



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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OFFICE OF
CHIEF COUNSEL

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CONEX-136505-08

The Honorable Richard G. Lugar
United States Senate
Washington, DC 20510

Attention:

Dear Senator Lugar:

This letter responds to your letter dated August 15, 2008, on behalf of your constituent, . asked for guidance on the proper tax treatment of amounts paid to pizza delivery drivers as mileage reimbursements rather than as increased wages.

The application of the employment tax rules to amounts designated as reimbursements depends upon the facts and circumstances of the arrangement. While described her situation in some detail, the taxability of the particular payments depends upon the totality of the circumstances. I provide the following discussion of the applicable law to assist in determining the appropriate tax treatment or in understanding what additional factual information might be necessary to obtain from her employer.

Generally, amounts employers pay as reimbursements for employee business expenses are taxable unless 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 on the employee's Form W-2, and are exempt from withholding and payment of employment taxes. 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.

The law treats a reimbursement or other expense allowance arrangement as an accountable plan only if it meets the requirements of:

- Business connection
- Substantiation
- Return of excess

[Section 62(c) of the Internal Revenue Code (the Code) and section 1.62-2(c) of the Treasury Regulations (the Regulations)].

Business Connection Requirement

An arrangement meets the business connection requirement if the employer pays advances, allowances, or reimbursements only for deductible business expenses that the employee pays or incurs while performing services for the employer. If, however, an employer pays an employee regardless of whether the employee incurs (or is reasonably expected to incur) bona fide business expenses, the arrangement does not satisfy the business connection requirement and the amounts are treated as paid under a nonaccountable plan and are subject to employment taxes.

An employer may choose whether to reimburse employee expenses. However, an employer may not treat as a nontaxable expense reimbursement an amount that would otherwise be paid as wages. We base the determination of whether an amount would otherwise be paid as wages on the totality of the facts and circumstances. For example, the fact that state law required an increase in the minimum wage for all employees and that an employer provided an expense reimbursement instead of the required increase may be relevant to such a determination.

Substantiation Requirement

To meet the substantiation requirement, an arrangement must require the employee to substantiate each business expense to the payor within a reasonable period of time. The employee must submit enough information to allow the employer to identify the specific nature of each expense and attribute the expense to the employer'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 each of his or her expenses. However, for an arrangement that reimburses expenses governed by section 274(d) (such as use of vehicles), the employee must submit to the payor actual substantiation of the amount of their expenses in operating their vehicles in performing services for the employer, as well as the time, place, and business purpose of such expenses. [Sections 1.274-5(f)(4) and 1.274-5T(b)(6) of the Regulations.]

We have an optional, simplified method, known as “deemed substantiation,” for an employee to substantiate the amount of his or her vehicle expenses when performing services for the employer (Revenue Procedure 2007-70). We explain this optional substantiation method, and the other accountable plan rules, in *Publication 15 (Circular E), Employer’s Tax Guide*, available on www.irs.gov. This method provides a deemed substantiated amount of expense but still requires the employee to substantiate the time, purpose, and number of actual miles driven.

Either way, if the substantiation requirement is not met, we treat the amounts as paid under a nonaccountable plan, and they are subject to employment taxes.

Return of Excess Requirement

To meet the return of excess requirement, the employee must return to the employer within a reasonable period of time any amount the employer paid in excess of the employee’s substantiated (or deemed substantiated) expenses. [Section 1.62-2(f)(1) of the Regulations.] If an employer’s arrangement routinely pays allowances in excess of the amount that may be deemed substantiated without requiring actual substantiation of all the expenses and repayment of the excess amount, we will treat the arrangement as a nonaccountable plan and the entire amount of the allowance will be subject to employment taxes. [Revenue Ruling 2006-56. 2006-46 I.R.B. 874.]

I hope this information is helpful to _____ in determining the proper tax treatment of the payments received. If the payments are taxable, _____ should report them on her Form 1040, *U.S. Individual Income Tax Return*, even if her employer does not include them on her Form W-2, *Wage and Tax Statement*.

As you requested, I am replying in duplicate and returning your enclosure. If you have any questions, please call me at () _____ or _____ of my staff at () _____.

Sincerely,

Nancy J. Marks
Division Counsel/Associate Chief Counsel
(Tax Exempt & Government Entities)

Enclosures (2)