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A Quarterly Update of Essential Tax Information

DEALER TAX WATCH

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DEALER TAX WATCH *OUT*

If you had called me personally to ask, "What's happening lately with IRS audits of dealers and dealerships that I need to know about?" ... Here's what I'd say:

#1. TECHNICIANS' TOOL REIMBURSEMENT PLANS. Tool reimbursement plans could save employers and their technicians thousands of dollars ... every year. To get an idea of the savings for your company in a matter of minutes, just ask the Snap-On or other tool company drivers to give you some figures on how much your average technician has spent in buying tools from them over the last 12 months. At a minimum, a Section 62(c) expense reimbursement plan could be eliminating employers' payroll taxes on these amounts, and the technicians could receive these amounts as tax-free income.

Multiply these savings by thousands of automobile dealers, and then by hundreds of thousands of other employers ... and maybe that suggests one of the reasons why the IRS has not been overly eager to provide real guidance for those who want to set up these plans.

Right up until June 30th, the biggest concern overshadowing the use of Section 62(c) accountable reimbursement plans was whether the IRS would issue a Revenue Ruling to the effect that the only type of Sec. 62(c) plan that it would permit would be a plan that is solely receipts-based.

This would be a real blow to dealers and thousands of other employers who employ technicians who provide their own tools for on-the-job use.

Well, June 30 has come and gone. The Priority Guidance List deadline is now history. Why haven't we heard anything? There are probably many reasons, and we won't speculate on them. One significant movement forming now is a new coalition called *ACT* ... the *American Craftsmen and Tradesmen Association.* Its efforts may have something to do with the final evolution of guidance from the IRS on Section 62(c) plans.

WATCHING OUT FOR

Our first major article on the subject of tool plans, back in 1999, was burdened by the need to make distinctions between "rental" plans and "accountable" plans. Many plans marketed at that time were either completely "rental-oriented" or significantly less Section 62(c)-oriented. That article attempted to clear away much of the clutter and emphasize that most companies in their right minds would not want to be using rental plans.

In 2000, the IRS issued its infamous Coordinated Issue Paper relating to auto dealership service technicians. Even then, it was necessary to try to get most people to understand that "rental plans" were so

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different from Section 62(c) accountable plans that any general "IRS guidance" about tool plans would be more confusing than helpful.

Over the years, other cases and IRS developments have surfaced, and these have involved truck drivers, delivery services, couriers, rig welders and an assortment of other employees receiving payments that they and their employers hoped would be tax-free.

Because of the current hype regarding what the IRS "might do" about accountable plans, this issue of the *Dealer Tax Watch* focuses on tool reimbursement plans solely in the context of those attempting to qualify under Section 62(c). This material incorporates and condenses some of the prior coverage, but it should suffice as a reasonably up-to-date compilation of what has led up to the current state of affairs.

#2. ELECTRONIC RECORDS RETENTION REQUIREMENTS FOR AUTO DEALERS. In the last issue of the *DTW*, we reproduced the IRS' *"Automotive Alert"* on this subject. Below and on page 3, we've reproduced a typical IRS *Information Document Request* (Form 4564) that will give you an idea of what to expect in this regard should your dealership be selected for audit.

Form 4564	Department of the Treasury Internal Revenue Service Information Document Request	Request Number
To:	Subject: Machine sensible records	
	Submitted to: Mr.	
	Dates of Previous Requests:	

Description of Documents Requested:

Please provide copies of the following machine sensible files for the tax year ended December 31, 2003 for _____ and qualified subchapter S subsidiaries.

1. General Ledger year to date detail transaction file. This file will include all journal entries for the fiscal period identified and will tie into the general ledger. Fields to be included in the file should be general ledger account number, journal entry date, journal entry number, period charged, description of journal entry, and dollar amount of journal entry. Any other fields required to request source data for journal entries should also be included in the file. An acceptable alternative to this file is a print (report) file in machine sensible format.

2. Accounts Payable Distribution File. This file will include all charges to accounts payable. Fields to be included should be general ledger account number, date (period) posted, invoice date, vendor number, vendor name, and dollar amount charged to accounts payable. Any other fields required to request source data for accounts payable should also be included in the file. An acceptable alternative to this file is a print (report) file in machine sensible format.

3. Chart of Accounts File. Fields to be included in the file should be general ledger account number and account description. An acceptable alternative to this file is a print (report) file in machine sensible format.

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Information Due By 4/11/05 At Next Appointment ☐ Mail In ☒

	Name and Title of Requestor	Date:
FROM	Computer Audit Specialist Badge #	March 24, 2005
	Office Location: Phone: Voice FAX	Page 1 of 2

Form 4564

Form 4564	Department of the Treasury Internal Revenue Service Information Document Request	Request Number

To:	Subject: Machine sensible records
	Submitted to: Mr.
	Dates of Previous Requests:

Description of Documents Requested:

4. General Ledger Master File – if the opening balances for the balance sheet accounts are not available as part of either 1 or 3 above, please provide this information.

5. General Ledger trial balance in order to reconcile the general ledger detail computerized files being supplied with the beginning balances to the final book figures from the trial balance.

6. Vendor Master File. Fields to be included in the file should be vendor number and vendor name. This file is necessary **only if** the vendor name is not part of the accounts payable distribution file. An acceptable alternative to this file is a print (report) file in machine sensible format.

Please provide a record layout for each file that will include a field description, length of field, type of field, and a brief description of what the field is. A record layout will not be necessary if the file(s) provided are report files with column headers as part of the report.

The files may be provided on nine track tape, 3480/3490/3490e IBM compatible cartridge, 3½" diskette, CD, DVD, Jaz disk, or Zip disk. Each file must be a flat, sequential file either in ASCII or EBCDIC in a non-backup, non-compressed format. If on disk, files may be compressed using Winzip. Tapes should have 6250 BPI and a maximum blocking factor of 32,000.

Please identify all systems, which directly interface with the GL and whether or not postings are in summary or in detail sufficient to obtain source documents. Also, identify those systems which do not directly interface with the GL and method used to post from such systems.

Please provide the name and telephone number of a MIS contact person who is familiar with the files provided. If there is any question regarding the information requested in this document request, please contact me at the number listed below.

Information Due By 4/11/05 **At Next Appointment** ☐ **Mail In** ☒

FROM	Name and Title of Requestor Computer Audit Specialist Badge #	Date: March 24, 2005
	Office Location: Phone: Voice FAX	Page 2 of 2

Form 4564

TECHNICIANS TOOL REIMBURSEMENT PLANS UNDER SECTION 62(c)

Right now, many employers are having difficulty finding and retaining qualified technicians and mechanics. The fact of the matter is that if these employers were to take a look at how they are paying their technicians and mechanics, they might find that they can set up a tax-favored accountable plan that will provide more take-home pay for these employees and eliminate the payroll tax associated with expense reimbursements. Truly a win-win situation for the employers and for their employees.

In many instances, accepted industry practice is to require that as a condition of their employment, technicians are required to provide, maintain and upgrade their own tools and equipment. These technicians repair and maintain their tools and equipment at their own expense, and often on their own time.

The broad range of applications, the "typical" technician profile and a look into a typical technician's toolbox (pages 10-12) provide compelling evidence that millions of mechanics and technicians may be missing benefits which Congress provided for them when it enacted Section 62(c).

Recently, there has been much discussion about "arrangements" whereby employers can split hourly wage payments to technicians and mechanics who provide their own tools into two separate payments. Under these arrangements, each payday, their paycheck is split into two separate payments. One payment continues to be a payment for services rendered, and thus, wages reportable on Form W-2. The second payment, however, is intended to be "tax-free" for the use or reimbursement of tools owned by the technician which are provided as a condition of employment.

These arrangements are sometimes lumped together and loosely referred to as "tool rental plans." The *"Multiplicity of Reimbursement Plans in the Marketplace"* (pages 13-15) shows the need to be more precise when dealing with the tax issues associated with different plans.

This article will address only arrangements that are allowed by Section 62(c) of the Internal Revenue Code to "reimburse" employees for the use of their tools if they own those tools and are required to provide them as a condition of their employment. These accountable plan reimbursement arrangements will simply be referred to as "Section 62(c) plans." Bear in mind that workers must be classified as "employees"–and not as independent contractors–in order for the Section 62(c) plan rules to be applicable.

A reimbursement plan satisfies Section 62(c) if it meets the requirements summarized in the following two paragraphs. (A more detailed discussion of these technicalities and an explanation of *"Why a Technician Is Better off Receiving Payments Under a Section 62(c) Plan"* is included on pages 16-18.)

Business connection. An arrangement meets the business connection requirement if it provides advances, allowances, or reimbursements only for business expenses that are paid or incurred by the employee in connection with the performance of services as an employee of the employer. 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 bona fide business expenses related to the employer's business.

Substantiation & Returning amounts in excess of expenses. The substantiation requirement is met if the arrangement requires each business expense to be substantiated to the payor (plan administrator) within a *reasonable* period of time. Most Section 62(c) plans comply with the provisions that an arrangement meets the *substantiation* requirement if a payor provides employees with periodic statements, no less frequently than quarterly. These periodic reports must (1) state the amount, if any, paid under the arrangement in excess of the expenses the employee has substantiated and (2) request the employee to either substantiate any additional business expenses that have not yet been substantiated (whether or not such expenses relate to the expenses with respect to which the original advance was paid), or to return any amounts remaining unsubstantiated within 120 days of the statement. The employee must return any excess.

Tax results where Sec. 62(c) requirements are met. Amounts that an employer pays to an employee for employee business expenses under an ***accountable plan***

- Are excluded from the employee's gross income,
- Are not required to be reported on the employee's Form W-2, and
- Are exempt from the withholding and payment of income taxes and employment taxes.

see **TOOL REIMBURSEMENT PLANS**, page 6

TECHNICIANS' TOOL REIMBURSEMENT PLANS UNDER SECTION 62(c)

Tool Reimbursement Plans

(Continued from page 4)

Obviously, these tax results are favorable and enticing ... and zealously guarded by the IRS ... some would say, guarded by an "overprotective" IRS. Going as far back as 1990, and even further, the IRS has provided general guidance and warnings about misuse of accountable plan arrangements.

We have included specific discussions of several developments, Rulings and Procedures and cases, all emphasizing the IRS' concerns. In addition, the summary timeline of developments from 1997 to date (see pages 32 to 37) helps to place the IRS' activity in the context of how its decisions in dealing with Section 62(c) accountable plan issues today is/will be affected by what it has already said and done in the past. The summary timeline is not intended to be an exhaustive compilation, but it should provide adequate perspective for this purpose.

An IRS Coordinated Issue Paper, entitled *Service Technician Tool Reimbursements*, addressed the issue of "whether amounts paid to motor vehicle service technicians as reimbursements for the use of the technicians' tools are paid under an accountable plan?" The CIP concluded, "Generally, (such) amounts ... will ***not*** meet the accountable plan requirements."

However, in complete contradiction to this conclusion, the CIP elsewhere states, "Each tool reimbursement arrangement should be reviewed to determine whether the accountable plan rules are met. In addition to the factors previously discussed, ***there are other factors to take into account*** ."

As a result of this internal IRS Coordinated Issue Paper (CIP), issued in June of 2000 and addressed to automobile dealer applications, most Section 62(c) plans now being marketed include features designed to comply more closely with the business connection, substantiation and return of excess requirements. For example, such Section 62(c) plans include specific detailed provisions for determining whether amounts paid are appropriate and for the return of any excess payments to the employer. Often, the reimbursement rates are determined based on individualized tool inventories and receipts-based current purchases. Hopefully, these plans can be distinguished from the ambit of the generally negative IRS Coordinated Issue Paper.

Recently, several attempts have been made to convince the IRS that it should provide more specific guidance in connection with these "Section 62(c) plans" under its Industry Issue Resolution (IIR) Program (see timeline, page 32). To date, all efforts in this regard have been rebuffed by the IRS. This IRS attitude is somewhat contradictory in light of its acceptance of the widespread use of hourly accountable plan reimbursement arrangements in Revenue Procedure 2002-41. This Rev. Proc. allows businesses in the pipeline construction industry to provide reimbursements of up to $13 per hour under an accountable plan to employees who also furnish welding rigs or mechanics rigs as part of their performance of services as employees.

Stepping back for some perspective. Is there any way for some of the technical uncertainties to be resolved? It may be helpful to take a "second look" at the problem from a different angle. One approach that may be helpful is to *Visualize the Components* of the compensation rate by which mechanics and technicians are paid. (See page 38.) This may help to deal with one of the very significant technical issues ... namely that of alleged *"Wage Recharacterization,"* which is discussed on pages 39-40.

Toward resolving the issues. It appears that a resolution of the conflicting technical and practical issues underlying the implementation of a Section 62(c) accountable plan for mechanics and technicians requires several attitude adjustments or compromises... some by the IRS and some by employers and their employees.

First, employers, third party providers and technicians must recognize the possibility–or the strong likelihood–that the dollar amount per hour paid to a technician ***before*** adopting a plan, cannot–should not–probably must not–be exactly the same dollar amount per hour (expressed as the sum of the "wage / skill" and the "tool reimbursement" components) ***after*** a reimbursement plan is set up.

Until now, the basic approach in all plans is to simply try to divide the existing hourly rate into these two components. That approach is too simple and unrealistic, even though, admittedly, it seems to be the most practical.

The intention of the law is to provide a tax-free reimbursement only for "expenses incurred, etc." This means that the various and sundry processes by which third party administrators have developed reimbursement rates should be considered as nothing more than refined estimates of the amounts to be advanced. What really matters, and what should only be the amount received tax-free by technicans under a Section 62(c) plan, is the amount of actual expenses they have incurred over a period of time.

Ultimately, this requires an exact comparison of the amount of "expenses incurred, etc.," by the technician against the total amount he or she has received in anticipation of an accounting for these expenses.

see **TOOL REIMBURSEMENT PLANS**, page 8

EXECUTIVE SUMMARY

1. By failing to take advantage of Section 62(c) accountable plan benefits, many employers are passing up significant payroll tax reductions for themselves, and preventing their employees from receiving higher take-home pay.
   - At a minimum, if these employers adopted nothing more than a simple dollar-for-dollar receipts-based plan, significant savings/benefits would begin immediately. These receipts-based plans avoid any controversy or need for guidance from the IRS and simply require compliance with the three requirements.
2. A reimbursement or other expense allowance arrangement satisfies the requirements of IRC Section 62(c) if it meets these ***three requirements*** ...
   - ***Business connection***,
   - ***Substantiation***, and
   - ***Returning amounts (received) in excess of expenses (to the employer, so that only actual expenses have been reimbursed tax-free)***.
3. The essence of an accountable plan in the context of mechanics and/or technicians is that amounts paid to reimburse employees for their expenses and ownership and use of their tools in connection with their employment are not subject to income tax or to employment taxes.
   - Although it is true that employees may deduct the cost of their tools as itemized deductions in their income tax returns, there are several disadvantages (discussed elsewhere) to this approach.
4. There are several types of accountable plan tool reimbursement programs in the marketplace.
   - Some of these plans are either rate-based or depreciation-based. There is no connection or justification in tying reimbursement rates (under either approach) to a State or Department of Labor minimum wage hourly rate.
   - Each type has its own peculiarities and underlying unanswered tax questions.
   - There is a long list of costs that are associated with the ownership and maintenance of a technician's tool inventory. The IRS has not provided any guidance on which costs it will recognize as the proper subjects for reimbursement and, in certain instances, how some of these costs should be measured. See *"Unanswered Questions"* on pages 42-43.
5. There is a considerable amount of confusion and uncertainty because of the failure of the IRS to provide more detailed guidance on the application of Sec. 62(c) to tool reimbursement situations. To date, the Service has lumped all plans into what it broadly calls "tool rental plans" when, in fact, there are many different types of arrangements in existence and many of them have industry-specific peculiarities.
6. The Regulations clearly provide that employees may be reimbursed in advance for reasonably anticipated expenditures. The need for guidance or clarification from the IRS is most critical in situations where employers have adopted, or are considering adopting, rate-based plans.
7. The three major problems associated with Section 62(c) accountable plans for mechanics and technicians...
   - The "wage recharacterization" issue: A difficult technical issue
   - How the repayment of excess reimbursements should be handled ...Often a practical problem
   - Recordkeeping obligations are unclear
8. One of the major unanswered questions relates to how plan administrators should deal with the third requirement that excess or over-reimbursements must be returned by the employee. Does the Regulation mean exactly and only what it says? If it does, then two methods more commonly thought to satisfy this Requirement would seem to fall short.
   - Including the amount of an excess reimbursement payment as "wages" on the employee's Form W-2 at year-end.
   - Reducing the reimbursement rate to be applied to hours worked by that technician in a subsequent period to adjust for an overreimbursement in a prior period.

   While some would argue that these approaches should be considered to evidence reasonable compliance efforts, neither one is actually an immediate repayment to the employer of the amount of the "excess reimbursement."
9. Scrupulous attention to detail and employee reporting and monitoring are part of the "price" that an employer and the covered employees must be willing to pay in order to enjoy the tax-free treatment afforded to Sec. 62(c) plan payments.
10. Tool ***rental plans*** that are actually rental arrangements should be avoided at all costs. Employees receiving rents for the use of their equipment are subject to self-employment tax on the net rental income related to these payments. In *Stevenson v. Comm.* (T.C. Memo 1989-357), the Court held that the term "net earnings from self-employment" under Section 1402(a) includes net rental income from leased ***personal*** property.

(Continued from page 6)

This is where guidance is needed from the IRS to assist (sooner, rather than later) in identifying those expenses for which technicians may legitimately be reimbursed and the appropriate mechanisms (such as depreciation convention equivalents to be applied in underlying tool reimbursement rates).

In this regard, it is neither fair nor legally defensible for the IRS to contend that reimbursements cannot be made on the basis of expenses ***anticipated to be incurred***. This is one of the major lessons derived from *Trucks, Inc.*, in which the Appellate Court stated that, ***"the focus of the business connection test is on the employer's reasonable expectations, not the drivers' actual expenditures."*** Accordingly, that is why clarification or guidance is needed from the IRS so that employers may establish reasonable parameters or guidelines that can be used in setting reimbursement rates consistent with this standard. Some of these questions and issues needing clarification are listed on pages 42 to 43.

This notion clearly challenges the possible assertion by the IRS that only a "receipts-based" accountable plan can be set up. As long as there is a reasonably timely current accounting for amounts advanced, with return of any excess, any mismatch between amounts advanced by the employer and expenses incurred by the technician simply involve a mismatch in timing.

Another area requiring an "attitude adjustment" relates to certain claims of exactitude in rate determination by third party administrators. Some third party administrators contend that they are able to approximate with a high degree of accuracy the exact amount of any given tax-free reimbursement. If a plan has been in operation for any period of time, and there has been no comparison of exact amounts spent by technicians with amounts that have been advanced to them, this lack or failure of accounting will be a fatal flaw for that plan.

One unmistakable common thread running through all of the litigated cases is that it is completely unrealistic to expect that technician s can receive tax-free reimbursements without making an exact accounting to their employer for expenses incurred and substantiating those expenses. Also, the notions of "substantial compliance" and/or "approximate compliance" cannot safely be relied upon.

To the extent that one recent IRS pronouncement, Rev. Rul. 2004-1, may be interpreted as "a guidance blueprint" for Section 62(c) plans, it would be erroneous to assume that it might be relied upon in general, but at the same time, that it would not require a strict accounting by the technician of expenses actually incurred.

Another critical issue is the manner in which an employee who has received an excess reimbursement is required to repay to such excess. Are the words of the Regulation so ambiguous here? It seems not ... "Repayment" should require an immediate return of all of the excess funds advanced. Bonusing those "excess amounts" by including them on a year-end Form W-2 or reporting those amounts on a Form 1099 are realistic alternatives ... But, will the IRS consider these types of "repayment" as satisfying the third essential condition? It seems not.

Similar practical alternatives used by many plans involve either a reduction of the reimbursement rate for a subsequent period or allowing the employee to repay over a period of time (i.e., perhaps 25% of the required repayment is withheld out of each of the next 4 payroll checks as an advance). Again, the question is, will the IRS consider either of these types of "repayment" alternatives as satisfying the third condition?

Finally, an issue about which virtually nothing has been written to date relates to the recordkeeping responsibilities that befall those who wish to adopt Section 62(c) plans. Who is supposed to keep records, and what kind of records, and for how long should these records be kept? Does everybody ... i.e., the employer, the employee and the third party administrator ... think one of the other two parties is keeping the records?

Namyst and all of the other cases suggest that the burden of proof is clearly on the taxpayer in these matters. And, relatively few assumptions in favor of the taxpayer are to be granted if records are not retained and produced on audit. It seems clear that one of the costs or obligations attendant to securing the benefits of Section 62(c) treatment–and these benefits involve both the employer and the employee –is that the inconvenient process of obtaining documentation and saving it must be accepted as part of the overall quid pro quo.

Also, presentations made by third party administrators to employers and to employees should not communicate the misleading or inaccurate notion that State minimum wage requirements somehow, or in someway, validate their reimbursement rates as "conservative" or as a substitute for the detailed accounting required of every employee who would like to receive tax-free expense reimbursements.

Reliance on FAVR (fixed and variable rate) approaches, or national generalized databases, to determine reimbursement rates, may be shaky at best,

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until the IRS provides some guidance, clarification or standardization. Acceptance of these latter generalizations may require some attitude adjustments on the part of third party plan administrators.

Is it not possible to develop a safe harbor approach by industry as a substitute for the Service's inability to audit every situation, by allowing the use of a reimbursement rate computed under a methodology set forth in a Revenue Procedure?

If this seems too radical or extreme to the IRS at first blush, then why not try that approach but also require that a small "haircut" be given to that rate? In other words, allowing the use of 90% of a rate computed in accordance with the methodology prescribed in a Revenue Procedure would reflect the understanding that that 10% reduction is a trade-off against the great difficulty–or near impossibility–of providing exact rules for all situations as well as providing for the possibility of errors in the compilation of databases that underlie various rate determinations.

A pure receipts-base approach ... imputed to a yet-unreleased or phantom Revenue Ruling ... has many flaws as well as being illogical when considered against tool purchases in large dollar amounts and in light of the language specifically permitting reimbursement for expenses reasonably anticipated to be incurred.

Many employers have already adopted Section 62(c) accountable plans in order to better provide for their employees and to benefit from the payroll tax savings involved. Presently, there is no way for these employers to gain clarification on any of these issues from the IRS. Putting them in harm's way by refusing to supply clear guidance, even when they are willing to pay a $6,000 user fee just to get some clarification or answers from the IRS, seems unconscionable.

The preamble for Revenue Procedure 2002-41 states ... "***The Service recognizes that employers in other industries may similarly provide payments to employees for the costs of providing equipment as employees used in the performance of services as employees.*** To the extent that the unique features of other industries creates similar challenges to implementing accountable plans, the Service welcomes comments regarding the appropriateness and design of similar relief."

Hopefully, many of the businesses and industries affected by the current inequity for their workers and the higher (employment) taxes they are paying on valid expense reimbursements will band together to effectively present information to the IRS to address this problem. Various trade associations and industries will have to put their heads together to come up with information that is reasonable and representative of their respective constituencies.

Situation #1 in Revenue Ruling 2004-1 would seem to provide some general guidance to which employers and/or third party administrators might refer in attempting to structure their own Section 62(c) accountable plans. Unfortunately, the general guidance one finds in Rev. Rul. 2004-1 cannot be relied upon, other than by hopeful inference, and any such inference could prove to be disastrous if the IRS interprets the Section 62(c) Regulations narrowly.

Unless Congress were to step in to say "give the working stiffs some relief," the only alternative at the present time seems to be to continue trying to convince the IRS to provide more liberal guidance in this area.

As the final portion of our coverage, and indicative of our suggestions, see *"If I Could Write the Rules, Here Are the Points I'd Cover,"* on page 42 and *"But, Since I Can't, Here Are Some Practical Suggestions,"* on page 44. Until clarification from the IRS is forthcoming, the *Practice Guide Checklist* appearing on pages 45-47 may also be useful.

CONCLUSION

Sound business reasons for adopting Section 62(c) accountable plans include the desire to minimize technician turnover and to provide a more attractive compensation and benefits package to prospective technician employees. For these and other reasons, businesses should consider adopting Section 62(c) plans as a new cost management strategy.

This new strategy requires compliance by the employer and by its employees who elect to participate in the program with the requirements of I.R.C. Section 62(c). Compliance with these requirements will allow employers to provide a compensation package to employees that will include a nontaxable expense reimbursement payment for the expenses associated with the tools and equipment they are required to provide and maintain on the job as a condition of their employment.

If a business and its employees are willing to accept the "burdens" of complying with Section 62(c) requirements that are clearly set forth, then there should be no reason why they should not be entitled to enjoy its "benefits."

Background	GENERALITIES, PRACTICALITIES & BROAD RANGE OF APPLICATIONS	
	For Employees	**For Employers**
Advantages	• Increased after-tax (i.e., "take-home") pay • Incentive to increase tool inventory • Incentive to maintain tool inventory • Avoids income tax restrictions that would otherwise apply if technicians were to "expense" tools and other job-related expenses in their individual tax returns	• Decreased payroll tax expense • Increased profitability & cash flow • Increased employee morale • Incentive to attract, retain & reward more experienced technicians
Disadvantages	• Must comply with exacting requirements prescribed in Sec. 62(c) and the Regulations thereunder. ◆ Business connection, ◆ Substantiation, and ◆ Return of amounts received in excess of substantiated expenses. • IRS has provided guidance or clarification related to compliance requirements in only a few situations.	
Some of the Occupations Where Employees Are Required to Provide Their Own Tools	• Aircraft • Automotive body • Automotive service technician • Boilermakers • Brick masons, blockmasons and stonemasons • Carpenters • Carpet, floor and tile installers • Cement masons and concrete finishers • Construction Laborers • Diesel • Drywall installers • Electricians • Elevator installers and repairers • Glaziers	• Hazardous materials removal workers • Heavy vehicle and mobile equipment • HVAC • Industrial Machine maintenance • Iron and metal workers • Line installers and repairers • Machinists • Maintenance and repair worker • Millwrights • Pipelayers, plumbers, pipefitters and steamfitters • Plasterers and stucco masons • Roofers • Sheet metal workers
IIR Requests Rejected by IRS	• Some of the ***industries*** that have recently requested consideration under the IRS' Industry Issue Resolution (IIR) Program, but whose applications were not selected include ... ◆ Diving industry ◆ Logging industry ◆ Motor vehicle industry ◆ Petroleum industry ◆ Trucking industry	
Costs & Related Items Included in Various Expense Reimbursement Programs	• Cost of equipment & tools purchased after participation in an accountable plan begins with the current employer. ◆ Depreciation and/or complete expensing • Sales tax • Consumable supplies • Major repairs • Replacement cost • Loss and theft rates • Insurance • Safety equipment purchases • Training classes, literature, etc. • *Note:* In determining costs that should be considered, the Regulations under Section 263A provide a comprehensive list of activities related to the acquisition and retention of these tools ◆ Interest on amounts financed to purchase equipment ◆ Shipping and/or delivery costs ◆ Travel and other related costs incurred to purchase the equipment	

Stats

"TYPICAL" TECHNICIAN PROFILE

One recent national survey conducted by a third party administrator included approximately 800 mechanics and technicians, out of which approximately 600 worked in the automotive industry. All respondents were employees, not independent contractors. Although this is only one survey out of many, the responses summarized below provide a general idea of the "typical" technician included in this survey. These results are summarized and reported with the permission of the third party administrator who conducted the survey.

1. 99%+ of the technicians provided their own tools on the job.
2. The average monthly balance for those who purchased tools on credit was in excess of $800, with an average interest rate in excess of 10%. Average amount paid on tool account ... $50 per week ... $2,600 per year.
3. Average income per week ... Slightly under $750, based on working an average of 45 hours per week.
4. Average tool inventory for auto technicians ... Just over $26,000 (based on over 500 responses).
5. Average age ... 36.2 years. Average vacation and sick days taken in a single year ... 9.2 days.
6. Average time in the industry ... 14 years, with slightly over 5 years worked with the current employer.
7. 70% of the technicians are paid based on flagged hours; 30% are not.
8. Average hourly rate of pay ... $17 per hour.
9. Amount of current tool inventory purchased since becoming employed by current employer ... 45%.
10. Average amount of time spent cleaning tools, including wiping down before putting away ... 21 minutes each day.
11. Average amount of time spent repairing tools ... 13 minutes each week.
12. Average amount paid for tool box (excluding tool contents) ... $3,900.
13. Average time until expected replacement of tool box ... 8.4 years.
14. Amount employer requires technician to pay for the use of facilities or equipment (bays, lifts, heavy equipment) ... Out of 600 responses, slightly more than ½ were not required to pay anything, and almost all of the others paid less than $100 per year.
15. Tax treatment of tools in individual tax return ... 14% depreciated their tools, 75% did not depreciate their tools and 11% didn't know.

For responses below, the survey results include detailed breakdowns of spending ranges, with middle value computations and final average results weighted by number of respondents. Some of the final averages have been rounded.

16. ***Spending & Expense Patterns ... Average Dollar Amount Technician Spends on...***
    - ***New Tools*** ... $53 per week ... $2,736 per year
    - ***Cleaning Supplies*** ... $7 per month ... $84 per year
    - ***Safety Equipment*** ... $12 per month ... $144 per year
    - ***Insurance*** ... $6.75 per month ... $80 per year
    - ***Tool Rentals*** ... $9.80 per month ... $118 per year
    - ***Shipping Cost for Delivery of Tools Purchased*** ... $3 per month ... $36 per year
    - ***Warranties for Tools Purchased*** ... $1.50 per month ... $18 per year
    - ***Hiring Labor to Repair Tools*** ... $4 per month ... $48 per year
    - ***Preventative Maintenance for Lubricants or Other Solutions*** ... $8 per month ... $96 per year
    - ***Replacing Parts for Tools (Saw Blades, Grinding Surfaces, Belts, Recalibration)*** ... $11 per month ... $121 per year
    - ***Diagnostic Equipment Software*** ... $14.50 per month ... $174 per year
    - ***Continuing Education (i.e., Training Classes, Magazine Subscriptions, Certification Classes)*** ... $140 per year
    - ***Licensing and/or Certification Fees*** ... $28 per year
    - ***Uniforms, Work Clothes & Cleaning*** ... $34.50 per month ... $414 per year
    - ***Interest on Tool Purchases*** ... $10 per month ... $120 per year

Tools

THE TECHNICIAN'S TOOL BOX

A typical technician's inventory of tools might include some or all of the following. This list is not meant to be exhaustive. Many items listed below are merely general categories for which there could be a dozen or more detailed entries.

- Adhesives
- Air Compressor Accessories
- Air Conditioner Tools
- Air Tools, Guns, Hammers, Ratchet Wrenches
- Alignment Equipment
- Aligning Studs
- Allen Drivers
- Axle Nut
- Ball Joint Tools
- Battery
- Bearing Tools
- Break Tools
- Cam Tools
- Caulking Guns
- Chassis lubricator
- Chisels
- Clamps
- Cleaning
- Clutch Tools
- Color-Matching Light System
- Coolant Recovery Equipment
- Coupler Removers
- Creepers, Crimpers & Crow Feet
- CV Service Tools
- Diagnostic Testing Equipment including Calipers, Computer Equipment, Detectors, Gauges, Indicators, Micrometers, Multimeters, Testers & Timing Meters
- Die Grinding Tool Set
- Dollies
- Drills
- Electric Heat Guns
- Electronics
- Engine Stands
- Extractors
- Files & Combs
- Fuel Injection
- Grease Guns
- Hammers
- Hoists, Lifting Equipment & Accessories
- Jacks
- Joint Stands
- Lights
- Measuring Tools
- Miscellaneous
- Oil & Paint Equipment
- Pickup Tools
- Pliers
- Power Tools
- Pry Bars & Pullers
- Punches
- Ratchets
- Ring Cleaners, Compressors & Expanders
- Rivet Guns
- Safety & Protective Equipment, including Belts, Ear Protection, Face Shields, Safety Glasses & Goggles
- Sanding Tools
- Saws: Hand Saws, Power Saws, Saw Accessories
- Scrapers
- Screw Drivers
- Shock Absorber Tools
- Snips & Scissors
- Sockets
- Soldering Equipment
- Spark Plug Tools
- Spray Guns
- Spring Compressor Tools
- Strut Tools
- Tap & Die Sets
- Tie Rod Tools
- Tire Chucks
- Tire Inflators
- Tool Box
- Torches
- Transmission - Transaxle Special Tools
- Tube & Tubing Tools
- Vacuum Pumps
- Valve Equipment
- Vices
- Water Pumps
- Welder & Accessories
- Wheel Alignment Tools
- Wire Brushes
- Work Benches & Stands
- Wrenches & Wrench Sets

General Tool Categories Often Used in Purchasing Trends Surveys

- ***Specialty Tools***
- ***Hand Tools***
- ***Hand-Held Diagnostic Tools***
- ***Power Tools***
- ***Safety Tools & Equipment***
- ***Other***

Types of Plans	MULTIPLICITY OF "REIMBURSEMENT PLANS" IN THE MARKETPLACE

Typical Presentation of Benefits for Technician Rental, Reimbursement and/or Allowance Plans

- ***Savings from the Employer-Dealership Side ...***

	Current Wage Plan	TOOL USAGE PLAN: Wages	TOOL USAGE PLAN: Tool Usage
Monthly Payroll Base (assuming 10 employees)	$ 40,000	$ 26,000	$ -
FICA (6.2%)	2,480	1,612	-
Medicare (1.45%)	580	377	-
Workers' Compensation	3,200	2,080	-
General Liability	1,200	780	-
Payment for Tool Usage	-	-	14,000
Fee for Administration & Check Writing			1,120
Total Costs	$ 47,460	$ 30,849	$ 15,120
Monthly Savings Factor	*$ 1,491*		
Annual Savings Factor	*$ 17,892*		
10 Year Savings	*$ 178,920*		

- ***Savings from the Employee-Technician Side ...***

Monthly Earnings	$ 4,000	$ 2,600	$ 1,400
Federal Tax Withholding (15%)	(600)	(390)	(210)
State Tax Withholding (3%)	(120)	(78)	(42)
FICA	(248)	(161)	-
Medicare	(58)	(38)	-
State Disability Insurance	(20)	(13)	-
Fee for Administration & Check Writing	-	-	(21)
Net Take-Home Pay	$ 2,954	$ 1,920	$ 1,127
Monthly Savings/Increase	*$ 93*		
Annual Savings/Increase	*$ 1,116*		
10 Year Savings/Increase	*$ 11,160*		

- *Notes*
  - This does not reflect any possible liability on the part of the technician for self-employment tax on the net income from personal property.
  - All presentations simply divide the hourly rate of compensation paid into two pieces, the sum of which equals the original hourly compensation rate ... thus, exacerbating the IRS' concern over the plan being a mere "wage recharacterization" plan.

Many Possible Plan Variations, Depending on Third Party Administrator

1. Situations involving ***rental*** plans and/or arrangements.
2. Situations involving accountable plan reimbursement arrangements which ***do not satisfy*** the requirements of Section 62(c).
3. Situations involving accountable plan reimbursement arrangements which ***do satisfy*** the requirements of Section 62(c).
4. Situations involving accountable plan reimbursement arrangements which ***do satisfy*** the requirements of Section 62(c) ***and which require clarification as to tax issues relating to reimbursement rate determination***.
5. Other situations (For example, ***hybrid*** arrangements that are initially intended to qualify as accountable plan arrangements, but which default into rental plans when "excess" reimbursements have been made.)

- *Note:* None of this takes into account the differences in industry-specific or occupation-specific needs that must be tailored to the Sec. 62(c) application.
- Some third party administrators are Johnny-Come-Lately into the marketplace and may have simply copied their plan specifics from an unreliable source ... In other words, the blind leading the blind.

Types of Plans	MULTIPLICITY OF "REIMBURSEMENT PLANS" IN THE MARKETPLACE
Several Variations of Sec. 62(c) Plans	1. Rate-based plans 2. Depreciation-based plans 3. Receipts-based plans 4. Hybrid combinations where the plans have features that are not clearly one of the three above. ◆ ***External considerations determine cap on hourly rate.*** Some plans limit the amount of reimbursement paid per hour to the amount of the State's minimum wage formulation. Thus, if the State of California mandates that if an employee is required to provide his or her own tools for work, then their hourly compensation must be at least twice the hourly minimum wage, and if the minimum hourly wage is $6.75 per hour, then the plan will arbitrarily cap the reimbursement rate at $6.75 per hour - even though this amount is not connected to any computation of expenses incurred. ◆ Rate-based or depreciation-based plans which provide that "excess reimbursements" will be treated as rentals (reportable on Form 1099).
Rate-Based Plans	• Compared to depreciation-based plans, rate-based plans are more conservative. • When technicians sign up under a rate-based accountable plan, their tools are inventoried. However, the value or undepreciated cost of these tools is not reimbursed to the employee. ◆ The key distinction here is that the nature of the employee's tool inventory assists the employer (or other independent accountable plan administrator) in analyzing the technician's buying habits with a view to predicting or anticipating future tool purchases. ◆ Thus, under rate-based plans, tool acquired before the adoption of the plan are not factored into the reimbursement rates. • The reimbursement rates are based on expenditures incurred and expenses reasonably expected to be incurred. These amounts are determined under a fixed and variable expense analysis approach similar in many ways to the FAVR (Fixed And Variable Rate) allowance approach recognized by the IRS in connection with setting the annual standard mileage allowance. ◆ In the context of FAVR allowances for owned or leased automobiles, the FAVR allowance must be based on data derived from the employee's locality and reflect prices paid by the employee and represent the actual expenses an owner would occur. In addition, there are other constraints that must be satisfied in constructing an FAVR mileage allowance. ◆ To the extent that some accountable plan providers justify the setting of their reimbursement rates based on an FAVR-type approach proclaiming that the reimbursement rates reflect broad, national averages, there is an inconsistency with the constraints which the Service places on the construction of FAVR mileage allowances which must be locally sensitive, rather than nationally representative. • The reimbursement rate for each technician is calculated on an individual-by-individual basis. • Factors considered in setting rate-based plan reimbursements ... ◆ Cost of tools purchased after electing to participate in an accountable plan offered by the technician's current employer ◆ Anticipated useful life of tool purchases ◆ Sales tax ◆ Maintenance required by normal wear and tear ◆ Major repairs ◆ Replacement cost ◆ Incidence of theft and/or other loss ◆ Insurance cost ◆ Special requirements for safety, OSHA or other compliance ◆ Cost of special training to use tools, equipment, diagnostic databases, etc., to the extent not paid for directly by the employer • If one accepts the idea that the employee's ownership and use of his/her tools permits reimbursement for all reasonably associated expenses, then, it may be instructive to look to the Regulations under Section 263A by which the IRS includes a variety of associated, indirect costs. ◆ Interest paid on installment purchases of tools. ◆ Travel expenses incurred to purchase tools if they are not bought on site from mobile vendors who regularly service the dealership employees. ◆ Cost of recordkeeping, which ought to include any fees paid by the employee to the plan administrator for plan monitoring, etc.

Types of Plans	***MULTIPLICITY OF "REIMBURSEMENT PLANS" IN THE MARKETPLACE***
Depreciation-Based Plans	• In general, depreciation-based plans determine a tool inventory for each technician, and the dollar amount of undepreciated basis is computed to be reimbursed over a period of years. ◆ The dollar amount to be reimbursed increases whenever new tool purchases are made, and it decreases should loss or theft of tools occur. ◆ Once a technician has been completely reimbursed, there are no further reimbursements (until additional tools are purchased). ◆ Basically, these plans take into consideration tools and equipments purchased by the employee before (1) the adoption of the plan by the current employer and/or (2) the employment of the technician by the current employer. • These plans are comparatively simple to administer and do not seem to involve any periodic statements issued to the employees. • In the earlier periods of plan operation, employee reimbursement rates are usually higher than reimbursement rates under rate-based plans.
Receipts-Based Plans	• These plans limit employee reimbursements to offset dollar-for-dollar purchases of equipment. • Special items, such as insurance and interest cost on purchased tools, may or may not be included.
Hybrid or Combination Plans	• These are plans that blend some of the characteristics of depreciation-based, rate-based and/or receipts-based plans described above. • Some states, such as California, have provided that if an employee is required to provide his or her own tools as a condition of employment, then that employee's compensation must be at least twice the amount of the state's minimum hourly wage. Under these circumstances, for example, California imputes the hourly value of the use of the technician's tools to be worth at least an amount equal to the minimum wage. ◆ Some plans introduce limitations on their reimbursement rates that are directly related to state minimum wage considerations, rather than to an individualized computation under the rate-based or the depreciation-based plans.
The All-Inclusive Term ... "Tool Rental" Plans ... Is Too Broad to Be of Any Use	• The IRS Priority Guidance Plan for 2004-2005 was announced on July 26, 2004. This Plan contained 276 projects which the IRS expects to complete over a 12-month period from July 2004 through June 2005. • Guidance was promised as follows: "Revenue Ruling on tool rental." This is Item #4 in Section B under the broad topic of "Employee Benefits." • The broad language used in describing the topic included on the Priority Guidance Plan may result in attention being focused only on tool rental programs. ***Rental plans***, per se, are only one of several types of reimbursement plans used for technicians.
Tax Issues Common to All Plans Requiring Clarification by the IRS (or by Congress)	• In determining an appropriate reimbursement rate, the answers to several tax questions directly bear on the final calculation. • These questions include the proper tax treatment of ◆ Pre-employment expenditures for tools and equipment, ◆ Pre-plan adoption expenditures for tools and equipment and ◆ Prior-year tax treatment of those expenditures by the employee technicians in their previously filed income tax returns. • To what extent, if any, may anticipated or projected future expenditures for tools and equipment by current technicians be factored into determining a current reimbursement rate?

The Technicalities	TAXABILITY OF EMPLOYER REIMBURSEMENTS OF EXPENSES UNDER ACCOUNTABLE & NONACCOUNTABLE PLAN ARRANGEMENTS
Section 62(c) Governs Tax Treatment of Payments Under Reimbursement Arrangements	• Section 62(a) generally defines "Adjusted Gross Income" for an individual 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 performance of services as an employee, under a reimbursement or other expenses allowance arrangement with his employer. ◆ To qualify for this treatment (on the individual's income tax return/Form 1040), the reimbursement or allowance arrangement must satisfy certain requirements. ◆ If these requirements are satisfied, then the employer's related reporting procedures for accountable plan payments result in providing this above-the-line deduction (for the individual), in effect, by netting the payment against the amount that would otherwise be reported as wages on Form W-2. ▪ In other words, the payment received by the individual under an accountable plan does not have to be included in wages on Form W-2 reported by the employer. • Section 62(c) provides that an employer's arrangement will not be treated as a reimbursement or other expense allowance arrangement for purposes of Section 62(a)(2)(A) if ◆ Such arrangement does not provide for a business connection, or ◆ Such arrangement does not require the employee to substantiate the expenses covered by the arrangement to the person providing the reimbursement [Sec. 62(c)(1)], or ◆ Such arrangement provides the employee with the right to retain any amount in excess of the substantiated expenses covered under the arrangement [Sec. 62(c)(2)].
Rules When an Employer Reimburses an Employee for Employee Business Expenses	• The tax rules that apply when an employer reimburses an employee for employee business expenses depend upon whether or not the reimbursement is made under an accountable plan. • An ***accountable plan*** is a reimbursement or other expense allowance arrangement that meets three requirements under Regulation Section 1.62-2. ◆ Payments are excluded from the employee's gross income. ▪ They are not reported as wages or other compensation paid on the employee's Form W-2. ▪ Payments are not subject to Federal income tax. [Reg. Sec. 1.62-2(c)(4)] ◆ Payments are also exempt from the withholding and from payment of employment taxes. ▪ Not subject to Federal Insurance Contribution Act (FICA) employment tax ▪ Not subject to Federal Unemployment Tax Act (FUTA) tax ◆ No return of information (i.e., Form 1099) is required to be filed with the IRS by the employer for payments made under an accountable plan. [Reg. Sec. 1.6041-3(h)(1)] • A ***nonaccountable plan*** is a reimbursement or other expenses allowance arrangement that does not satisfy one or more of the three requirements. ◆ Payments are included in the employee's gross income. These payments must be reported as wages or other compensation paid on the employee's Form W-2. [Reg. Sec. 1.62-2(c)(5)] ◆ These payments are subject to ▪ Withholding and payment of income taxes ▪ Withholding and payment of employment taxes ... Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) ◆ Payments made under a nonaccountable plan are not to be reported on Forms 1099. • ***Application of rules on an employee-by-employee basis.*** If an employer is making reimbursements under an accountable plan, and with respect to any individual employee, the plan fails to qualify (because, for example, an excess reimbursement has not been returned by that employee,) "the failure by one employee to substantiate expenses under an arrangement ... ***will not cause amounts paid to other employees to be treated as paid under a nonaccountable plan.***" In this regard, overall compliance of the plan is not conditioned on 100% compliance by all employees receiving payments. [Reg. Sec. 1.62-2(i)] • *If* a payor's reimbursement or other expense allowance ***arrangement evidences a pattern of abuse*** of the rules of Section 62(c) and the applicable regulations, ***all payments made under the arrangement will be treated as made under a nonaccountable plan.*** [Reg. Sec. 1.62-2(k)]
Accountable Plan Requirements	#1 ... ***Business connection*** #2 ... ***Substantiation*** #3 ... ***Return of amounts in excess of substantiated expenses***

The Technicalities	TAXABILITY OF EMPLOYER REIMBURSEMENTS OF EXPENSES UNDER ACCOUNTABLE & NONACCOUNTABLE PLAN ARRANGEMENTS
#1 "Business Connection"	• The ***business connection*** requirement is satisfied if the arrangement provides advances, allowances or reimbursements only for business expenses allowable as deductions under Sections 161-198 that are paid or incurred by an employee (or that the employer reasonably expects the employee to incur) in connection with the performance of services as an employee. • If both wages and the reimbursement or other expense allowances are combined in a single payment, the reimbursement or other expense allowances must be identified either by making a separate payment or by specifically identifying the amount of the reimbursement or other expense allowance. • ***Caution:*** 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 bona fide business expenses related to the employer's business. [Reg. Sec. 1.62-2(d)(3)(i)]
#2 "Substantiation"	• The ***substantiation*** requirement is satisfied if the arrangement requires each business expense to be substantiated to the employer within a reasonable period of time. • The determination of a reasonable period of time depends on the facts & circumstances. [Reg. Sec. 1.62-2(g)(1)] • The Regulations provide two possible safe harbor approaches for compliance. ◆ Under a *fixed date method*, Reg. Sec. 1.62-2(g)(2)(i) considers reimbursements to have been made within a reasonable period of time if they are made in connection with ▪ An advance made within 30 days of a paid or incurred expense, ▪ An expense substantiated to the payor within 60 days after it is paid or incurred, and ▪ An amount returned to the payor within 120 days after an expense is paid or incurred. ◆ Under a *periodic statement method*, Reg. Sec. 1.62-2(g)(2)(ii) considers an arrangement to meet the *substantiation* requirement if ▪ A payor provides employees with periodic statements (no less frequently than quarterly) stating the amount, if any, paid under the arrangement in excess of the expenses the employee has substantiated in accordance with Reg. Sec. 1.62-2(e), and ▪ That payor requests the employee to either ... ★ Substantiate any additional business expenses that have not yet been substantiated (whether or not such expenses relate to the expenses with respect to which the original advance was paid), or ★ ***Return any amounts remaining unsubstantiated within 120 days of the statement.*** • *Note:* All of the third party administered Sec. 62(c) accountable plans that I have reviewed to date rely upon the ***periodic statement method***, which basically gives the employee 120 days within which to return/repay any excess reimbursement. • ***Caution:*** If a payor has a plan or practice to provide amounts to employees in excess of (properly) substantiated expenses and to avoid reporting and withholding on such amounts, the payor may not use either of the safe harbor methods (i.e., the *fixed date method* or the *period statement method*) for any years during which such plan or practices exists. [Reg. Sec. 1.62-2(g)(3)]
#3 "Return of Amounts in Excess of Substantiated Expenses"	• The ***return of excess*** requirement is satisfied 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. ◆ Typically, this coordinates with the 120-day time limit under the periodic statement method. ◆ However, it would not seem to be unreasonable for an excess payment to be "returned to the payor" by means of an offset against the immediately following expense advance payment. • ***Caution:*** Extreme care should be taken in interpreting Example (8) in the Regulations. ◆ ***"Return Requirement.*** Employer Y provides expense allowances to certain of its employees to cover business expenses ... under an arrangement that requires the employees to substantiate their expenses within a reasonable period of time and to return any excess amounts within a reasonable period of time. ***"Each time an employee returns an excess amount to Employer Y, however, Employer Y pays the employee a "bonus" equal to the amount returned by the employee.*** ***"The arrangement fails to satisfy the requirements*** of paragraph (f) (returning amounts in excess of expenses) of this Section. Thus, Employer Y must report the entire amount of the expense allowance payments as wages or other compensation and must withhold and pay employment taxes on the payments when paid. "Compare example (6) (where the employee is not required to return the portion of the mileage allowance that exceeds the amount deemed substantiated for each mile of travel substantiated)." [Reg. Sec. 1.62-2(j), Example 8]

The Technicalities	TAXABILITY OF EMPLOYER REIMBURSEMENTS OF EXPENSES UNDER ACCOUNTABLE & NONACCOUNTABLE PLAN ARRANGEMENTS
#3 *"Return of Amounts in Excess of Substantiated Expenses"* *Comments*	• There may be problems if a reimbursement / accountable plan interprets compliance with the "return of excess" requirement to be satisfied by either (1) bonusing the excess dollar amount at the end of the year on the Form W-2, (2) reporting the excess dollar amount on a Form 1099 or (3) adjusting / decreasing the reimbursement rate for the succeeding quarter or year. ◆ See *"Dangers in the Handling of 'Return of Excess' Reimbursements"*... Page 41. • Although it seems to be clear that the failure by one employee to return an excess payment does not disqualify the accountable plan arrangement as to all employees, it is not clear where the IRS might draw the line in situations where it may be shown that a majority (or more than a few) situations exist where excess reimbursements have remained unpaid. In other words, at what point does a "pattern" or an "abuse" situation invoke the Regulation(s) that treats all reimbursements as falling under the nonaccountable plan rules? • These provisions show the importance of having guidance (from the IRS or Congress) on the proper computation to be used to determine reimbursement rates and exactly what expenses may be included as reimbursable expenses.
Employer's Tax Treatment Of Employee Expense Reimbursements Made Under an Accountable Plan	• Employment taxes ... employer's portion of FICA and Medicare tax ... are not required to be paid. • Unemployment compensation may be reduced. • Substantiation of status of payments as having been made under an accountable plan (would seem to) require that employer fully satisfy all related record retention requirements. ◆ Periodic reports submitted by employees. ◆ Receipts or copies of receipts for actual expenditures or other corroborative documentation. ◆ Records showing compliance with requirement that there has been a return to the employer/payor of any excess payments made under the plan, if such payments were made in advance or in anticipation of expenditures or expenses to be incurred by the employee.
Why a Technician Is Better Off Receiving Payments Under a Sec. 62(c) Plan... *Disadvantages to Employee If Expense Reimbursements Are Received from Employer Under a Nonaccountable Plan*	• Generally, an individual may claim a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including the trade or business of being an employee. [Section 162(a)] ◆ The employee is not precluded from deducting business expenses for which he/she has received reimbursement under a nonaccountable plan. ◆ However, the employee's Adjusted Gross Income will be increased by the amount of the reimbursements received under a nonaccountable plan because those amounts will have been included in the amount of gross wages reported by the employer. • In the employee's individual income tax return, his or her actual business expense deductions may only be claimed in Schedule A as miscellaneous itemized deductions. ◆ First of all, this means that the employee must be willing to forego the benefit of the standard deduction, which in many cases, may be significantly greater than the sum of all itemized deductions to which the employee would otherwise be entitled. This would especially be true if the individual as a renter (i.e., did not own his/her own home) or did not have a significantly large medical deductions or charitable contributions. ◆ Second, if the employee does itemize his/her deductions in Schedule A, the deduction for business expenses incurred is limited by Section 67 to the amount in excess of 2% of Adjusted Gross Income. ▪ For example, if the technician had Adjusted Gross Income of $50,000, the first $1,000 of business expenses would not be deductible. In addition, if the technician's AGI were higher, a further 3% of AGI limitation might apply. ◆ Third, the inclusion of the nonaccountable play payments in the employees AGI will increase the limitation on all other deductions that are a function of AGI (such as the medical expense deduction). • The employee will incur the FICA and Medicare payroll tax expense on the full amount of the nonaccountable plan payments included in wages on Form W-2. • In many states, the amount of Adjusted Gross Income from the Federal return becomes the starting point for the calculation of taxable income in the state income tax return. ◆ As a result, there is no deduction for any of the employee business expenses which may be a part of the nonaccountable plan payment included in wages in the Federal return. • Without the discipline that is built into, or part of, an accountable plan to submit appropriate invoices and/or other documentation, the employee may lose his/her tax deduction benefits because required documentation has not been saved for IRS review.

T. D. 8324 (1990)	***TREASURY DECISION 8324*** ***SUMMARY - EXPLANATION OF FINALIZED REGULATIONS UNDER SECTION 62(c)***
Summary	• On December 12, 1989, the Treasury/IRS published temporary Regulations on employee business expense reimbursements and allowances, providing guidance concerning the taxation of and reporting and withholding on payments with respect to employee business expenses under a reimbursement or other expense allowance arrangement. • In response to these temporary Regulations, written comments were received from the public, and public hearings were held. • On December 17, 1990, the finalized Regulations were published with a multiplicity of effective dates.
More Than One Expense Allowance Arrangement	• Clarification had been requested on what factors are to be considered in determining whether an employer has one arrangement or more than one arrangement with an employee. • The concern was that small amounts of nonaccountable payments might be treated as part of an otherwise accountable plan, thereby "tainting" the accountable payments if clearly separate plans were not adopted. • The final Regulations clarify that if an arrangement provides advances, allowances, or reimbursements for deductible employee business expenses and for other bona fide expenses related to the employer's business that are not deductible, the payor will be treated as maintaining two arrangements. ◆ The portion of the arrangement that provides payments for the deductible employee business expenses will be treated as one arrangement that satisfies the business connection test, and ◆ The portion of the arrangement that provides payments for the nondeductible employee business expenses will be treated as a second arrangement that does not satisfy the business connection test.
"Reimbursement" Requirement vs. Wage Recharacterization	• Questions arose over 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 Reg. Sec. 1.62-2(d) ◆ In that case, ***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.***
Employer's Obligation to Report	• The final Regulations clarify that amounts treated as paid under an accountable plan are not reported as wages or other compensation on the employee's Form W-2. ◆ If an employer operates an accountable plan and the employee meets all the requirements of the Regulations in terms of timely substantiation and return of excess, the employer may not report such amounts as wages or other compensation on the employee's Form W-2. • The Regulations do not require the employer to provide an accountable plan. ◆ If the employer chooses to provide an expense allowance arrangement that does not meet the accountable plan requirements, the employer must report all amounts paid under the plan as wages or other compensation on the employee's Form W-2. ◆ This treatment is required even though an employee might voluntarily substantiate expenses to the employer and return any excess amounts to the employer.
Patterns of Abuse ... Overreimbursements	• The safe harbors provided for satisfying the reasonable period of time requirements are designed to meet the reasonable administrative needs of employers. ◆ These safe harbors are not intended to permit avoidance of the rules regarding accountable plans. • If, under a reimbursement or other expense allowance arrangement, a payor has a plan or practice to provide amounts in excess of substantiated expenses to employees and to avoid reporting and withholding on such amounts, the payor may not use either of the safe harbors provided under the reasonable period of time requirement ***for any years during which such plan or practice exists.***
Anti-Abuse Rule	• If a payor's reimbursement or other expense allowance arrangement evidences a ***pattern of abuse,*** ◆ All payments made under the arrangement will be treated as made under a nonaccountable plan. ◆ Appropriate penalties will be imposed.
Citation	• 55 FR 51688-51698, December 17, 1990

1999

FIRST WARNINGS AS IRS DISCUSSES ACCOUNTABLE PLANS FOR AUTO DEALERS AT AN AICPA DEALERSHIP CONFERENCE

Several years ago, the Internal Revenue Service established the Office of the Motor Vehicle Technical Advisor to assist in the development and coordination of issues that arise in connection with audits of automobile dealerships. This Office was first headed by Robert Zwiers. Upon his retirement from the IRS, his position as MVTA was filled by Mary Burke Baker for a few years. After Ms. Baker, Terri Harris assumed the MVTA position.

In October, 1999, Ms. Baker spoke at the AICPA National Dealership Conference on a number of tax issues, and her remarks on dealership technician plans were reported in the *Dealer Tax Watch*, December 1999. To provide appropriate continuity for understanding the IRS activities regarding (dealership) accountable plans over a period of years, including a frame of reference for the IRS Coordinated Issue Paper published in 2000 while she was MVTA, her remarks at the AICPA Conference in 1999 on technician plans are reprinted in full below.

IRS Motor Vehicle Specialist (Mary Burke Baker) Comments Re: Plan Issues ...October, 1999

In her remarks, Ms. Baker indicated that this is an area that the Service is spending "an awful lot of time on." She said, "This issue has really mushroomed during the past year."

Nothing's Impossible ... But...

"I want to preface my remarks by saying that it is not impossible that there could be a plan formulated that would fall under Section 62(c) - that would meet the requirements of Sec. 62(c) which governs accountable plans. It is also not impossible that there could be a plan formulated that is not under Sec. 62(c), but would be perhaps some sort of a reimbursement program that is not intended to be tax exempt that possibly could fit in as a bona fide arrangement for reimbursement expenses."

"Unfortunately, the plans that we have reviewed and have had occasion to look at, at this point, we have not seen something that fits. Particularly with respect to Section 62(c), the requirements to qualify are pretty clear and for one reason or another the plans that we've reviewed at this point just don't seem to fit. ***It seems to us it's more like fitting a square peg into a round hole.*** So, I want to be very careful not to disparage all plans–I have not seen all plans, but the ones that we have seen, we have some very serious concerns about."

Ms. Baker indicated her awareness "of pressure out there, a lot of marketing going on, and we want you to be very careful if you're considering this. If it doesn't seem to fit, there's a possibility that it doesn't."

Some Basics

"The gist of the issue is that the character of payment to the service techs is changed from being entirely a wage to partly wages and partly a payment for the tools. Whether you call that a *flat allowance* for the tools, a payment *for the use of* tools, a payment *for the rent of* tools, or a payment *under an accountable plan*... it is some sort of a payment...a reconfiguration of the payment structure from wages into something else.

"When I first became aware of this, it was in the context of Section 62(c) which is an accountable plan. An accountable plan (involves) employer reimbursements to employees for business expenses - legitimate, otherwise deductible business expense - that if they fit under that category, then they are not taxable income to the employee, nor are they subject to any type of employment taxes.

"In order to qualify for this exemption, ***there has to be a bona fide business purpose, other than just circumventing employment taxes.*** There has to be substantiation of actual expenses. There has to be a provision for the return of any excess reimbursement. There may or there may not be a third-party administrator. ***It is not required that there be a third-party administrator to handle these plans."***

The IRS Is Curious ...What's the Business Purpose?

"The issues that we are finding with respect to Section 62(c), is that many times there is no business purpose that is established. The service techs are being paid the rate before this reconfiguration of their wage base. They're generally being paid what service technicians are normally being paid. So, ***we're very curious*** about the reconfiguration of wages if suddenly their wage base would drop as low as it does, and that this reimbursement would be taking place. ***We are very curious*** about whether or not that is for the purpose of accurately reflecting a true wage rate, or whether it is to circumvent employment taxes."

Substantiation & Current Deductibility Issues

"The second problem that we see is that there doesn't appear to be in the plans that we have seen actual substantiation of actual expenses. Now, we're talking when we talk about substantiation - if I go buy a tool for $50, I turn in the receipt to the dealer and the dealer reimburses me the $50 ... There has to be an actual expense that is incurred.

"Another problem that we run into then, is that if we are not actually substantiating actual expenses that are incurred...In many of the plans that we've reviewed, instead of submitting the actual expense or the actual receipt, what we're finding is that there is a list that is made of the tools that the service tech has.

"Whether the service tech got them yesterday, a year ago, five years ago, whatever tools are in the service tech's inventory are put on this list, and there's some sort of a computation that is done, which then, in turn, determines an hourly rental rate or a weekly rental rate or some way of computing how much those tools are worth. That amount is then applied to the hours that the service tech is working - whether it be actual hours or maybe their "flag rate" - and then that is the amount that the tech is being reimbursed.

FIRST WARNINGS AS IRS DISCUSSES ACCOUNTABLE PLANS FOR AUTO DEALERS AT AN AICPA DEALERSHIP CONFERENCE

"There are problems with that: First of all, these are not actual expenses that incurred, because if you're putting down the *value* of the tool, then that's not the actual expense. Another problem is that the tool may have been purchased a year ago. ***Well, if it was purchased a year ago, outside the tax year, it's not going to be otherwise currently deductible this year.*** If it was purchased ten years ago, it's not going to be otherwise currently deductible this year. So, it is a problem, even if the tech was able to substantiate the actual expense, if it was not something that was currently deductible in the current tax year, it still doesn't fit under Section 62(c)."

Measuring Excess Reimbursements

"Putting all of these problems in place, then, it's very difficult to determine if there are excess reimbursements. How do you measure those? Unless they're being reimbursed for the actual expense that they are incurring, how can you measure what the excess reimbursements are? I mean, it would appear that all of them would be excess reimbursements, and under Section 62(c) any excess reimbursements have to be returned. So, those are the problems with Section 62(c).

Rental Plans ... Not Just Sec. 62(c)

"As we are becoming more familiar with this issue, we are finding that the issue is not just Section 62(c). The issue is also a ***rental*** issue. Maybe you're not even trying to fit it (i.e., the payments) in under Section 62(c), but you're trying to say that it's just rental. Then there are all sorts of other questions that come into play because there has to be some benefit there in order for it to be determined to be a rental as opposed to a wage. That has to fall into the employment tax arena.

"So, by saying that it is a rental, what we're finding is that there is a recommendation that the income just be reported on line 21 as "other income," and it escapes any type of employment taxes.

"Another alternative is that the income would be reported on a Schedule E, which is the rental form, and that would not be subject to self-employment tax or any other type of taxes. The IRS' position on the rental of personal property is that it goes on a Schedule C. Only the rental of real property goes on a Schedule E. So, if it goes on a Schedule C, then you're still back on the same boat of being subject to self-employment tax.

"Then you also get in the business of whether or not the state sales taxes apply to these transactions. That's something that I don't have a lot of personal knowledge about, but as I'm learning about the issue and talking with folks from a lot of different states, there is apparently a sales tax applicable on the rental of personal property in several states.

"So, if you have a rental situation, if it (i.e., the rental payment) goes on Schedule C and the tech has to pay self-employment tax and these state sales taxes, ***the tech may end up in a worse position than if it was just included in the wage base all along."***

The Threshold: Bona Fide Rental

"Another question with the rental is the threshold question before you get into what form does it go on is, "Is it a truly bona fide rental situation?" If I am going out to rent something, ... if I'm paying rent, I expect that I'm going to have free use of whatever it is I am renting. That doesn't appear to be the case here. The service techs are the ones who use the tools. The dealer can't go in and use those tools; nobody else who works for the dealer can use the tools either. They are the service technician's sole property. So, there seems to be a threshold question that needs to be answered: "Is this a bona fide rental situation?" and then you move on to the other questions.

Coordinated Issue Paper Coming Soon

"The status of this issue, at this point in time, is that we are trying to work with the industry and the practitioners. Once again, I will caution you that we're not saying that there can't be a plan out there that doesn't fit, that doesn't work. Toward that end, to try to find those plans, and see if they're out there, I have had a lot of contact in the last month with a lot of third-party administrators asking me for a discussion of their plan and trying to get some insight on where we might perceive there might be problems with those plans.

"So, we are taking an active role to try to make sure that we have all the facts and all the fact patterns on this issue. There are some examinations, some live examinations, that have this issue. This issue started not in the motor vehicle industry, it actually started in the timber industry, and there are some other industries that have it as well."

"There is a proposed Coordinated Issue Paper in process in the National Office. That Coordinated Issue Paper only pertains to the Section 62(c) issue. It does not include the rental issue. We're debating whether we want to tack on a second question of the rental issue or whether we want to put forth a second Coordinated Issue Paper on just the rental. I think we will probably go with the option #2 of two separate Papers because the rental issue is probably a more dicey issue than the Section 62(c) issue–a little more difficult to get your hands around.

"There are no private letter rulings out there, no TAMs out there that are directly on point. There are no Court cases that are directly on point. There have been some private letter ruling requests that have been pending in National Office, and as you are aware: If a private letter ruling request is going to be negatively determined, the taxpayer has the option of withdrawing that request. ***As I indicated, there are no private letter rulings that have actually been promulgated. You can draw your own conclusions.***

"Revenue Ruling 68-624 is often cited as support for these plans. I would caution you that although 68-624 has not been revoked, it was pre-Section 62(c)."

Coordinated Issue Paper June, 2000	***IRS GENERALLY NEGATIVE ON TOOL REIMBURSEMENT PAYMENTS TO AUTO DEALERSHIP SERVICE TECHNICIANS***

TEXT	***OUR COMMENTS***
MOTOR VEHICLE INDUSTRY SPECIALIZATION PROGRAM ***COORDINATED ISSUE PAPER*** ***JUNE, 2000*** ***SERVICE TECHNICIAN TOOL REIMBURSEMENTS*** *[Note: Below is the entire text of the Coordinated Issue Paper. It has been edited slightly for presentation purposes.]*	
ISSUE	
Whether amounts paid to motor vehicle service technicians as reimbursements for the use of the technicians' tools are paid under an accountable plan?	
CONCLUSION	
Generally, amounts paid to motor vehicle service technicians as tool reimbursements will not meet the accountable plan requirements. Amounts paid under a nonaccountable plan are included in the employee's gross income, must be reported to the employee on Form W-2 and are subject to the withholding and payment of federal employment taxes.	
FACTS	
Motor vehicle service technicians (service techs) are hired as employees by dealerships, repair and body shops, and various other enterprises to perform repair and maintenance services on vehicles. As a condition of employment, service techs are required to provide and maintain their own tools, which are kept on-site at the business locations. Generally, the tools are used exclusively by the technician to whom they belong. Service techs are paid hourly wages.	
Instead of paying an hourly wage for the performance of services, many employers bifurcate the hourly wage paid to the service techs into "wages" and "tool reimbursements". These plans purport to fall under the aegis of accountable plans as described in Internal Revenue Code (the Code) section 62 and the regulations thereunder. Under I.R.C. Section 62(c) reimbursements for employee business expenses meeting certain requirements are not wages includible in income or subject to the withholding and payment of employment taxes. These plans may be administered either by a third party for a fee or by the employer.	
In a typical arrangement, the hourly wage paid to the service tech is divided into a wage portion and a tool reimbursement portion. Income and employment taxes are withheld and paid on the wages, but no income or employment taxes are withheld on the tool reimbursement. Employers use various methods to determine the amount paid as tool reimbursement. For example, the method used might measure the hourly value of the tools the service tech owns multiplied by the number of hours the service tech worked. The method may consider the type of tool, its useful life, original cost or replacement value, geographic location of the worker and other factors. Alternatively, service techs could be paid a tool allowance or advance not based upon the value of the tools or the expenses incurred in use. ***None of the methods, however, are directly correlated with or based exclusively upon the actual expenses paid or incurred by the service technician for tools.*** In a typical arrangement amounts paid as tool reimbursements are not reported on Form W-2, but are sometimes reported on Form 1099.	• *While some of these generalizations about "typical" arrangements may have been true in 1999 and 2000, many plans have been revised since the issuance of the Coordinated Issue Paper to reflect concerns expressed by the IRS.* • *Accordingly, the generalizations in the CIP, particularly that "none of the methods ... are directly correlated with or based exclusively upon the actual expenses paid or incurred," are inaccurate in today's environment where businesses are trying to implement Section 62(c) accountable plans in good faith.*

TEXT	***OUR COMMENTS***
APPLICABLE LAW - WAGES	
In general, wages are defined for Federal Insurance Contributions Act (FICA), Federal Unemployment Tax Act (FUTA) and income tax withholding purposes as all remuneration for employment unless otherwise excluded. There is no statutory exception from wages for amounts paid by employers to employees for employee business expenses. However, Reg. Sec. 1.62-2(c)(4) provides that amounts an employer pays to an employee for employee business expenses under an "accountable plan" are excluded from the employee's gross income, are not required to be reported on the employee's Form W-2, and are exempt from the withholding and payment of employment taxes.	
APPLICABLE LAW - ACCOUNTABLE PLAN REQUIREMENTS	
Whether amounts are paid under an accountable plan is governed by I.R.C. Section 62 which includes the provisions on employee reimbursement or other expense allowance arrangements. 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 the employer.	
Section 62(c) provides that an arrangement will not be treated as a reimbursement or other expense allowance arrangement for purposes of I.R.C. Section 62(a)(2)(A) if (1) such arrangement does not require the employee to substantiate the expenses covered by the arrangement to the person providing the reimbursement or (2) such arrangement provides the employee with the right to retain any amount in excess of the substantiated expenses covered under the arrangement.	
Under Reg. Sec. 1.62-2(c)(1), a reimbursement or other expense allowance arrangement satisfies the requirements of I.R.C. Section 62(c) if it meets ***the three requirements*** set forth in paragraphs (d), (e), and (f) of Reg. Sec. 1.62-2: 1. ***Business connection***, 2. ***Substantiation***, and 3. ***Returning amounts in excess of expenses***.	• *There is nothing new, surprising nor controversial in the Service's discussion of the applicable law. All of these requirements are well-known*
If an arrangement meets the three requirements, all amounts paid under the arrangement are treated as paid under an accountable plan. The regulations further provide that if an arrangement does not satisfy one or more of the three requirements, ***all*** amounts paid under the arrangement are paid under a "nonaccountable plan." Amounts paid under a nonaccountable plan are included in the employee's gross income for the taxable year, must be reported to the employee on Form W-2, and are subject to withholding and payment of employment taxes.	• *The CIP (for whatever reason) omits the fact that the Regulations clearly provide that the requirements will be applied on an employee-by-employee basis. Thus, the failure by one employee to substantiate expenses ... will not cause amounts paid to other employees to be treated as paid under a nonaccountable plan. Reg. Sec. 1-62-2(i)*
An arrangement meets the business connection requirement if it provides advances, allowances (including per them allowances, allowances for meals and incidental expenses, and mileage allowances), or reimbursements for business expenses that are allowable as deductions by Part VI (section 161 through section 196), Subchapter 8, Chapter I 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).	

TEXT	OUR COMMENTS
Reg. Sec. 1.62-2(e) 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. As for the third requirement that amounts in excess of expenses must be returned to the payor, the general rule of Reg. Sec. 1.62-2(f) 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.	
Reg. Sec. 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.***	
The Service has not issued any private letter rulings or technical advice memoranda concerning whether a tool reimbursement arrangement meets the accountable plan requirements. However, in a recent unreported decision, ***Shotgun Delivery, Inc. v. United States***, No. C 98-4835 SC (January 20, 2000) (Appeal pending 9th Circuit), the United States District Court for the Northern District of California granted the government's motion for summary judgment and found that Shotgun's expense reimbursement arrangement with its employees was not an accountable plan within the meaning of I.R.C. Section 62(c). The Court held that the payments Shotgun made to its employees were wages subject to employment taxes.	• *The facts in* Shotgun Delivery *are significantly different from many of the fact patterns underlying rate-based accountable plans in today's marketplace. The Service's frequent citation of* Shotgun *as a generalized argument against the use of accountable plans now seems to be misplaced given the specific requirements in the Regulations that must be satisfied.*
In *Shotgun*, the plaintiff, Shotgun, 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 percent of the tag rate. The couriers were compensated with two separate checks. The first check was a "wage check," which paid the couriers a small 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.	
Under its arrangement, the plaintiff reimbursed its drivers regardless of the actual miles driven or expenses incurred. The Court concluded that ***"as Shotgun's reimbursement arrangement had no logical correlation to actual expenses incurred it was an abuse of section 62(c) an was therefore a nonaccountable plan."***	
That same reasoning applies to tool reimbursements where a portion of the service tech's hourly wage payment is designated as a tool reimbursement, but the amount has no logical connection to the expenses incurred. In the typical tool reimbursement arrangement the employer carves out a portion of the workers hourly wage and recasts it as reimbursement for expenses, when in fact the amount treated as reimbursement is not related the employee's expenses.	• *This appears to be the "wage recharacterization" argument employing the term "carves out" as the equivalent term.* • *The general statement that a "typical" tool reimbursement agreement involves payments that are "not related to the employee's expenses" is totally inaccurate in the context of many of the rate-based plans fashioned by third party administrators today.*

IRS GENERALLY NEGATIVE ON TOOL REIMBURSEMENT PAYMENTS TO AUTO DEALERSHIP SERVICE TECHNICIANS

TEXT	OUR COMMENTS
DISCUSSION & ANALYSIS	
Employers typically claim reliance on Rev. Rul. 68-624, 1968-2 CB 424, as authority for designating a portion of an employee's compensation as a payment for the use of tools and excluding that amount from wages. Rev. Rul. 68-624 considers what percentage of the total amount paid by a corporation for the use of a truck and the services of a driver is allocable 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 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.	• *The assertion by the Service concerning reliance on Rev. Rul. 68-624 is not a factor cited currently by any proponents for guidance from the Service in dealing with Section 62(c) issues.*
Although ***Rev. Rul. 68-624*** has not been obsoleted, it ***should not be relied upon to exclude tool reimbursement payments for service technicians from wages.*** The analysis in Rev. Rul. 68-624 does not comport with current law because it does not consider the application of I.R.C. Section 62(c).	
Under current law, tool reimbursements can be excluded from wages only if paid under an accountable plan. ***An employment contract that merely allocates compensation between wages and tool reimbursements will not satisfy the requirements of I.R.C. Section 62(c).*** To exclude employee reimbursements or other expense allowance payments from wages, an employer must establish an accountable plan.	• *Many of the current providers of Section 62(c) plans are not "merely allocating" compensation. In fact, they are specifically attempting to comply with all of the requirements of IRC Section 62(c), but they are clearly frustrated by the lack of any real guidance from the IRS on implementation mechanics.*
An arrangement will qualify as an accountable plan if it meets the three requirements of business connection, substantiation, and return of excess.	• *All we need is some real clarification.*
Reg. Sec. 1.62-2(d)(1) specifies that the business connection requirement is met only if the arrangement provides advances, allowances or reimbursements for business expenses that are allowable as deductions and 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, for example, fair tool rental value, regardless of whether the employee incurs (or is reasonably expected to incur) the type of business expenses described above, the reimbursement arrangement does not meet the business connection requirement. Since service techs are generally required to provide their own tools as a condition of employment, expenses paid or incurred in connection with the tools would constitute ordinary and necessary deductible employee business expenses if not reimbursed. ***"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.	

IRS GENERALLY NEGATIVE ON TOOL REIMBURSEMENT PAYMENTS TO AUTO DEALERSHIP SERVICE TECHNICIANS

TEXT	*OUR COMMENTS*
Reg. Sec. 1.62-2(e)(1) requires that each business expense be substantiated to the payor within a reasonable period of time. Reg. Sec. 1.62-2(g)(1) indicates that, in general, the determination of a reasonable period of time will depend on the facts and circumstances; however, Reg. Sec. 1.62-2(g)(2) provides a safe harbor allowing an advance to be made within 30 days of an expense, substantiation of paid or incurred expenses within 60 days, and the return of excess reimbursements within 120 days of payment or incurring. It is clear from these regulations that an advance or allowance is not intended to be open-ended or unassociated with specific, otherwise deductible, expenses. ***Amounts paid by the employer not representing specific expenses that are actually incurred by the employee fail to meet the terms of an accountable plan and are considered wages.***	
In addition to the requirement that ***substantiation*** be made on a timely basis, such substantiation of expenses ***must be detailed and complete.*** For expenses governed by I.R.C. Section 274(d), the employee must submit information sufficient to satisfy the requirements of I.R.C. Section 274(d) and the regulations, which deal with substantiating the amount, time, place, and business purpose of the expenses to the employer by adequate records.	
For expenses not governed by Code Section 274(d), the employee must submit information sufficient to enable the employer to identify the specific nature of the expense and to conclude that the expense is attributable to the employer's business activities. ***Fair tool rental value, regardless of the accuracy of its estimation, does not satisfy this requirement, as it does not provide any information about the amount of, or the specific nature of, any expenses paid or incurred by the employee.***	• *The Service seems to be reacting to many plans in vogue in years prior to 2000 which relied solely upon a "rental equivalency" position. These plans are/were disastrous because they force the technician to bear the entire brunt of the payroll tax burden. Accordingly, they are no longer likely to be found in use.*
The requirements set forth in Reg. Sec. 1.62-2(f) regarding the return of amounts in excess of expenses further clarify that only expenses actually paid or incurred may be treated as paid under an accountable plan. Employees are required to return to the payor within a reasonable period of time any amount paid in excess of expenses substantiated. This section specifies that an arrangement advancing money to an employee to defray expenses will satisfy the requirements of an accountable plan only if the amount of money is reasonably calculated not to exceed the amount of anticipated expenditures and the advance is made on a day within a reasonable period of the day that the anticipated expenditures are paid or incurred. ***A regular, routine allowance or advance for the rental value or use of tools would not meet this requirement.***	
Each tool reimbursement arrangement should be reviewed to determine whether the accountable plan rules are met. In addition to the factors previously discussed, ***there are other factors to take into account.*** It is relevant to know when the employer began compensating its employees in part with a tool reimbursement program. It should be ascertained whether the arrangement is written, and, if so, the writing should be reviewed to determine if its terms comply with the requirements of an accountable plan. Such writing may be in the form of a lease, an employee handbook, or an employment contract. Whether the written terms of the arrangement are actually followed is important. The service technicians' understanding of the arrangement also should be considered.	• *In early 2004, an auto dealership submitted a request for a Private Letter Ruling in connection with its adoption of a Section 62(c) accountable plan, under which technicians were receiving rate-based reimbursements.* • *The Service declined to issue a Private Letter Ruling in this case, citing the fact that these issues were under consideration elsewhere.*
Employers frequently assert that it is industry practice to pay service techs for the use of their tools. ***There is no "industry practice" exception*** to the accountable plan requirements. After analyzing the tool reimbursement arrangement, a determination can be made whether it meets the accountable plan requirements. *[End of text.]*	

Rev. Proc. 2002-41	***USING ACCOUNTABLE PLANS TO PAY "DEEMED SUBSTANTIATED" HOURLY RATES TO PIPELINE CONSTRUCTION INDUSTRY WORKERS***
Summary	• Revenue Procedure 2002-41 provides an ***optional expense substantiation rule*** so that businesses in the pipeline construction industry can provide reimbursements that qualify for accountable plan treatment under Section 62(c). ◆ Applies to employees who furnish welding rigs or mechanics rigs as part of their performance of services as employees. ◆ Typically, rig welders and heavy equipment mechanics work for multiple companies for relatively short periods. Under these circumstances, the proper allocation of fixed costs related to the equipment among employers is unclear. • ***Background.*** As part of the IRS Industry Issue Resolution Pilot Program, representatives of the pipeline construction industry requested clarification of the proper treatment of amounts paid to employee welders and heavy equipment mechanics who provide heavy equipment in connection with the performance of their services. At issue was whether certain amounts paid could be treated as payments of rent, payments of wages, or as the reimbursement of expenses subject to the accountable plan requirements of Section 62(c).
Challenges & the Need for Guidance from the IRS	• The Revenue Procedure applies to rigs that are mobile, and not to rigs that are used primarily while stationary. ◆ ***Welding rigs*** are ¾ ton or heavier trucks equipped with a welding machine and other necessary equipment, such as tanks and generators. ◆ ***Mechanics rigs*** are heavy trucks equipped with permanently installed mechanics bed and other necessary equipment that is used to repair and maintain heavy machinery on a job site. ◆ Both types of rigs are qualified nonpersonal use vehicles. • These employees incur substantial expenses in providing these rigs as a condition of their employment. • Due to these unique features, reimbursing employees for rig-related expenses under the existing accountable plan requirements (i.e., pre-Rev. Proc. 2002-41) was unworkable for this industry.
Guidance & Relief	• To enable this industry to reimburse rig-related expenses to employees under an accountable plan, Rev. Proc. 2002-41 provides an ***optional expense substantiation rule*** under which rig-related expenses may be treated as "substantiated" under Section 62(c). • An employer may pay certain welders and heavy equipment mechanics ... ◆ An amount of up to $13 per hour for rig-related expenses ◆ An amount up to $8 per hour, if the employer provides fuel or otherwise reimburses fuel expenses. • These amounts may be subject to annual inflation adjustments after 2003. • ***The use of these rates is not mandatory.*** The method in this Rev. Proc may be applied when businesses choose to use an accountable plan to reimburse individuals who are employees for rig-related expenses incurred as employees. • The payment of these rates will not qualify to the extent they are paid in connection with hours that the employer actually knew the employee's rig was not used (such as during a work stoppage for inclement weather). • The Revenue Procedure is effective for payments made on or after January 1, 2003. • The style of the Revenue Procedure is basically a "Question & Answer" format (24 Q&As).
An Invitation to Other Industries to Request Guidance *A "Guidance Blueprint" in Disguise?*	• The preamble to the Revenue Procedure invites other industries to apply for guidance. ◆ "The Service recognizes that employers in other industries may similarly provide payments to employees for the costs of providing equipment as employees used in the performance of services as employees. ◆ "To the extent that the unique features of other industries creates similar challenges to implementing accountable plans, ***the Service welcomes comments regarding the appropriateness and design of similar relief.***" • ***Reliance.*** In their promotional literature, some third party (accountable plan) administrators have expressed their beliefs/opinions that Rev. Proc. 2002-41 "can be relied on as a clear demonstration of how employees can be properly reimbursed at an hourly rate for the expenses that they incur on their tools and equipment, as employees, through an accountable plan." ◆ Such reliance may be overlooking the fact that there may be a considerable "burden of proof" that will have to be met through an industry-wide effort to persuade the IRS that an "optional" or a "deemed substantiation" rate approach is warranted under the circumstances.
Citation	• 2002-23 I.R.B. 1098

Rev. Rul. 2004-1	***USING ACCOUNTABLE PLAN ARRANGEMENTS TO PAY MILEAGE ALLOWANCES TO DELIVERY/COURIER EMPLOYEES***
Summary	• The basic issue in Rev. Rul. 2004-1 (2004-4 I.R.B. 325) relates to whether or not certain mileage allowances paid by a package delivery business to its driver/courier employees could be treated as qualifying as paid under the accountable plan rules. • The Rev. Rul. illustrates two different situations... ◆ ***Situation One*** ... Is acceptable to the IRS and will qualify under Sec. 62(c). ◆ ***Situation Two*** ... Is not acceptable to the IRS and will not qualify under Sec. 62(c). • Both situations concentrate on analyzing the business connection requirements.
Package Delivery Business & Courier Employees	• The Revenue Ruling involves a courier company whose employees are drivers who deliver packages locally. These drivers must own or lease their own vehicles (automobiles, vans, pick-ups or panel trucks) for use in connection with the performance of their services as couriers. ◆ While delivering packages, the drivers incur the ordinary and necessary expenses of operating the vehicle. • Employer charges customers for deliveries based on location, time of day, expedited service (if requested), mileage between pickup and delivery, size and weight of a package, and other factors. This per package charge is referred to as the "tag rate." ◆ The mileage component of the tag rate is computed as though each package were delivered separately. ◆ However, drivers often pick up multiple packages from one location, deliver multiple packages to another location, and travel overlapping routes between and among customers. ◆ Consequently, the tag rate may not accurately reflect the transportation expenses incurred with respect to a particular package.
Situation #1 ***Reimbursement Arrangement***	• Employer pays drivers a commission equal to X percent of the tag rate as compensation for services. ◆ Additionally, employer pays drivers a mileage allowance equal to Y percent of the tag rate to cover the expenses of operating their automobiles. ◆ Because the mileage allowance is computed based on a percentage of the tag rate, the mileage rate (cents per mile) paid with respect to any particular package varies depending on the number of miles traveled. • Employer determines the percentage of the tag rate paid as a mileage allowance annually and the percentage remains fixed throughout the calendar year. ◆ The percentage paid as a mileage allowance is based on employer's review of a sample of documents submitted by drivers reflecting the drivers' operating and fixed costs. ▪ These documents include receipts, logbooks, and invoices. ◆ Employer pays the mileage allowance only with respect to miles traveled while delivering packages. • Employer requires that, on a monthly basis, each driver provide information sufficient to substantiate the number of business miles traveled. ◆ Employer multiplies the number of miles traveled times the business standard mileage rate (as published by the Commissioner) to calculate the amount of travel expenses deemed substantiated. ◆ Employer subtracts the amount deemed substantiated from the mileage allowance paid and reports the excess as wages on the driver's Form W-2 at the end of the year.
Situation #1 ***Business Connection Requirement***	• In *Situation One*, the mileage allowance meets this requirement found in Reg. Sec. 1.62-2(d). • The mileage allowance is paid with respect to deductible employee business expenses reasonably expected to be incurred by the drivers. • Employer reviews a sample of receipts, logbooks, and invoices annually to estimate the drivers' operating and fixed costs and, correspondingly, to set the percentage of the tag rate paid as a mileage allowance. • Although the mileage allowance is computed on a basis similar to that used in computing the driver's compensation and, consequently, is paid at a variable mileage rate, the percentage of the tag rate paid as a mileage allowance remains fixed throughout the calendar year. • Unlike the reimbursements at issue in *Shotgun Delivery, Inc. v. United States*, [269 F.3d 969 (9th Cir. 2001)], the mileage allowance in *Situation One* is paid with respect to expenses reasonably expected to be incurred and does not vary inversely with the commission based on the number of hours worked.

Rev. Rul. 2004-1	**USING ACCOUNTABLE PLAN ARRANGEMENTS TO PAY MILEAGE ALLOWANCES TO DELIVERY/COURIER EMPLOYEES**
Situation #1 *Substantiation Requirement*	• In *Situation One*, the mileage allowance meets this requirement found in Reg. Sec. 1.62-2(e). • The drivers are required to substantiate monthly the time, use, and business purpose (i.e., the number of business miles traveled), relating to their use of an automobile while delivering packages. • In lieu of substantiating the actual amount of the driver's deductible transportation expenses, an amount is deemed substantiated equal to the number of miles traveled multiplied by the business standard mileage rate. • An allowance paid with respect to ordinary and necessary transportation expenses that is ***reasonably calculated not to exceed*** the amount of anticipated expenses and is paid at a flat rate or stated schedule ***constitutes*** a mileage allowance pursuant to Reg. Sec. 1.274-5(g) and the rules promulgated thereunder. (See Rev. Proc. 2003-76.) • While the mileage allowance in *Situation One* is paid at a variable mileage rate, it is nonetheless computed based on a fixed percentage of the tag rate (i.e., the per package charge) and is considered paid at a flat rate or stated schedule. • Thus, drivers are deemed to have substantiated expenses at the business standard mileage rate with respect to each mile of travel actually substantiated.
Situation #1 *"Return of Excess" Requirement*	• In *Situation One*, the mileage allowance meets the requirements found in Reg. Sec. 1.62-2(f). • Employer intends to pay the mileage allowance only with respect to miles of travel substantiated by the drivers. • Consequently, drivers are not required to return the portion of the mileage allowance exceeding the amount of expenses deemed substantiated. • See Reg. Sec. 1.62-2(f)(2) which permits ... in situations limited to per diem or mileage allowances ... the retention of an amount paid in excess of expenses deemed substantiated. ◆ Reg. Sec. 1.62-2(f)(2) provides that a reimbursement or other expense allowance arrangement that provides mileage allowances for ordinary and necessary expenses of local travel will be treated as satisfying the return of excess requirements even though the arrangement does not require the employee to return the portion of such an allowance that relates to the miles of travel substantiated and that exceeds the amount of the employee's expenses deemed substantiated. ◆ This exception (i.e., the waiver of the requirement to return the excess portion) applies only if (1) the allowance is paid at a rate for each mile of travel that is reasonably calculated not to exceed the amount of the employee's expenses or anticipated expenses and (2) the employee is required to return to the payor within a reasonable period of time any portion of such allowance which relates to miles of travel not substantiated.
IRS Approves Situation #1	• A mileage allowance for local transportation expenses computed on a basis similar to that used in computing a courier's compensation may be treated as paid under an accountable plan. • Having met the business connection, substantiation, and return of excess requirements of Reg. Sec. 1.62-2(c)(1), ***the portion of the mileage allowance that is not in excess of the expenses deemed substantiated may be treated as paid under an accountable plan.*** ◆ Such amounts are excluded from the drivers' gross income and are exempt from the withholding and payment of employment taxes. • ***The portion of the mileage allowance that is in excess of the expenses deemed substantiated is treated as paid under a nonaccountable plan.*** ◆ These amounts must be included in the drivers' gross income and are subject to the withholding and payment of employment taxes.
Situation #2 *Reimbursement Arrangement*	• The facts in *Situation Two* are the same as in *Situation One* except for the commission payment. ◆ In *Situation Two*, the employer pays the drivers a commission equal to Z percent of the tag rate reduced by a mileage allowance equal to the number of miles traveled multiplied by the business standard mileage rate. • In *Situation Two*, the drivers always receive Z percent of the tag rate. ◆ However, the amount treated as a mileage allowance varies based on the number of business miles traveled and subsequently substantiated by the drivers.

Rev. Rul. 2004-1	***USING ACCOUNTABLE PLAN ARRANGEMENTS TO PAY MILEAGE ALLOWANCES TO DELIVERY/COURIER EMPLOYEES***
Situation #2 ***Fails to Satisfy the Business Connection Requirement***	• In *Situation Two* the reimbursement arrangement does not meet the business connection requirements of Reg. Sec. 1.62-2(d). • A variable allocation between commission and mileage allowance ensures that each driver receives Z percent of the tag rate regardless of the amount of deductible employee business expenses incurred by the driver. • A bona fide reimbursement arrangement must preclude the ***recharacterization*** as a mileage allowance of amounts otherwise payable as a commission. ◆ The Rev. Rul. cites here Reg. Sec. 1.62-2(j), Example (1) and also H. R. Conf. Rep. No. 998, 100th Cong., 2d Sess. 202-206 (1988). ◆ "Example (1). *Reimbursement requirement.* 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. 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' Forms W-2 and must withhold and pay employment taxes on the entire $200 when paid." • A variable allocation between commission and mileage allowance does not meet the business connection requirements. • Conclusion: the reimbursement arrangement in *Situation Two* is treated as a nonaccountable plan. ◆ All amounts paid under the plan must be included in the drivers' gross income and are subject to the withholding and payment of employment taxes.
Shotgun Delivery, Inc.	• In *Shotgun*, the District Court found that "because Shotgun's tag rates were not based solely on distance traveled, and since Shotgun drivers could double up on deliveries, Shotgun's reimbursement arrangement, was in fact, reimbursing its drivers in a manner not correlated to expenses Shotgun's employees incurred or were reasonably likely to incur." • Consequently, the District Court concluded that Shotgun's reimbursement arrangement failed to meet the business connection requirements and held that the mileage reimbursements were paid under a nonaccountable plan. • The fact pattern in Rev. Rul. 2004-1 is similar to the facts in *Shotgun Delivery, Inc.* • *Shotgun Delivery, Inc. v. United States*, 85 F.Supp. 2d 962, 965 (N.D. Cal. 2000.; 269 F.3d 969 (9th Cir. 2001)
Limitations	• This Revenue Ruling addresses only mileage allowances ◆ It may be distinguishable from technician tool rate reimbursement programs because of its narrow scope involving only "deemed substantiated" mileage allowances and Reg. Sec. 1.62-2(f)(2). • The favorable holding in *Situation One* is based, in part, on the combination of the application of reasonable business practices which are regarded as the "equivalent to substantiation of the amount of such transportation expenses." ◆ Although the dollar amount of the reimbursement rate is protected by the annually published standard mileage rates for business use, the taxpayer is still required to substantiate the other elements of time, use and business purpose relating to the expenses.
Comments	• In approving *Situation One*, the IRS really issued a "split decision" insofar as it held that "***The portion of the mileage allowance that is in excess of the expenses deemed substantiated is treated as paid under a nonaccountable plan.***" • In approving *Situation One*, the IRS is emphasizing two observations that the District Court made in *Shotgun Delivery*. ◆ Some arrangements, like that used by Shotgun, fail to meet the business connection requirements and blur "the fundamental distinction between taxable compensation and tax-exempt reimbursement which underpins this entire aspect of the tax system." ◆ "Requiring a demonstrable connection to actual business expenses prevents companies from improperly sheltering otherwise taxable compensation under the guise of reimbursement."

Namyst	***NAMYST IN THE TAX COURT***
Summary	• This case involves the determination of the tax liability of an individual, Namyst, who worked under an unusual fact pattern and circumstances. • Namyst received significant payments which he omitted from income on the basis of his belief that these amounts were received as payments from his employer under an accountable plan.
Four Issues	• ***First***... Were amounts received by Namyst excludable from his income because they were received under a Section 62(c) accountable plan ... or were they includable in income because they were received under a nonaccountable plan? ... ***The payments received were includable in gross income.*** • ***Second***... Were the amounts received by Namyst for the sale of his tools includable in his gross income? ... ***The amount received for the sale of tools were includable in gross income.*** • ***Third***... Did the 6-year statute of limitations under Section 6501 apply? ... ***The 6-year statute did apply because the amounts not reported (thought to be received as accountable plan payments and therefore excluded by Namyst) were large enough to trigger the 25% limitation that extends the statute from 3 to 6 years.*** • ***Fourth***... Was Namyst subject to accuracy-related penalties under Section 6662? ... ***The accuracy-related penalties did not apply.***
Observations	• The *Namyst* case is instructive because it indicates exactly how the Tax Court would analyze a tax dispute over the application of Section 62(c) requirements. • The Tax Court simply set out the three requirements (business connection, substantiation and return of excess). • The Court observed that these requirements are to be applied on an employee-by-employee basis, and therefore, 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. [Reg. Sec. 1.62-2(i)] • With regard to the substantiation rules, the Court observed that the substantiation rules for business expense deductions under Sections 162 and 274(d) are incorporated by Reg. Sec. 1.62-2(e)(1) through (3), for the purpose of determining whether a reimbursement arrangement constitutes an accountable plan. ◆ The Court agreed that the taxpayer's lists constituted proper substantiation under Section 162, and they were sufficiently detailed to qualify as proper substantiation under the requirements of Section 274(d), where applicable. (Note: Namyst had detailed lists of expenses incurred and tools purchased.)
The Fatal Flaw... ***Namyst Did Not Return Excess Payments***	• The fatal flaw for Namyst was that "***There is no evidence that petitioner was required to return any amounts he received that exceeded his expenses.***" ◆ "Although petitioner (Namyst) was required to substantiate expenses, the annual reimbursement amounts exceeded petitioner's expenses. ***If the excess amounts were meant to be advances for anticipated expenses petitioner would make, there is no evidence that the advances were calculated to approximate the amounts of the anticipated expenditures.*** ◆ "The record does not show whether petitioner (Namyst) did in fact return any of the excess amounts to his employer. ◆ "Based on all the facts available to us, we do not believe that the arrangement between petitioner and (his employer) required petitioner to return excess amounts to (his employer). ◆ "Therefore, the arrangement did not satisfy the returning amounts in excess of expenses requirement of Reg. Sec. 1.62-2(f)." • Although the Court gave the taxpayer credit for having sold his tools to his employer, despite lists and photographs, the Court was unwilling to accept any assumptions regarding cost basis in those tools which could be applied against the sales proceeds to reduce the gain on the sale.
Citation	• *Steven J. and Terry L. Namyst v. Comm.*, T.C. Memo 2004-263 (November 17, 2004)

Tool Plans Timeline	SELECTED CASES, RULINGS & DEVELOPMENTS ... 1997 TO DATE
June 30, 2005	• So-called "deadline" for issuance of "Priority Guidance" expires without the issuance of any guidance by the IRS on "tool rental plans."
2004-2005 IRS Priority Guidance List Placement	• ***"Tool Rental Plans" Finally Make It to the IRS Priority Guidance List.*** • Industry Issue Resolution (IIR) Program submissions ◆ In several instances, the IRS declined to include in its IIR Program various submissions made in 2003 and in 2004 by taxpayers and their representatives involving the use of tool rental and reimbursement programs in several industries. See page 10, *"IIR Requests Rejected by IRS"*. • On July 26, 2004, the IRS announced the release of its 2004-05 Priority Guidance Plan. ◆ The Priority Guidance Plan contains 276 projects that the IRS intends to complete over the 12-month period from July 2004 through June 2005. In a response to a Congressman's inquiry made to the IRS on behalf of the dealer whose request for the Private Letter Ruling had been denied, the Service indicated that it was "pleased to tell ... the Congressman ... that the specific issue ... is one of 276 projects listed on the Priority Guidance Plan." • The broad topic "Revenue Ruling on Tool Rental" is included as Item #4 under *Section B, Executive Compensation, Health Care and Other Benefits, and Employment Taxes* of the 2004-05 Priority Guidance Plan (PGP). • Several taxpayer representatives have submitted letters to the IRS requesting that the subject of Section 62(c) accountable plans for technicians ***not*** be addressed under the Priority Guidance List procedures, but rather that this issue be again reconsidered for IIR treatment. ◆ The concern expressed by these representatives appears to be related to a potentially adverse Revenue Ruling that is speculated to limit acceptable plans to include only those which are actual dollar-for-dollar receipts-based reimbursement plans.
IRS New Vehicle Dealership Audit Technique Guide (ATG) 2004	• Service technician tool reimbursements are discussed in Chapter 14 of the *ATG*. • This discussion reprints the Coordinated Issue Paper dated July 21, 2000, which concluded that, generally, amounts paid to motor vehicle service technicians as tool reimbursements will not meet the accountable plan requirements. • There is no other discussion except for a list of documents to request and a list of audit techniques. • Under the caption "Test Compliance," the *ATG* states, "...Determine if expenses were not substantiated nor excess expenses were returned to the employer within a reasonable amount of time. These unsubstantiated or excess amounts are paid to a non-accountable plan subject to Employment Taxes. The taxpayer (employer/dealership) is liable for the withholding taxes unless the employer can show the employee's related income and employment tax liability has been paid." • Publication 4435 (01-2005) Catalog No. 39491F
Auto Dealership Files Request for Private Letter Ruling 2004	• In February of 2004, one automobile dealer who had adopted a rate-based Sec. 62(c) accountable plan implemented by a third party administrator requested a Private Letter Ruling from the Internal Revenue Service. • This request for Ruling disclosed basically everything that the IRS might need to carefully consider a specific plan under Section 62(c). Information submitted included a detailed description of the plan, statements of law, arguments differentiating this specific plan from those more generally described in the IRS Coordinated Issue Paper of June 2000, and specific requests for rulings. • Several months later, the IRS sent the taxpayer a letter advising it that the Service would not be able to issue a ruling in this matter. The Service cited its "discretionary authority to issue Letter Rulings when appropriate in the interest of sound tax administration," and it also cited Section 5 of Revenue Procedure 2004-3. This Section provides several areas under ***extensive study*** in which rulings or determination letters will not be issued until the Service resolves the issue through publication of a Revenue Ruling, Revenue Procedure, Regulations or otherwise. The IRS's letter said ... "One of these areas of extensive study included reimbursement arrangements. ... After careful consideration, we have determined that your request comes within this area of extensive study."

Namyst v. Comm. *November 2004*	• Namyst received significant payments which he omitted from income based on his belief that these amounts were received as payments from his employer under an accountable plan. • The fatal flaw for Namyst was that "***There is no evidence that petitioner was required to return any amounts he received that exceeded his expenses.***" • This recent case is instructive because it indicates exactly how to expect the Tax Court to analyze a tax dispute over the application of Section 62(c). • *Steven J. and Terry L. Namyst v. Comm.*, T.C. Memo 2004-263 • See additional discussion of this case on page 31.
Rev. Rul. 2004-1	• The basic issue in Rev. Rul. 2004-1 (2004-4 I.R.B. 325) relates to whether or not certain mileage allowances paid by a package delivery business to its driver/courier employees could be treated as qualifying as paid under the accountable plan rules. • The Rev. Rul. illustrates two different situations... ◆ ***Situation One*** ... Is acceptable to the IRS and will qualify under Sec. 62(c). ◆ ***Situation Two*** ... Is not acceptable to the IRS and will not qualify under Sec. 62(c). • See separate discussion of this Revenue Ruling on page 28.
Rev. Proc. 2002-41	• Revenue Procedure 2002-41 (2002-23 I.R.B. 1098) provides an ***optional expense substantiation rule*** so that businesses in the pipeline construction industry can provide reimbursements that qualify for accountable plan treatment under Section 62(c). Applies to employees who furnish welding rigs or mechanics rigs as part of their performance of services as employees. • An employer may pay certain welders and heavy equipment mechanics ... ◆ An amount of up to $13 per hour for rig-related expenses ◆ An amount up to $8 per hour, if the employer provides fuel or otherwise reimburses fuel expenses. • See separate discussion of this Revenue Procedure on page 27.
FSA 200127004 ***August, 2001***	• This Field Service Advice (FSA) involved treatment of payments to rig welders, an issue more currently discussed in Rev. Proc. 2002-41. • One question was whether or not the rig welders who performed services for the company in question were common law employees of the company. ◆ On this issue, the FSA concluded that further factual development was necessary before it could reach a conclusion. • The second issue was ***if*** the rig welders ***were*** common law employees of the company, ***then*** would payments by the company that were characterized as "rig rentals" be payments made under an arrangement separate from the employee relationship? ◆ The answer to this question was that ***if*** the rig welders were employees, ***then*** those payments would not be made under an arrangement that was separate from the employment relationship. • The third question was whether such payments made would be excludible from wages as payments made under an accountable plan. ◆ It was held that these payments would not be considered as made pursuant to an accountable plan. Therefore, they would be wages for employment tax purposes. • This FSA contains a listing of factors relevant in determining whether a "rental" arrangement has independent significance for tax purposes. ◆ Whether a worker is compensated for services regardless of whether the worker provides equipment. In other words, whether providing equipment is integral to providing services. ◆ Conversely, whether the worker is paid for the rental of equipment regardless of whether the worker performs services. ◆ Whether the worker retains control over the equipment. ◆ Whether the worker is responsible for all operating expenses incurred while the equipment is being leased. ◆ Whether there is a definite lease term, or whether the lease is valid only during the hours of employment. ◆ Whether the worker is free to use the equipment in performing services for any person. ◆ Whether the rental payments bear a reasonable relationship to the fair rental value of the equipment. ◆ Whether the purported leases were put in place for some regulatory reason (other than federal taxes) such as, for example, to minimize overtime wages. ◆ Whether the worker rents the equipment to another person under an arrangement that does not call for the worker's services. ◆ Whether the employer treated the activities as separate activities for reporting purposes.

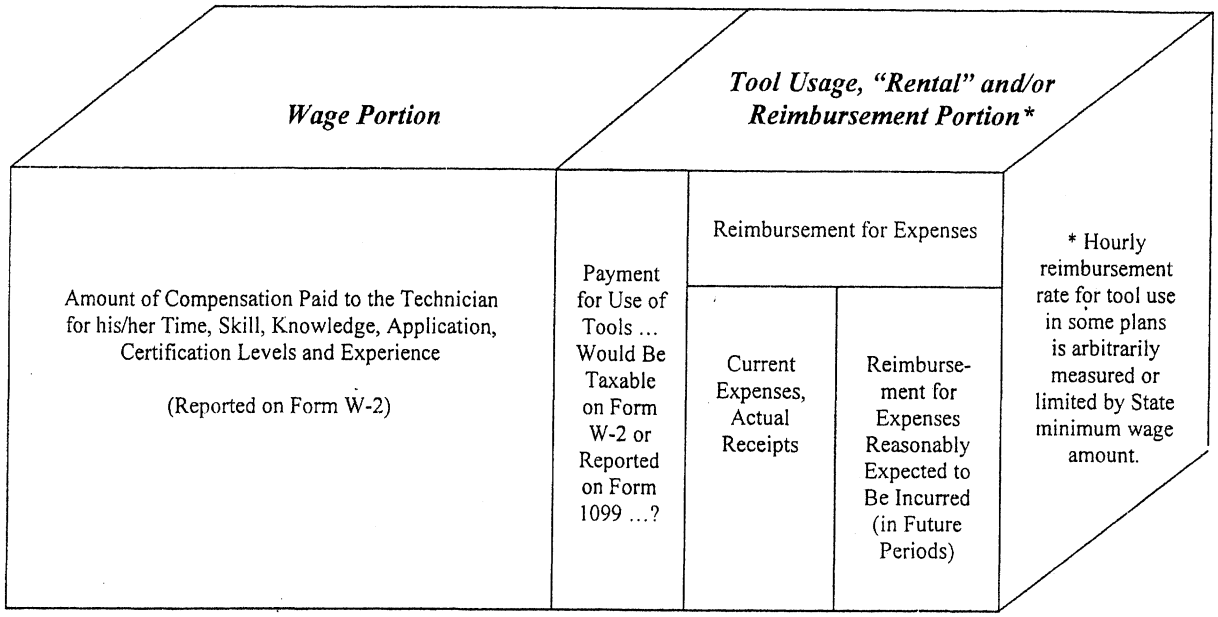
FSA 200132003 *July, 2001*	• This Field Service Advice (FSA) involved treatment of payments to couriers, an issue the IRS addressed more currently discussed in Rev. Rul. 2004-1. • In this FSA, the question was whether the taxpayer's arrangement to reimburse certain expenses of its employee drivers qualified as an accountable plan. ◆ The IRS held that it did not because the arrangement failed to satisfy (1) the business connection requirements, (2) the substantiation requirements and (3) the return of excess payments requirements for an accountable plan. • This FSA said that if an employer pays an amount to an employee as a business expense regardless of whether the employee incurs, or is reasonable expected to incur, the business expense, the payment does not meet the business connection requirement. ◆ In this FSA, the taxpayer reimbursed its drivers under its arrangements regardless of actual mileage or vehicle rental expenses. • As to the return of excess payments requirement, the courier service's plan payments 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. • The FSA concluded that the taxpayer's plan was ***abusive*** under Section 1.62-2(k) of the regulations. Therefore, all payments made under the arrangement were 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)."
Trucks, Inc. v. U.S. *December, 2000*	• Trucking company treated per diem payments to drivers as non-taxable payments under a Section 62(c) plan. ◆ This case involves special application of waiver of return of excess payments where Commissioner has specifically authorized procedures for flat, per diem payments. • In 1997, the District Court had held that the per diem payments were not made under a Sec. 62(c) plan. • ***In 2000, Court of Appeals reversed the District Court.*** ◆ "[Taxpayer] produced sufficient evidence ... to show a genuine dispute over the reasonableness of its decision that expense reimbursements were paid under an accountable per diem allowance." ◆ The issue involved "whether an employer reasonably anticipated that on-the-road employees would incur certain expenses" ... and this was not a question of law (properly decided on Summary Judgment by the District Court), but a question of fact for a jury to decide. • The Appeal Decision contains interesting language about the "state of mind of the company's president." ◆ This relates to the issue of whether there was a reasonably anticipated calculation of the drivers' expenses before reimbursing them. ◆ Special emphasis placed on wording ... "The employee incurs (or is reasonably expected to incur)...". (Reg. Sec. 1.62-2(d)(3)(i)) ◆ Company president had done research on how other trucking companies had reimbursed drivers for expenses, and based on this research, claimed it had relied on standard business practices. • Court said... "It is possible that a jury would decide that (the company) passes the business connection test because (the company president) could reasonably expect the drivers to incur the same expenses as other drivers in the industry. Additionally, ***the focus of the business connection test is on the employer's reasonable expectations, not the drivers' actual expenditures.*** These questions of reliability and state of mind fall within the purview of the jury." • DC - Georgia - 97-2 USTC ¶ 50,707; 987 FSupp 1475 • CA-11 - (rev'g and rem'g DC), 2001-1 USTC ¶ 50,116; 234 F3d 1340

Tool Plans Timeline	SELECTED CASES, RULINGS & DEVELOPMENTS ... 1997 TO DATE
Trans-Box Systems, Inc. v. U.S. *June, 2000*	• Company treated 55% of wages as non-taxable lease payments or vehicle expenses. • In 1998, District Court held that the courier service payments to employees were not paid under a Section 62(c) accountable plan. ◆ In 2000, District Court decision affirmed upon appeal. • Payment were fixed, and there was no relation to the subsequent mileage expenses that were reimbursed. • Company's position that payments were made to owner-operators (employees) as independent contractors was rejected by the Court. • Company's position that it had at least "substantially complied" with the requirements of Section 62(c) was also rejected. • DC - Northern District of California, 84 AFTR2d ¶ 1999-5390 • CA-9 - 86 AFTR2d ¶ 2000-5005 ... affirmed District Court
IRS Coordinated Issue Paper *June, 2000*	• In 2000, the IRS Coordinated Issue Paper concluded, "***Generally, amounts paid to motor vehicle service technicians as tool reimbursements will not meet the accountable plan requirements.***" • The Coordinated Issue Paper (indirectly) expresses concern over service technician reimbursement plans that arbitrarily recharacterize a portion of taxable compensation as "reimbursements" in order to avoid (or evade) income tax responsibilities. • In part, the CIP states ..."That same reasoning applies to tool reimbursements where a portion of the service tech's hourly wage payment is ***designated*** as a tool reimbursement, but the amount has no logical connection to the expenses incurred. ... In the typical tool reimbursement arrangement the employer ***carves out*** a portion of the workers hourly wage and ***recasts*** it as reimbursement for expenses, when in fact the amount treated as reimbursement is not related the employee's expenses." ◆ The antecedent for "same reasoning" refers to the District Court opinion in ***Shotgun Delivery*** that payments under Shotgun's reimbursement arrangement had no logical correlation to actual expenses incurred. • Complete text of Coordinated Issue Paper appears on pages 22-25.
DePaz, et al. v. Comm. *May, 2000*	• In this case, the Tax Court considered situations involving three different California taxpayers, each of whom took the position that part of the income they earned from their trucking activity could be allocated to a separate leasing activity. • The individuals involved (Marcos de Paz, Jose Batres and Agustin Perez) were each employed by different trucking companies and entered into agreements with their employers regarding their working relationships. • The individuals reported their income in slightly different ways. De Paz reported only wage income, and included no Schedule C, Schedule E nor any other listing of expenses in his tax return in connection with his alleged rental income. Mr. Batres and Mr. Perez reported wage income, and reported rental income in a separate Schedule E, with an offsetting amount of vehicle/rental equipment expense so that the net rental income zeroed out. • The Tax Court held that these individuals (who leased their trucks to carriers for a rental fee that was equivalent to their vehicle expenses) were not engaged in the separate activity of leasing their trucks to the carriers. ◆ Accordingly, for income tax purposes, the lease arrangements with the carriers had no independent economic significance and all of the income the owner-operators received from the carriers was wage income. ◆ The expenses they incurred in connection with the operation of their trucks were deductible, but only as Schedule A itemized deductions, subject to the percent-of-AGI limitations imposed by Section 67(a). • *Marcos de Paz et. al. v. Comm.*, T.C. Memo 2000-176 ◆ This case is more fully discussed in the *Dealer Tax Watch*, June 2000, pages 12-13.

ILM 200006005 *February, 2000*	• This IRS Legal Memorandum (ILM) involved an individual who intended to construct an automotive repair facility. He also intended to hire two automotive technicians as employees of the automotive repair facility. As a condition of their employment, each technician would be required to provide his or her own tools to be used in performing repairs. • The technicians to be hired would be compensated with two paychecks: One paycheck would be for approximately 65% of the total hourly wage and that payment would be treated as wages subject to Federal Employment Taxes and reported at the end of the year on Form W-2 as wages. The second paycheck, for roughly 35% of the technician's total pay, would be intended to reimburse the employee for the use of the employee's tools. Those payments would not be reported at year-end to the employee as wages on Form W-2. • The IRS Memo concluded that the arrangement proposed by the taxpayer was one "evidencing a pattern of abuse" of the rules of Section 62(c). The IRS said, "***The arrangement*** attempts to recharacterize compensation as reimbursements made from an accountable plan and ***is nothing more than X's attempt to avoid payment of Federal Employment Taxes***." • As a result of holding that the plan had no legitimate business connection, the IRS found it unnecessary to discuss whether the other accountable plan requirements (involving substantiation and the return of excess payments) were satisfied.
Shotgun Delivery, Inc. v. U.S. *January, 2000*	• Much of the discussion in *Shotgun Delivery, Inc.* is similar to ILM 200006005. • Shotgun Delivery, Inc. was in the business of providing courier services for point-to-point deliveries, and the drivers it employed generally used their own vehicles to make pick-ups and deliveries. These drivers would tell their employer when they were available to work, and they would then be dispatched by radio to pick up and deliver packages on an as-needed basis. The employer had anticipated that the payments made under the plan as rentals for the use of the delivery vehicles would qualify for favorable Section 62(c) "accountable" plan treatment. • The District Court found that Shotgun's plan failed to satisfy the first Section 62(c) test which requires "legitimate business connection." The Court said that Shotgun's reimbursement arrangement "was, in fact, reimbursing its drivers in a manner ***not correlated to expenses*** Shotgun's employees incurred or were reasonably expected to incur." • Accordingly, the expense reimbursements paid by Shotgun did not meet the business connection requirement and were held to be paid pursuant to a ***non***accountable plan. Thus, these payments were subject to full treatment as W-2 wages subject to withholding and the payment by the employer of Employment Taxes. • The Court recognized that, due to its holding that Shotgun had not met the business requirement, it was not necessary for it to go any further in its analysis of the other two requirements for an accountable plan. • The Court said, "That fact notwithstanding, it should be noted that regarding the substantiation requirement, at the end of every pay period, Shotgun drivers did submit reports detailing the hours worked and miles driven each day, which would ostensibly be sufficient to meet the second requirement of an accountable plan. However, Shotgun did not fulfill the ***returning amounts in excess*** requirement." ◆ ... "It is clear that regardless of any effort made to prevent reimbursement above the allowable per-mile rate, such excess reimbursements were in fact made," and "...Despite this fact, Shotgun did not require its drivers to return these excess reimbursements...Thus, Shotgun's plan also fails the third requirement for a valid accountable plan." • The Court held that Shotgun's reimbursement arrangement had no logical correlation to actual expenses incurred, and therefore, it fell under the "abusive plan" rules of Reg. Sec. 1.62-2(k). Accordingly, all payments made under the plan were to be treated as made under a ***non***accountable plan. ◆ The District Court upheld the assessment of penalties against Shotgun Delivery. ◆ On appeal, the Appeals Court reversed the District Court's summary judgment as to penalties. • DC-Calif - 2000-1 USTC ¶ 50,210; 85 FSupp 2d 962 • CA-9 - (aff'g and rev'g DC) 2001-2 USTC ¶ 50,700; 269 F3d 969
IRS Comments *October, 1999*	• IRS Motor Vehicle Tax Advisor, Mary Burke Baker discussed accountable plan issues for auto dealer service technicians at the 1999 AICPA National Auto Dealership Conference. • Her comments at this Conference are reported on pages 20-21.

Tool Plans Timeline	***SELECTED CASES, RULINGS & DEVELOPMENTS ... 1997 TO DATE***
ILM 199921003 ***February, 1999***	• This ILM reflected the analysis of a position paper submitted to the Employee Benefits & Exempt Organizations Branch by District Counsel. This position paper involved "rig rentals" paid in a specialized industrial situation where rig welders provide equipment which generally includes a truck, welder and welding tanks. ◆ The position paper submitted for review had concluded that payments would be made under an accountable plan ***in every case***. ◆ The ILM did not agree with District Counsel's conclusion. • The ILM concluded that whether the rig rentals were wages depended on whether the rig rentals were paid pursuant to an accountable plan. If they were, the payments were not wages for income tax purposes. ◆ "... The issue that must be resolved based upon the facts and circumstances of each case is whether the rig rentals are paid pursuant to an accountable plan."
ILM 199917011 ***January, 1999***	• This ILM originated from a request within the IRS for advice about the treatment (for employment tax purposes) of payments made by an employer to its employees for the use of unspecified equipment. Although the nature of the payments was intended to be eliminated from the memo in the redacting process, in one place the word "tool" appears where it apparently should have been eliminated. • The ILM discusses the ***accountable plan*** payment requirements and two related tax cases. ◆ *Welch v. Comm.* (T.C. Memo 1998-3100) ◆ *Trans-Box Systems v. U.S.* (AFTR2d 6479 (N.D. Cal. 1998) affd. 2000 U.S. App Lexis 12595 (9th Cir. June 2, 2000)) • The ILM also discusses the "anti-abuse" provision which provides that if a payor's reimbursement or other expense allowance arrangement evidences a pattern of abuse of the rules of Section 62(c), ***all*** payments made under the arrangement will be treated as made under a ***nonaccountable plan***. ◆ The ILM does not mention Reg. Sec. 1.62-2(i) which states that requirements are to be applied on an employee-by-employee basis. This Regulation provides that the failure by one employee to substantiate expenses under an arrangement will not cause amounts paid to other employees to be treated as paid under a nonaccountable plan. Thus, the viability or *bona fides* of the plan is not intended to be determined on an overall basis where substantiation is the issue, but rather it is to be determined on an employee-by-employee basis. • The ILM includes a list of some of the questions that the IRS is likely to ask should a taxpayer's plan or arrangement eventually come under audit. ◆ Ironically, this list of questions follows the general statement that "It may not be assumed that every (payment under a reimbursement arrangement) is a disguised payment of wages or that an employer cannot establish an arrangement that satisfies the accountable plan requirements."
Trans-Box Systems, Inc. v. U.S. ***August, 1998***	• Company treated 55% of wages as non-taxable lease payments or vehicle expenses. • In 1998, District Court held that the courier service payments to employees were not paid under a Section 62(c) accountable plan. ◆ In 2000, District Court decision affirmed upon appeal ... See discussion above.
Trucks, Inc. v. U.S. ***September, 1997***	• Trucking company treated per diem payments to drivers as non-taxable payments under a Section 62(c) plan. ◆ This case involves special application of waiver of return of excess payments where Commissioner has specifically authorized procedures for flat, per diem payments. • In 1997, District Court held that payments by the company were not made under a Sec. 62(c) plan. • In 2000, the Court of Appeals reversed the District Court ... See discussion above.

COMPONENTS OF HOURLY PAY FOR TECHNICIANS



Part of the difficulty to date may be due thinking about a technician's hourly compensation rate as consisting of only two components (i.e., wage and tool use). In fact, it's more complicated than that because an hourly rate paid for "tool use" seems to reflect several elements:

1. Availability for use and actual use of tools,
2. A reimbursement for actual expenses incurred during the period and
3. A reimbursement for expenses reasonably anticipated to be incurred within the near future in connection with the tool inventory or the maintenance of the tool inventory.

The above "visualization" of an hourly tool rate may be more helpful in identifying some of the tax questions for which guidance is currently lacking. For example, to the extent that the technician purchases a very costly tool in the current period, can he/she be reimbursed in full immediately for that tool, or should there be some allocation of that cost to future periods (i.e., depreciation element). Similarly, to the extent that a technician has purchased a portion of his/her tool inventory in a prior period, the availability of that tool for use is clearly significant. To what extent is a depreciation-like reimbursement on those tools allowed to be factored into a reimbursement rate in the current year?

What other costs may be, or should be, included as reimbursable expenses, for which tax-free accountable plan reimbursements may be received? And, what other costs *reasonably anticipated* to be incurred in the near future (i.e., within one year?) may be, or should be, included as reimbursable expenses, for which tax-free accountable plan reimbursements may be received?

Essential to compliance with Section 62(c) is the fact that the technician must be required to make an accounting to the employer to justify that the amounts he/she has received either are or are not "in excess of" the amounts advanced. To the extent that a technician receives a reimbursement for expenses reasonably expected to be incurred (in future periods), with proper accountability, this advance will be matched against actual expenses, with the only difference being a difference in "timing."

To the extent that the entire amount of hourly pay is reported as wages on Form W-2, both the employer and the employees are being taxed on a portion of pay that should not be subject to tax.

The IRS Concern	***"WAGE RECHARACTERIZATION" A DIFFICULT TECHNICAL ISSUE***
Overview	• To achieve compliance with the requirements of Section 62(c) for accountable plan treatment, employers face both technical and practical issues. • The most significant technical issue is the so-called "wage recharacterization" issue. • Four discussions of the "wage recharacterization" issue, often cited by the IRS, are below.
Treasury Decision 8324 *(Dec. 1990)*	• Basically, T.D. 8324 states that, "... no part of an employee's salary may be ***recharacterized*** as being paid under a reimbursement arrangement or other expense allowance arrangement." • The full context of the discussion in Treasury Decision 8324 is below, and relates to questions the IRS received that involved the possibility and/or consequences of taking a short-cut approach in trying to disguise payments for wages as tax-free expense reimbursements ... ◆ "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 Reg. Sec. 1.62-2(d) ... 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.***"
Regulation Example Often Cited by the IRS	• Reg. Sec. 1.62-2(j). *Example (1). Reimbursement Requirement.* 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 (d)(3)(i) of this Section. Thus, no part of the $50 that 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. • This example is cited by the IRS in Revenue Ruling 2004-1, in *Situation Two*, in describing the failure of reimbursement payments to couriers to satisfy the business connection requirement.
IRS Coordinated Issue Paper *(June 2000)* *Auto Dealership Service Technicians*	• In 2000, the IRS Coordinated Issue Paper concluded, "***Generally, amounts paid to motor vehicle service technicians as tool reimbursements will not meet the accountable plan requirements.***" • The Coordinated Issue Paper (indirectly) expresses concern over service technician reimbursement plans that arbitrarily recharacterize a portion of taxable compensation as "reimbursements" in order to avoid (or evade) income tax responsibilities. • In part, the CIP states ..."That same reasoning applies to tool reimbursements where a portion of the service tech's hourly wage payment is ***designated*** as a tool reimbursement, but the amount has no logical connection to the expenses incurred. ... In the typical tool reimbursement arrangement the employer ***carves out*** a portion of the workers hourly wage and ***recasts*** it as reimbursement for expenses, when in fact the amount treated as reimbursement is not related the employee's expenses." ◆ The antecedent for "same reasoning" refers to the District Court opinion in ***Shotgun Delivery*** that payments under Shotgun's reimbursement arrangement had no logical correlation to actual expenses incurred.
Rev. Rul. 2004-1	• Rev. Rul. 2004-1 (2004-4 I.R.B. 325) analyzed two situations in connection with whether or not certain mileage allowances paid by a package delivery business to its driver/courier employees could be treated as qualifying as paid under the accountable plan rules. • The fact pattern in this Revenue Ruling closely resembles the fact pattern in *Shotgun Delivery, Inc.* • In one situation, the payments were found to be acceptable to the IRS as qualifying under Sec. 62(c). In the second situation, the payments were held not to qualify under Sec. 62(c) as accountable plan reimbursements. ◆ The Revenue Ruling states that a bona fide reimbursement arrangement must preclude the recharacterization as a mileage allowance of amounts otherwise payable as a commission. ◆ In the second situation, each driver received an identical percentage regardless of the amount of deductible employee business expenses he or she incurred, and the IRS held that a variable allocation between commission and mileage allowance did not meet the business connection requirements.

Resolution Considerations	*"WAGE RECHARACTERIZATION" TOWARD RESOLVING OPPOSING VIEWPOINTS*
Properly Implemented, Sec. 62(c) Plans ... Are Practical Cost Containment Strategies, Not Arbitrary "Wage Recharacterizations"	• Dealerships (and other businesses) adopting responsibly monitored Section 62(c) plans contend that they have not recharacterized part of the compensation paid to their technicians in an arbitrary manner. ◆ Rather, taxpayers adopting such plans are adopting prudent cost containment or cost management strategies which are made available to them under IRC Section 62(c). ◆ Reg. Sec. 31.3121(a)-3(a) provides that "if both wages and the reimbursement or other expense allowances are combined in a single payment, the reimbursement or other expense allowance must be identified either by making a separate payment or by specifically identifying the amount of the reimbursement or other expense allowance." ◆ Since this was not done previous to setting up a Section 62(c) plan, no claim could be made - nor was any made - that prior to the adoption of the Section 62(c) program, any of the compensation being paid to technicians could be treated as excludable for income and/or employment tax purposes. ◆ However, once an accountable plan is adopted, a dealership should be entitled to treat all properly computed and substantiated accountable plan reimbursements made to its employee service technicians as excludable for income and/or employment tax purposes. ◆ This strategy, with its attendant favorable reduction in tax burdens, is only available to taxpayers who are willing, and in fact, do, satisfy all of the requirements imposed by the Regulations. • For those taxpayers willing to incur the additional costs and burdens of compliance, there is no logical reason why they should not be permitted to enjoy the favorable tax results.
Need for Reasonable, Realistic "Attitude Adjustments" & Compromises	• Resolution of the wage recharacterization issue or controversy would seem to require a paradigm shift in thinking about the nature of the problem, with the understanding that there is no perfect solution or clear line of demarcation. • See "Components of Hourly Pay for Technicians" diagram and discussion on page 38. • It is an accepted industry practice to require technicians to provide their own tools as a condition of their employment. Every technician employed by a dealership prior to its adoption of a compliant Section 62(c) accountable plan is receiving, as part of his/her compensation, a reimbursement for providing his/her tools ◆ However, under these circumstances, no exclusion from income is permitted because they are receiving payments under a nonaccountable plan. • Ideally, resolution of the IRS concern over wage recharacterization might be achieved by independently valuing the component of the hourly compensation paid to an employee (providing his or her own tools) that relates to the "time/skill/experience" that employee brings to the job. ◆ To this component, ideally, would be added a second component which relates to the reimbursement for expenses which the employee is entitled to receive tax-free. • Currently, employers are faced with problems in valuing both components. ◆ As to the amount or component of an hourly rate that is paid for the employee's time/skill/experience ... Even though no employer would hire that employee unless he or she brought their own tools, it is unreasonable to argue that that "time/skill/experience" component has zero value, and that everything paid is paid as compensation for the tools provided. ◆ As to the amount or component of an hourly rate that is paid for the employee's ownership, use and maintenance of his or her tool inventory ... There is currently no guidance from the Internal Revenue Service as to what it will accept relating to (1) which expenses are related to a tool inventory (actual and/or reasonably anticipated to be incurred) and to (2) what extent, or how, those expenses should be measured. • ***Key point - requiring concession by employers and technicians...*** It should be understood that ***there can be no assurance that the single hourly rate paid to a technician before adoption of a Sec. 62(c) plan will be equal to the total of the two hourly rates when a division is made between the wage-skill component (W-2 wage) and the tool expense reimbursement component (tax-free).*** • The current impasse is what has motivated some taxpayers to request guidance from the IRS either in requests for Private Letter Rulings or through IIR Project status. The latter (IIR status) should attempt to move toward a mutually satisfactory approach which recognizes that neither of the absolute extremes is correct (nor fair) and it should establish or otherwise put in place some type of safe-harbor methodology that taxpayers can use with certainty.

DANGERS IN THE HANDLING OF "RETURN OF EXCESS" REIMBURSEMENTS

1. ***Technicians are not above the law ... If they want tax-free treatment, they must "earn" it by being accountable.*** It is absolutely unrealistic for an employer or a third party administrator to believe that they can justify an accountable plan under Section 62(c) and not require each covered employee/technician to be accountable for the amounts they receive as "tax-free" advances. In other words, that employee must submit evidence and documentation of expenses incurred in connection with which amounts have been advanced and treated as tax-free income.
   - ***There must be an accounting ... sooner or later.*** Take a simple situation... As an employee, you are going out of town on a business trip and your employer advances you $500 for anticipated expenses. While away on business, you spend $100 on meals, $300 on lodging and $120 on cabs and transportation. Shortly after you return, you give your employer an expense report (with receipts, as required) showing $520 of expense and ask to be reimbursed for the additional $20 that you spent.
   - Alternatively, assume that on your business trip, you spent $100 on meals, $200 on lodging and $120 on transportation. Shortly after you return, you give your employer an expense report (with receipts, as required) showing $420 of expense, and you must return the overreimbursed amount of $80 to your employer.
   - In some instances, the excess or the shortfall may be carried against the next expense advance and expense report.
   - The essence of accountability to the employer for funds advanced is unmistakable. Anything less fails to comply with the requirements of Sec. 62(c). Any technician providing his or her own tools who is not willing to make the appropriate accounting to his or her employer is not entitled to receive any amounts tax-free. Any third party administrator who believes that an accounting is not required (of the general nature illustrated above) is seriously failing to fully comprehend the intent and thrust of the Regulations.

2. ***"We're always 100% correct."*** It is unrealistic for a third party administrator to claim, as some do, that "there can never be an overreimbursement" under its program mechanics. To the extent reimbursement rates are based upon a multiplicity of assumptions and national or other databases, the reimbursement rates computed and applied are no better than the blend of assumptions and fudge factors that go into the compilation of these databases.
   - At best, the hourly reimbursement rates are estimates. To the extent that the hourly rates advanced as tool reimbursements are arbitrarily limited by some ceiling amount (like a State minimum hourly wage rate), that hourly rate cannot be said to be reflective of actual expenses incurred.

3. ***Reducing the next reimbursement rate to offset the current excess.*** To the extent there is an accounting, and an overpayment situation exists, employers and/or third party administrators should not assume that adjusting the reimbursement rate in a subsequent period will automatically satisfy the "return of excess" requirement. Continuous adjustments over successive reporting periods which enable the technician to indefinitely postpone the ultimate "day of reckoning" cannot be expected to satisfy the requirements of the Regulation ... unless the IRS were to say that that approach is acceptable.

4. ***Don't bonus out the excess.*** To the extent that there is an accounting, and an overpayment exists, simply including the amount of overpayment as wages is not likely to satisfy the "return of excess payment" requirement. One example in the Regulations is quite clear on this.

   > ***Reg. Sec. 1.62-2(j), Example (8). Return Requirement.*** Employer Y provides expense allowances to certain of its employees to cover business expenses of a type described in paragraph (d)(1) of this section under an arrangement that requires the employees to substantiate their expenses within a reasonable period of time and to return any excess amounts within a reasonable period of time. Each time an employee returns an excess amount to Employer Y, however, Employer Y pays the employee a "bonus" equal to the amount returned by the employee. The arrangement fails to satisfy the requirements of paragraph (f) (returning amounts in excess of expenses) of this section. Thus, Employer Y must report the entire amount of the expense allowance payments as wages or other compensation and must withhold and pay employment taxes on the payments when paid.

5. ***Show me the money ... Give it all back.*** To the extent an excess reimbursement exists, as an administrative matter, it is much simpler to deal with that overreimbursement in one of the two ways discussed above. However, until there is some clarification from the IRS on what it will accept in these situations, the only safe thing to do is to have the employee return the overpayment, in full, immediately. Under the 120-day-periodic-statement method, there may be some leeway in offsetting the overreimbursement directly against the employee's next paycheck or two. But, if the reimbursement rates are reasonably accurate, the amount of overpayment should be relatively small.

Questions Needing Answers

IF I COULD WRITE THE RULES, HERE ARE THE POINTS I'D COVER ...

1. ***The whole (before) should not be equal to the sum of the parts (after).*** It would have to be understood that the hourly wage before adopting a plan would not be the same as the sum of the (two) components into which that compensation would be broken under a Section 62(c) accountable plan arrangement.
   - Once established, the wage component would not be changed as a result of fluctuations in the reimbursement component. However, the wage component could change as a result of cost-of-living / inflation adjustments or increases in skill or certification levels.

2. ***Expenses incurred or reasonably anticipated to be incurred.*** A list should be provided of expenses which may or may not be considered as "expenses incurred or reasonably anticipated to be incurred" so that they can be included in a computation that results in a reasonable reimbursement rate expressed in terms of a given dollar amount per hour. Alternatively, if only a receipts-based approach is mandated, the nature of these costs must be considered in that circumstance. The list would include the following...
   - Cost of equipment & tools purchased after participation in an accountable plan begins with the current employer ... Dollar-for-dollar reimbursement of actual cost vs. some pro-rated amount equivalent to a depreciation component
   - A depreciation component related to equipment and tools that are part of the employee's inventory, but that were purchased prior to signing up for participation in an accountable plan with the current employer
   - Sales tax paid on purchased tools
   - Consumable supplies (lubricants, replacement saw blades, etc.)
   - Major repairs
   - Replacement cost
   - Loss and theft rates
   - Insurance
   - Safety equipment purchases
   - Training classes, literature, etc.
   - Interest on amounts financed to purchase equipment
   - Shipping and/or other delivery costs incurred
   - Travel and other related costs incurred to purchase the equipment
   - Amounts paid to a third party administrator in connection with determining rates and issuing the accountable plan checks each payroll period
   - In determining costs to be included as reimbursable costs, to what extent may the Regs under Sec. 263A provide guidance?

3. ***Other questions require unambiguous guidance or clarification by the IRS.*** It should be understood that each of the questions below would be preceded by the following qualifying introductory language..."Under Section 62(c) accountable plans, established to reimburse auto dealer or other technician employees who provide their own tools and equipment for use on the job as a condition of their employment," ...
   - ***... How should the Plan treat the employees' expenditures for tools and equipment incurred before employment by the employer?***
   - ***... How should the Plan treat the employees' expenditures for tools and equipment incurred during the current year before the employer adopts an accountable plan?***
   - ***... How does the employees' tax treatment of those expenditures in years before employment by the employer affect the determination of a reimbursement rate?***
   - ***... How does the employees' tax treatment of those expenditures for tools and equipment incurred during the current year before the employer adopts an accountable plan affect the determination of a reimbursement rate?***
   - ***... To what extent, if any, must depreciation under the "allowed or allowable convention or rule" be taken into consideration where the employee in prior years has claimed a standard deduction instead of Schedule A itemized deductions in determining his or her taxable income for the year?***
   - ***... To what extent, if any, may a "projection of expenses to be incurred in the future" be taken into consideration in determining the reimbursement rate? May anticipated expenditures for insurance, maintenance and/or repairs be included?***

IF I COULD WRITE THE RULES, HERE ARE THE POINTS I'D COVER ...

4. ***Technicians' Accounting for actual expenses incurred.*** At regular periodic intervals, the employee should be required to submit appropriate receipts, documentation and substantiation so that "an accounting" is made to the employer to determine whether the amounts received as advances or reimbursements for the period are in excess of the amounts that can be substantiated and documented. In this regard, the following should be set forth...
   - Exactly what records and documentation the employee is required to submit periodically.
   - How frequently these accountings are required to be made.
   - Is there a de minimis amount below which the employee is not required to submit receipts and/or other substantiation?
   - There should be some coordination either on Form W-2 or on a Form 1099 to report the amounts which the employee has excluded from income because these amounts are accountable plan reimbursements under Section 62(c).
   - Which party is (or parties are) required to keep the records and documentation that the employee has submitted to justify the tax-free status of amounts advanced. The responsible parties involved include the employee, the employer, and/or the third party administrator. In this regard, see *"Recordkeeping"* below to avoid duplicative recordkeeping responsibilities.

5. ***Compliance with "return of excess" requirement.*** Without any ambiguity, answers would need to be provided to the questions that come up when an excess reimbursement occurs. In other words, each of the following should be specified as either acceptable or not acceptable compliance with the "return of excess" requirements.
   - Return the excess amount, in full, immediately.
   - Return the excess amount by offsetting the excess against salary in next pay period.
   - Excess amount included on employee's Form W-2 at the end of the year.
   - Excess amount included on Form 1099-MISC issued to employee at end of year.
   - Adjustment is made to reduce hourly reimbursement rate that will be applied in subsequent periods.

6. ***Recordkeeping.*** Specific requirements for the maintenance of recordkeeping by each party would be provided. This would include answers to the following questions...
   - Where is the evidence of the employee accounting to the employer for the expense reimbursements received?
     - Who is responsible for reviewing expense reports submitted by the employees and coordinating those expense reports with those amounts previously advanced?
     - Who is saving the expense reports and underlying documentation? ... The employee, the employer, or the third party administrator?
     - What records should be retained, and by whom?
     - For what period of time should those records be retained?

7. ***Provide a safe-harbor alternative.*** What is needed is an optional expense substantiation rule similar to that found in Rev. Proc. 2002-41.
   - To the extent that assumptions or judgments would be introduced in order to reach administratively-workable plan mechanics, a reduction of 5-10% would be required so that such assumptions or judgments would not resolve all doubt one way or the other.
   - This safe-harbor alternative should be an alternative to an exact cost/expense accounting computation (once all proper expenses have been identified and properly measured) since the amount of cost incurred by a technician might be significantly greater than the optional expense amount allowed, and the technician should be permitted to avail himself/herself of the larger benefit.

Watch Out	***... BUT SINCE I CAN'T, HERE ARE SOME PRACTICAL SUGGESTIONS***

1. A major concern of the IRS is that in seemingly all instances, the hourly rate of compensation to a technician before a Section 62(c) plan is adopted appears to be no different after a plan is adopted. For example, if a technician is paid $20 an hour before the plan is adopted, that technician is paid $15 plus $5 in two separate checks after the plan is adopted. In other words, total hourly compensation received by the technician is $20 per hour before the plan is adopted and total of the two components after the plan is adopted is still $20.

   Why not have the total of the two checks after the plan is adopted equal a total amount that is either more or less than the amount before? For example, why not $15 for compensation and $4.85 or $5.15 as the tool reimbursement?

   Expect that the total of the two components will not equal the total amount before. Don't be fixed on paying the technician the same amount before and after. The wage rate should be independent ... at all times ... of the tool expense reimbursement rate. The amount of the hourly compensation paid for skill, experience, etc., should be taxed. The amount paid as a tool reimbursement should be variable ... and not subject to tax.

2. In working out the reimbursement mechanics, just apply the reimbursement rate to hours spent "turning the wrench," rather than applying the reimbursement rate to the total of all vacation hours, holiday hours, sick pay hours, etc.

   As an administrative matter, the same overall result (i.e., the payment of the nontaxable amount to the technician) can be obtained by decreasing the reimbursement rate per hour actually worked and applying that slightly smaller amount to all hours paid. However, the specific identification of an "expense reimbursement" payment applied to "nonworking hours" might give rise to the argument by the IRS that there is no business connection for the payment of an "expense reimbursement" related to these nonworking hours.

3. Extensive overtime is likely to result in over-reimbursements. Accordingly, the repayment of excess reimbursements in these cases becomes critical.

4. Expense reimbursement rates should vary for each individual technician according to his/her skill level and tool inventory. Reimbursement rates should not be the same amount per hour across the board for all technicians.

   Even in those cases where several technicians are limited to receiving a maximum (or ceiling) amount per hour as the reimbursement, they would not necessarily have the same reimbursement rate. This is because the reimbursement rate is determined at the beginning of the year based on hours anticipated to be worked. And, these employees may have different anticipated hours which would produce a different reimbursement rate.

5. Be sure the technicians understand that they ***must*** repay any excess reimbursements. If the IRS were to ask covered technicians about their understanding of this potential liability on their part, it would be embarrassing if the technicians said that they were not aware of this requirement. Is there any harm in including a proforma notice reminding the employee of his responsibility with the last paycheck each quarter?

6. Don't rely on generalized "extensive data" or studies to support the position that there never will be an over-reimbursed situation, i.e., that technicians can never receive excess reimbursements. This smacks of hubris, which the IRS is sure to challenge.

7. Technicians should be given the option to decide whether or not participate in a Sec. 62(c) accountable plan arrangement. There may be circumstances where the technician wishes to claim deductions currently, notwithstanding the adverse impact of the various percentage limitations that apply when these amounts are claimed as itemized deductions in Schedule A.

8. In some states, there is a requirement that the minimum hourly wage paid cannot exceed the amount paid as a tool reimbursement where the employees are required to provide their own tools. Some plan administrators applying this as a limitation on the tool reimbursement rate contend that this artificial ceiling makes their plans either "conservative" or less vulnerable to attack by the IRS. Both of these ideas are without substance. In many cases, this limitation simply prevents the payment of a more accurately computed reimbursement amount.

9. Don't get hung up on trying to do everything perfectly, or waiting for the IRS to answer all of your questions. The Regulations clearly indicate that, if there is a failure to satisfy one of the three Section 62(c) requirements, that merely invalidates the accountable plan treatment with respect to that individual.

   Therefore, if one or two (or even a few) technicians are over-reimbursed and they do not repay the excess reimbursement, that failure does not taint the entire plan as it relates to all other employees. That failure only taints the individuals who received the excess reimbursements and did not repay them. Get off of the "all-or-nothing" mentality that the IRS would like to inflict on employers who are considering using Sec. 62(c) plans.

Considerations in Evaluating Exposure to Challenge by the IRS ... Technician Tool Reimbursement Plans Under Section 62(c)	***PRACTICE GUIDE*** *Page 1 of 3*
	COMMENTS
1. ***Type of plan.*** In which category does the technicians' tool reimbursement arrangement fall? • ***Rental*** plans and/or arrangements. • Accountable plan reimbursement arrangements which ***do not satisfy*** the requirements of Sec. 62(c) ... i.e., payments are made under nonaccountable plan rules. • Accountable plan reimbursement arrangements which ***satisfy*** the requirements of Sec. 62(c). • Accountable plan reimbursement arrangements which ***satisfy*** the requirements of Sec. 62(c) ***but which require clarification as to tax issues relating to reimbursement rate determination.*** • Other ***hybrid*** arrangements that are initially intended to qualify as accountable plan arrangements, but which default into rental plans when "excess" reimbursements have been made.	
2. ***Eligibility requirements.*** If the plan is intended to qualify as an accountable plan under Section 62(c), are ***each of the three*** following requirements satisfied? • Business connection, • Substantiation, and • Return of any amounts paid out in excess of actual expenses incurred.	
3. Is the dealer/employer aware that if ***any*** of the payments made under a Section 62(c) plan do not satisfy the requirements, then ***all*** payments made under the plan to that individual will be treated as non-qualifying wage payments subject to withholding and employment taxes?	
4. When did the dealer/employer begin paying service technicians in part under a Sec. 62(c) tool reimbursement program? • Is the plan written? • Is the plan included in an Employee Handbook or in an employment contract? • When was the written plan document last revised? ◆ If plans have been in place for a while, current IRS objections to them may not have been anticipated when the plan provisions were originally set up.	
5. Is the plan described in the form of a lease? If so, this may suggest a rental arrangement which does not fall under Section 62(c).	
6. Are the terms and conditions of the Sec. 62(c) accountable plan reimbursement program as described in its documentation actually followed in practice? • How is the plan ***actually*** operating, in comparison with the written description of how the program is ***intended*** or ***supposed to*** operate?	
7. ***Third party administrators.*** Is the dealer/employer using a third party to administer the reimbursement payment program? • Who is the third party administrator? • Have you reviewed the plan document? • When was the plan document last modified? • Did the dealer use a different reimbursement or rental plan before adopting the current one? If yes, also provide details on previous plans used.	
8. Does each technician have the option to elect not to be covered?	
9. What is the average cost of the tool inventory maintained by the technicians who are being paid under the accountable plan reimbursement arrangement? • What is the average amount spent for the purchase of new tools in the last 12 months by technicians covered under the plan? • Has a separate hourly reimbursement rate been calculated for each technician based on his/her own unique tool inventory?	

Considerations in Evaluating Exposure to Challenge by the IRS ... Technician Tool Reimbursement Plans Under Section 62(c)	*PRACTICE GUIDE*
	COMMENTS
10. ***Technicians' accounting to employer for actual expenses incurred.*** At regular periodic intervals, is the employee submitting appropriate receipts, documentation and substantiation so that "an accounting" is made to the employer to determine whether the amounts received as advances or reimbursements for the period are in excess of the amounts that can be substantiated and documented? • Exactly what records and documentation is the employee required to submit periodically? • How frequently are these accountings made? • Who is keeping the records and documentation that has been submitted ... the employee, the employer, or the third party administrator? • For how long is this documentation being retained?	
11. ***Frequency of excess reimbursements.*** Has the dealer/employer ever overpaid/overreimbursed a technician under the plan? • How often has this occurred in the last 6-month period? • How often has this occurred in the last 12-month period? • How often has this occurred in the last 18-month period? • Extensive overtime is likely to result in over-reimbursements. Accordingly, the repayment of excess reimbursements in these cases becomes critical.	
12. ***"Don't worry, the rates we use will never result in an overpayment."*** Is the dealer/employer using a rate-based reimbursement program, and relying on assurances from the third party administrator that the hourly reimbursement rates have been computed by the third party administrator in such a way that there will never be an overpayment or overreimbursement to the technician? • These claims should be evaluated critically. • It could be dangerous to rely on the notion of "extensive database," "national experience" or FAVR equivalence, by itself, as conclusive proof that there could never be an overreimbursed situation. • Some databases are compiled with questionable accuracy or partial information (sampling), and reimbursement rates based on national averages are not likely to stand up unless they are "safe harbored" by the IRS in a Revenue Ruling or Procedure.	
13. ***Artificial conservatism.*** Is the hourly tool reimbursement rate that is applied believed to be either "conservative" or "guaranteed not to cause problems" because that rate has been capped (i.e., it does not exceed) an hourly rate related to the State hourly minimum wage? • Recognize that there is no logical connection between a State or Federal hourly minimum rate and either ◆ The accounting that employees are required to make under Sec. 62(c) for actual expenses or ◆ The amounts a technician may actually expend for business-related tool expenses.	
14. ***Handling / Repayment of excess reimbursements.*** What does the employer/third party administrator require the technician to do if he/she has received an excess reimbursement? • Return the excess amount, in full, immediately. • Return the excess amount by offsetting the excess against salary in next pay period. • Excess amount included on employee's Form W-2 at the end of the year. • Excess amount included on Form 1099-MISC issued to employee at end of year. • Adjustment is made to reduce hourly reimbursement rate that will be applied in subsequent periods. • ***Warning: Until there is further clarification by the IRS,*** there may be problems if a reimbursement/accountable plan handles compliance with the "return of excess" requirement by either (1) bonusing the excess dollar amount at the end of the year on the Form W-2, (2) reporting the excess dollar amount on a Form 1099 or (3) adjusting/decreasing the reimbursement rate for the succeeding calendar quarter or year.	

	COMMENTS
15. ***Recordkeeping.*** Where is the evidence of the employee accounting to the employer for the expense reimbursements received? • Who is responsible for reviewing expense reports submitted by the employees and coordinating those expense reports with those amounts previously advanced? • Who is saving the expense reports and underlying documentation? ... The employee, the employer, or the third party administrator? • What records should be retained, and by whom? • For what period of time should those records be retained?	
16. ***Do the technicians understand the program?*** What is the technician's understanding of how he/she is required to treat any payments received under the plan for income tax purposes? • How are the technicians treating payments they have received under the plan on their individual income tax returns? • Does the technician understand that he/she is required to return the amount of any "excess reimbursements" to the employer? ◆ How has the technician's understanding of this requirement been documented or verified?	
17. ***Compliance adjustments.*** Has the employer or third party administrator modified the tool reimbursement plan to make any changes as a result of positions expressed by the IRS in the Coordinated Issue Paper (June 2000) or in any other IRS Rulings, Revenue Procedures and/or court cases? • If so, specifically what changes to the plan have been made? • Which IRS pronouncement or court case triggered these changes in the plan?	
18. ***Rental arrangements.*** If the compensation plan with the technicians is a ***rental arrangement***, has the dealership filed Forms 1099-MISC with the IRS ***each year*** reporting these rental payments to the individuals? • If the plan is a ***rental*** arrangement plan, are the technicians aware that ***all*** payments they receive are: ◆ ***Fully taxable as regular income*** ... ***AND*** ◆ Subject to ***self-employment tax*** (reportable on Schedule SE), taxable at rates that are ***higher*** than the FICA tax rate?	
19. ***Other reimbursement arrangements.*** If the arrangement with the technicians is an ***other reimbursement arrangement***, has the employer/dealership filed Forms 1099 each year to report payments in excess of $600 to the technicians?	
20. ***Penalty exposure.*** Is the employer/dealer aware that if the reimbursements do not satisfy the requirements of Section 62(c), the IRS may assess penalties against the dealership? • In *Shotgun Delivery*, this actually happened ... although the penalties were not upheld on appeal. • Under Section 62(c), if any of the payments fail to satisfy the accountable plan requirements, then all payments will be deemed to be made under a nonaccountable plan arrangement. • If a plan evidences a ***pattern of abuse*** of the rules of Section 62(c), all payments made under the arrangement will be treated as made under a nonaccountable plan. (Reg. Sec. 1.62-2(k))	
21. ***Indemnification agreements.*** Does the dealer/employer have an agreement with the third party administrator to reimburse/indemnify the dealer/employer for any penalties which the dealership may be assessed as a result of the failure of the plan to satisfy the requirements of Sec. 62(c)? • Some third party administrators offer indemnification to the employer against interest and/or penalty assessments that may be incurred if the IRS successfully challenge the status of the plan under Section 62(c). • In some instances involving payroll taxes that should have been withheld, but were not withheld, the IRS may make an arbitrary assessment against the employer to collect the income tax that would have been paid at some assumed rate and collects that amount from the employer. The employer, in turn, may try to recover those taxes paid from the employee. ◆ Would these payments also be subject to the indemnification agreement?	

SELECTED PRIOR ARTICLES ON TECHNICIANS' TOOL PLANS & SEC. 62(c) ACCOUNTABLE PLANS

DTW Articles

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