductible expense was incurred. Charron v. United States, 200 F.3d 785, 793 (Fed. Cir. 1999).

Returning Amounts in Excess of Expenses

Section 1.62-2(f) provides that, in general, an arrangement meets the requirement of returning amounts in excess of expenses 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 the expenses substantiated. Section 1.62-2(f) further provides that an arrangement whereby money is advanced to an employee to defray expenses will be treated as satisfying the return of excess requirement only if the amount of money advanced is reasonably calculated not to exceed the amount of anticipated expenditures, the advance of money is made on a day within a reasonable period of the day that the anticipated expenditures are paid or incurred, and any amounts in excess of the expenses substantiated are required to be returned to the payor within a reasonable period of time after the advance is received. Furthermore, an arrangement will not meet the return of excess requirement if it fails to satisfy the substantiation requirement under § 1.62-2(e) since any amounts paid under the arrangement that are not substantiated are treated as excess and must be returned.

Revenue Ruling 2005-52

In Rev. Rul. 2005-52, 2005-35 I.R.B. 423, the Service addressed the tax consequences of a tool plan. In the revenue ruling, the employer paid each employee an hourly wage plus a set amount for each hour worked as a “tool allowance” to cover costs the employee incurred for acquiring and maintaining tools. The employer set 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 the employer. Employer then used a projection of the total number of hours the employee was expected to work during the year that would require the use of tools to convert the employee’s estimated annual tool expenses into an hourly rate for the tool allowance. The tool allowance, therefore, was 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 reported the number of hours worked requiring the use of tools. Employer then multiplied the number of hours reported as worked requiring the use of tools by the employee’s hourly rate for the tool allowance and paid the resulting amount to the employee in addition to compensation for services performed during the pay period. Employer furnished each employee with a quarterly statement that reported the amount paid to the employee as a tool allowance during the quarter, and the tool expenses estimated to be incurred in the quarter. Employees were not required to provide any substantiation of expenses actually incurred for tools either before or after the quarterly reports were issued. Employer did not require employees to return any portion of the tool allowance that exceeded the expenses they actually incurred either before or after the quarterly reports were issued.

The revenue ruling concludes that the arrangement fails to meet both the substantiation and return of excess requirements because it does not require employees to substantiate the actual expenses they incur; 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. The ruling provides that

although reasonable expectations for expenses can be used to establish that a plan providing an allowance meets the business connection requirement, satisfaction of the substantiation and return of excess requirements must be based on actual expenses. The ruling emphasizes that employers may not substitute a reasonable estimate of expenses based on statistical data and hours worked for the substantiation of actual expenses as required by § 1.62-2(e)(3), absent explicit guidance permitting the use of such “deemed” substantiation.

The ruling provides that the employer does not cure the absence of substantiation or return of excess by providing the employees with the quarterly statements, since the employer does not require the 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. Therefore, the revenue ruling concludes that employer does not provide a periodic statement within the meaning of § 1.62-2(g)(2)(ii).

The revenue ruling goes on to provide that, even if employer required its employees to substantiate the actual amount of expenses incurred and treated any excess amount as additional wages, the arrangement would still fail to qualify as an accountable plan. To qualify as an accountable plan, an arrangement must require that amounts paid in excess of substantiated expenses be returned. Simply including excess amounts in wages does not satisfy the requirement of returning amounts in excess of expenses, the exception being where employee expenses are covered through a mileage or per diem allowance pursuant to § 1.62-2(f)(2).

Consequently, the ruling holds that the arrangement described is not an accountable 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 subject to withholding and payment of federal employment taxes.

It is important to note that Rev. Rul. 2005-52 did not address how an arrangement intending to reimburse tool expenses can satisfy the business connection requirement. Accordingly, Rev. Rul. 2005-52 did not address the prohibition against wage recharacterization nor the level of detail necessary to establish the requisite connection between the expense and the employee’s job. Such analysis was not necessary in light of the tool allowance’s failure to satisfy the equally fundamental requirements of substantiation and return of excess.

Anti-abuse Provision

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 this section, all payments made under the arrangement will be treated as made under a nonaccountable plan.

ANALYSIS

Based on the facts provided, Taxpayer's Tool Plan does not satisfy the requirements of an accountable plan. Specifically, the Tool Plan fails each of the three requirements of business connection, substantiation, and return of excess. As shown in the facts above, the Tool Plan fails the business connection and return of excess requirements, both in design and operation, and, though the Tool Plan as outlined in the plan materials may appear to contain elements that satisfy the substantiation requirement, it is insufficient in both design and in operation and therefore also fails the substantiation requirement.

Business Connection Requirement

To satisfy the business connection requirement, the Tool Plan must pay amounts only for deductible business expenses that are actually paid or incurred or are reasonably expected to be paid or incurred.¹⁰ Additionally, the expenses must be paid or incurred by the Technician in connection with the Technician's performance of services for Taxpayer, rather than another employer. If amounts are paid regardless of whether the Technician pays or incurs or is reasonably expected to pay or incur expenses, business connection is not satisfied.

We conclude that the Tool Plan fails the business connection requirement. First, the Tool Plan does not require Technicians to provide information sufficient for Taxpayer to determine the amount of expenses¹¹ related to the performance of services for Taxpayer that properly may be reimbursed.¹² While some versions of the enrollment forms requested information pertaining to prior depreciation and reimbursement of the cost of the tools, there is no indication that this information was actually obtained or taken into account. The forms also failed to request information on other elements needed to establish business connection, for example when the tools were purchased, that could be used to determine whether the expenses were incurred in connection with employment for a different employer. In fact, we understand that life-time guarantees, the payment for tools as part of tuition for educational programs, and the sharing of tools mean that it is quite possible in some cases that a complete tool inventory has little or no correlation to the actual types or amounts of expenses that may be related to performing services for Taxpayer.¹³ Therefore, the amount that purportedly is being

¹⁰ A reimbursement arrangement can also reimburse nondeductible bona fide employee business expenses, but such reimbursements are treated as a separate plan and are includible in income and wages. See Treas. Reg. § 1.62-2(d).

¹¹ We are assuming for purposes of this analysis that all of the tools listed were in fact used in employment with Taxpayer.

¹² While Rev. Rul. 2005-52 references the ability for reasonable expectations to establish business connection, it does so in the context of a tool allowance provided under a plan that failed to follow up such reasonable expectations with the substantiation and return of excess necessary to satisfy the accountable plan rules.

reimbursed under the Tool Plan is not based on the tool expenses incurred in connection with performing services for Taxpayer.

Second and perhaps more fundamental to the structure of the Tool Plan, the amounts at issue are not reimbursements. Instead, the Tool Plan merely recharacterized a portion of a Technician's compensation and labels that compensation as a "reimbursement." Taxpayer's employee Technicians received the same hourly amount regardless of whether they incurred or would reasonably be expected to incur expenses; the hourly amount was merely broken down into two components and issued via two different payment methods. The Technicians continued to receive the same amount of total compensation regardless of the amount of expenses paid or incurred, and the amount treated as wages varied in relation to the amount of the Tool Benefit.¹⁴ Under the totality of circumstances, the Plan effectively served to recharacterize as expense reimbursement that which was previously treated as wages and would be treated as wages again once the total Tool Benefit amount had been paid out. In fact, the Plan materials marketed the fact that Technicians' gross compensation would stay the same, with more take-home pay in light of the saved taxes. Under the Plan, once a Technician received his full Tool Benefit, the Technician's "wages" automatically reverted back to its original hourly amount.

The fact that the Technician's previous hourly wages may have inherently included some unstated portion to cover any tool expenses does not mean the Tool Plan merely altered a previous "nonaccountable" reimbursement plan into an "accountable" reimbursement plan only to go back to a nonaccountable plan once the entire Tool Benefit was paid. An employer's general intent that the compensation it pays be sufficient to cover any expenses does not create an expense reimbursement arrangement of any sort, even a nonaccountable one. Taxpayer has not shown that there was any type of reimbursement arrangement in place prior to implementation of the Tool Plan.

Furthermore, an accountable plan may not reimburse an expense that had already been reimbursed, regardless of whether the first "reimbursement" was taxed. Even if Taxpayer had a taxable reimbursement arrangement (i.e., a nonaccountable plan) prior to implementation of the Tool Plan, the Tool Plan would still need to satisfy all the requirements of the accountable plan rules. Consequently, in order for the Tool Plan to have qualified as an accountable plan, Taxpayer would have had to distinguish the previously reimbursed expenses, whether reimbursed in full by Taxpayer or reimbursed in part through depreciation, from any expenses reimbursed by the Tool Benefit. However, the Tool Benefit amount was based on the entire tool inventory cost, including those expenses that purportedly had been reimbursed under the prior nonaccountable plan, and did not identify any previously reimbursed expenses. Furthermore, the gross

¹³ We also note that references in Tool Plan materials to "value" of inventory may belie the Tool Plan's purported attempts to get information about cost.

¹⁴ See Rev. Rul. 2004-1, *supra*, note 9.

amount paid to the Technicians prior to implementation of the Tool Plan, the gross amount paid under the Tool Plan, and the gross amount paid once the Tool Benefit Amount had been paid are identical. The only difference is the portion treated as taxable. Accordingly, the facts above evidence impermissible wage recharacterization under the totality of the circumstances surrounding the Tool Plan since the Technicians' gross compensation remained the same and was payable in all events.

Based on the failure of the Tool Plan to demonstrate the connection between the tools listed and the supposed expenses incurred in performing services for Taxpayer and the impermissible wage recharacterization, the Tool Plan fails the business connection requirement, both in its design and operation, and does not qualify as an accountable plan.

The failure to satisfy the business connection requirement is sufficient to disqualify the Tool Plan as an accountable plan and to require treatment of all payments made under the Tool Plan as taxable wages. However, for purposes of providing a complete legal analysis, we will also address whether the Tool Plan satisfied the substantiation and return of excess requirements.

Substantiation Requirement

Based on the facts provided, the Tool Plan also fails the substantiation requirement. The general substantiation requirement under § 1.62-2(e)(3) requires the substantiation of the elements of the expense in accordance with § 1.162-17(b)(4), which includes providing an expense account or other written statement showing the amount and business nature of each expense.

The Tool Plan fails the substantiation requirement because the plan fails to require substantiation of all of the elements of the expenses. Section 1.62-2(e)(3) requires substantiation of each element of an expenditure or use, including business purpose and amount. The plan does not require substantiation of purchase dates, prior depreciation, prior reimbursements, and other relevant information required to substantiate these elements. To the extent the Tool Plan relied on cost totals for categories of tools without obtaining any information regarding the acquisition date, to determine when the initial expense was incurred, and any depreciation of such tools or prior reimbursement to the Technician, the Tool Plan failed to require the Technicians to substantiate the elements of the expenses so that Taxpayer could determine which expenses were attributable to its business activities. See Treas. Reg. § 1.62-2(e)(3). The Tool Plan's requirement for receipts for new expenses submitted on the Quarterly Update form, while satisfying substantiation for those particular expenses, does not salvage the substantiation failures in the design or operation of the remainder of the Tool Plan.

Taxpayer attempts to rely on the Cohan rule for the tools not subject to § 274(d) to assert that its use of estimates is permissible. The Cohan rule allows the use of

estimates to establish the amount of expenses not subject to the substantiation requirements of § 274(d). However, there must be a reasonable evidentiary basis for the estimate. Namyst v. Commissioner. There is no indication that Taxpayer made any attempt to obtain accurate cost information before relying on estimates. Additionally, there is no reasonable evidentiary basis to establish the other elements of the expenses that the Taxpayer must substantiate, such as whether the expenses for the tools were paid or incurred in connection with performing services for Taxpayer or whether any of the cost was previously recovered, and no indication that Taxpayer made any attempt to obtain this information.

Some of Technicians' tools may include computer components and may be subject to the more rigorous substantiation requirements of § 274(d). These statutory requirements supersede the Cohan rule, and a court may not estimate deductible expenses when the requirements are not met. Sanford v. Commissioner, 50 T.C. 823, 827-828 (1968), aff'd per curiam 412 F.2d 201 (2d Cir.); Chong v. Commissioner, T.C. Memo 2007-12. Taxpayer and the Tool Plan did not obtain substantiation that would satisfy § 274(d).

As a result, the Tool Plan in overall design and operation fails the substantiation requirement and does not qualify as an accountable plan for this additional reason. Although some specific expenses incurred in connection with performing services for the Taxpayer appear to have been properly substantiated (i.e., the Quarterly Update form), the reimbursement of these expenses nonetheless fails the business connection requirement.

Return of Excess Requirement

All amounts paid under the Plan that were not properly substantiated are treated as excess reimbursements. Based on the facts provided, both as designed and implemented, Taxpayer's reimbursement arrangement does not require that employees actually return any amounts paid in excess of substantiated expenses. Furthermore, the facts show that several Technicians received amounts in excess of their Tool Inventory value as calculated by Promoter and were not required to return the additional amounts. The Tool Plan therefore does not satisfy the return of excess requirement, either in design or operation, and does not qualify as an accountable plan for this additional reason.

Pattern of Abuse

We also note that, in addition to violating the basic requirements of an accountable plan, namely substantiation, business connection, and return of excess, the Plan as adopted by Taxpayer and as administered by Promoter may also evidence a pattern of abuse under §1.62-2(k), requiring the treatment of payments made under the Plan as made under a nonaccountable plan. These violations were not isolated errors with regard to a particular Technician or particular period of time or type of tool. They are routine and

fundamental to the design of the Tool Plan, where the goal is to ensure that the gross pay of each Technician never changes, by altering the compensation structure so that the amount of wages decreases by the same amount “reimbursed” in order to save on income and employment taxes that otherwise should be withheld and paid. The accountable plan rules were not meant to allow taxpayers to avoid paying taxes on their wages, even if for a short period of time, in the guise of expense reimbursement. The routine reimbursement of unsubstantiated expenses and the practice of recharacterizing wages as reimbursement until expenses are reimbursed, only to reinstate the original compensation amount at that point, evidence an abuse of the accountable plan rules.

In light of the failure to satisfy any of the three requirements for an accountable plan and the pattern of abuse, Taxpayer’s reimbursements to its employee Technicians do not satisfy the requirements of an accountable plan and are to be treated as paid under a nonaccountable plan. Therefore, amounts paid under the Tool Plan must be included in the Technician’s gross income, reported as wages or other compensation on the Technician’s Form W-2, and subject to withholding and payment of employment taxes.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS



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Please call _____ if you have any further questions.