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

**ISSUE**

Whether a reimbursement or other expense allowance arrangement meets the business connection requirement of an accountable plan where an employer pays an amount to its employee regardless of whether an expense is paid or incurred or reasonably expected to be paid or incurred by the employee in the performance of services for the employer?

**CONCLUSION**

A reimbursement or other expense allowance arrangement that pays an amount regardless of whether an expense is paid or incurred or reasonably expected to be paid or incurred by the employee in performing services for the employer violates the business connection requirement of an accountable plan. Specifically, such an arrangement violates the business connection’s reimbursement requirement under Treas. Reg. § 1.62-2(d)(3)(i). Accordingly, payments made under the arrangement are treated as made under a nonaccountable plan. Amounts treated as paid under a
nonaccountable plan must be included in the employee’s gross income for the taxable year, are subject to withholding and payment of employment taxes, and must be reported as wages or other compensation on the employee’s Form W-2.

FACTS

For purposes of providing advice to the Internal Revenue Service in examination activity, you have asked about the standard for determining whether a tool plan satisfies the business connection requirement of an accountable plan. You have not asked us to separately address the substantiation and return of excess requirements of an accountable plan.

In the facts you’ve seen, an employer participates in a tool plan administered by a third party. The tool plan is intended to reimburse the employer’s employees for the use of their tools and equipment. Under the tool plan, tool payments are made to employees as purported nontaxable reimbursement for the cost of the tools they are required to provide as a condition of employment. However, neither the employer nor the plan administrator verifies that the tools being claimed by the employees are actually required in the performance of services for the employer.

Prior to enrolling in the tool plan, an employer compensates its employees on an hourly wage basis, with no specific amount attributed to the provision of tools or equipment. Once an employer and its employees enroll in the tool plan, the employees’ hourly wages are split into two components: a reduced hourly wage and a tool plan payment, which is calculated as a set percentage of the employee’s hourly wage. Under the tool plan, an employer issues its employees one check for the reduced hourly wage amount; the employer also issues a second check for the tool plan payment which is treated as not subject to employment taxes. The employer’s employees continue to receive essentially the same amount per hour under the tool plan as they did before implementation of the tool plan, but under the tool plan the amount is 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. Once an employee has received an amount equal to the total amount to be “reimbursed” under the tool plan (i.e., the value or estimated cost of the employee’s tool and equipment inventory), the employee stops receiving tool plan payments and returns to his or her regular pay at the hourly wage rate earned prior to implementation of the tool plan.

The amount to be “reimbursed” is determined by taking an inventory of each employee’s tools and equipment. The tool plan administrator asks each employee for a list of their tools and equipment and for any available receipts. The inventory includes tools or equipment the employee acquired prior to being employed with his or her current employer. If an employee does not have receipts to establish cost, the initial inventory of tools is valued using estimates, valuation publications, or current price lists. The tool plan administrator asks each employee for a list of their tools and equipment and for any available receipts. The inventory includes tools or equipment the employee acquired prior to being employed with his or her current employer. If an employee does not have receipts to establish cost, the initial inventory of tools is valued using estimates, valuation publications, or current price lists. The tool plan administrator asks each employee for a list of their tools and equipment and for any available receipts. The inventory includes tools or equipment the employee acquired prior to being employed with his or her current employer. If an employee does not have receipts to establish cost, the initial inventory of tools is valued using estimates, valuation publications, or current price lists. The tool plan administrator asks each employee for a list of their tools and equipment and for any available receipts. The inventory includes tools or equipment the employee acquired prior to being employed with his or her current employer. If an employee does not have receipts to establish cost, the initial inventory of tools is valued using estimates, valuation publications, or current price lists.

We note that tool plans may vary in how they determine the value of an employee’s tool and equipment inventory. For example, tool plans may use vendor catalogs or valuation publications to determine
plan did not obtain information regarding any previous depreciation taken by the employee for the tools in inventory or prior reimbursements, which is necessary to determine the expenses actually incurred by the employee in performing services for the employer. Purchases made after implementation of the tool plan are generally determined at actual cost and require receipts.

LAW AND ANALYSIS

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 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 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 a paid under an accountable plan are excluded from the employee’s gross income, are exempt from withholding and payment of employment taxes, and are not reported as wages on the employee’s Form W-2. See § 1.62-2(c)(4). If the arrangement fails any one of these requirements, amounts paid under the arrangement are treated as paid under a nonaccountable plan. Amounts treated as paid under a nonaccountable plan must be included in the employee’s gross income for the taxable year, are subject to withholding and payment of employment taxes, and must be reported as wages or other compensation on the employee’s Form W-2. See § 1.62-2(c)(3) and (5).

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.

current replacement value, or base estimated cost on factors such as the type of tool or equipment, its useful life and geographic location of the worker.
If, as in the above described factual scenario, 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 amounts are paid regardless of whether the employee pays or incurs or is reasonably expected to pay or incur expenses, or 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) deductible business expenses, the arrangement does not meet the business connection requirement. Because the initial tool inventory amount is determined using estimates or current replacement value, the tool plan does not determine what expenses, if any, were incurred in the performance of services for the employer. As a consequence, tool plan payments are made regardless of whether an employee has incurred deductible business expenses in the performance of services for the employer.

Section 1.62-2(d)(3)(i) states that the business connection requirement will not be satisfied where a payor pays 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. 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 reasonable expectation to incur expenses), by reducing the wage payment in light of expenses incurred or reasonably expected to be incurred only to then increase the wage payment again after the expenses have been reimbursed, or by routinely paying a reimbursement allowance to an employee who has not incurred bona fide business expenses.

Treas. Reg. § 1.62-2(j) Example 1 illustrates a violation of the § 1.62-2(d)(3)(i) requirement that a reimbursement be paid only when expenses are incurred or reasonably expected to be incurred. 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 nontaxable reimbursement for the engineer’s travel expenses. On all other days, the engineer receives the full 200 as taxable wages. 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.

Where a plan serves to recharacterize amounts as a reimbursement allowance that would otherwise be paid if there were no expenses reasonably expected to be incurred
for the employer, amounts paid under the plan will not be treated as paid under an accountable plan. Further, although an employer may prospectively alter its compensation structure to include reimbursement of substantiated expenses under an accountable plan, an employer may not structure its compensation arrangement so as to avoid the payment of employment taxes by substituting reimbursements and expense allowances for amounts that would otherwise be paid as wages, as illustrated by a temporary reduction in an hourly wage amount only for as long as the tool rate amount is paid. Such recharacterization violates the business connection requirement of Treas. Reg. § 1.62-2(c) because the employee receives the same amount regardless of whether expenses were incurred or reasonably expected to be incurred.

The legislative history behind § 62(c), as implemented by the regulations, specifically Treas. Reg. § 1.62-2(d)(3)(i), indicates that a taxpayer should not be able to recharacterize an amount that would have been paid as wages just to avoid the limits of the two percent floor under § 67. When Congress passed the Tax Reform Act of 1986, it significantly changed the procedures for deduction of employee business expenses. It converted most of these expenses into itemized deductions which the taxpayer could only deduct if the aggregate of such expenses exceeded two percent of adjusted gross income. However, the 1986 Act left in place the above-the-line deduction permitted by § 62(a)(2)(A) for employee business expenses incurred by the taxpayer as part of a reimbursement or allowance arrangement with his employer. Pursuant to Treas. Reg. § 1.162-17, the employee was permitted to forego reporting the income and claiming a deduction if the expenses and the reimbursements were equal and if the employee made an “adequate accounting” to the employer. A 1988 article on this topic concluded that employers and employees could benefit from restructuring compensation arrangements to make greater use of these reimbursement or allowance arrangements. Blake D. Rubin, Tunneling Under the Two Percent Floor, 38 Tax Notes 177 (Jan. 11, 1988). The article suggested that restructuring compensation packages to make use of reimbursement and expense allowance arrangements to convert a portion of an employee’s compensation into a reimbursement amount would permit both the employer and the employee to be better off by reducing the employer’s after-tax compensation cost and increasing the employee’s after-tax compensation.

The legislative history to § 62(c) indicates that it was enacted to prevent such “tunneling under the two percent floor” by mandating that a reimbursement or other expense allowance arrangement require employees to substantiate their expenses to the person providing the arrangement and return any amount in excess of substantiated expenses. Family Support Act of 1988, H.R. 1720, 100th Cong. § 702 (1988). In other words, under § 62(c) an above-the-line deduction would be permitted only for expenses reimbursed under what became termed an accountable plan in legislative history.

Important to the wage recharacterization issue, the legislative history explains that a true reimbursement arrangement, or an accountable plan, is one “where the expenditure is made out of the earnings of the employer’s business, the employer has an incentive to require sufficient substantiation to ensure that the allowance to the
employee is limited to actual business expenditure incurred on the employer’s behalf and for the employer’s benefit.” Congress “viewed an employer’s agreement to reimburse certain expenditures pursuant to such an arrangement as evidence that the item was a bona fide, ordinary, and necessary expense of the employer’s business, and that in effect the employee was acting as an agent of the employer in paying for the item.” H.R. Rep. No. 100-998, at 203, 100th Cong., 2nd Sess. (Sept. 28, 1988).

Accordingly, Congress concluded that “if an above-the-line deduction is allowed for expenses incurred pursuant to a nonaccountable plan, the two percent floor enacted in the 1986 Act could be circumvented solely by restructuring the form of the employee’s compensation so that the salary amount is decreased, but the employee receives an equivalent nonaccountable expense allowance.” Id at 204.

Following this legislative history, the regulations under § 62(c) clarified that wages could not be recharacterized as part of an accountable plan. The preamble to Treasury Decision 8324, 55 FR 51688, 1991-1 C.B. 20, 21 (1990) states as follows:

Some practitioners have asked whether a portion of an employee’s salary may be recharacterized as being paid under a reimbursement arrangement. The final regulations clarify 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 that are not deductible, the arrangement does not meet the business connection requirement of § 1.62-2(d) of the regulations and all amounts paid under the arrangement are treated as paid under a nonaccountable plan. These amounts are subject to withholding and payment of employment taxes when paid. Thus, no part of an employee’s salary may be recharacterized as being paid under a reimbursement arrangement or other expense allowance arrangement.

(Emphasis added.) The preamble in the Treasury Decision made clear the intent of the regulations. Employers are not allowed to recharacterize wages as a means of minimizing their employment taxes. By making accountable plans require a reimbursement payment in addition to amounts otherwise paid as wages, the employer has incentive to require good substantiation. If the employer was going to pay the same amount either as wages or alternatively as a combination of wages and tool reimbursement, then the employer would have no real incentive to require valid substantiation before making a reimbursement and ensuring expenses were ordinary and necessary to its business.

In Shotgun Delivery v. United States, 269 F.3d 969 (9th Cir. 2001), the United States Court of Appeals for the Ninth Circuit affirmed in part and reversed in part the District Court’s decision which upheld the Internal Revenue Service’s assessment of more than $450,000 in delinquent employment taxes, plus interest and penalties. The Court agreed with the District Court’s determination that Shotgun’s expense reimbursement arrangement with its employees was not an accountable plan within the meaning of
§ 1.62-2 and that the contested payments should have been treated as wages and taxed as such.

In Shotgun, the plaintiff provided courier services. It charged customers an amount called a tag rate that was based on distance, time required for delivery, waiting time, and weight. The employees used their own vehicles for deliveries and were paid 40% of the tag rate. The couriers were compensated with two separate checks. The first check was a “wage check,” which paid the couriers an hourly amount. The second check was for “reimbursement of expenses/lease fee” and equaled 40% of the tag rate minus the amount paid on the wage check. Thus, couriers were always paid 40% of the tag rate. The court found the arrangement was not an accountable plan because it failed to meet the business connection requirement. The court stated that “the evidence suggests that the plan’s primary purpose was to treat the least amount possible of the driver’s commission as taxable wages” and concluded that “as Shotgun’s reimbursement arrangement had no logical correlation to actual expenses incurred it was an abuse of section 62(c) and was therefore a nonaccountable plan.”

The reasoning used by the court in Shotgun, where a portion of the employee’s commission was designated as an expense reimbursement, but the amount had no logical connection to the expenses incurred, applies here. Under tool plans, two employees who have the same inventory of tools but who pay or incur very different expenses for the taxpayer, for example, due to their different history of tool acquisitions, past reimbursements, or depreciation, would nonetheless receive the same total amount through tool plan payments. The tool plan payments lack a logical connection to expenses incurred or reasonably expected to be incurred during employment for the employer, mirror a reduction in hourly wages to be followed by a return to the former hourly wages, and are thus being paid without regard to whether the employee incurs or is reasonably expected to incur expenses for the employer. Therefore, the tool plan fails the business connection requirement.

Because you requested that we address only the business connection requirement, we did not discuss the substantiation and return of excess requirements but note that the facts summarized above suggest that the tool plan fails these requirements as well.

CASE DEVELOPMENTS, HAZARDS, AND OTHER CONSIDERATIONS

All three requirements of an accountable plan should be developed and addressed in any examination.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call Ligeia Donis at (202) 622-0047 if you have any further questions.