ISSUE

Whether an arrangement that recharacterizes taxable wages as nontaxable reimbursements or allowances satisfies the business connection requirement of the accountable plan rules under § 62(c) and the applicable regulations.

FACTS

Situation 1.

Employer A, a company contracting with cable providers, employs technicians to install cable television systems at residential locations on behalf of different cable providers. Employee technicians are required to provide the tools and equipment necessary to complete the various installation jobs to which they are assigned.

Employer A compensates its employees on an hourly basis, which takes into account the fact that technicians are required to provide their own tools and equipment. Employer A decides to begin reimbursing its technicians for their tool and equipment expenses through a tool reimbursement arrangement (tool plan).

Under Employer A’s tool plan, a technician provides Employer A with an amount equivalent to the technician's tool and equipment expenses incurred in connection with providing services to Employer A. Employer A takes the technician’s total expenses for the year and divides the total amount by the number of hours a technician is expected to work over the course of a year to arrive at an hourly tool rate. Once Employer A has determined the hourly tool rate amount for a technician, it pays the technician a reduced hourly compensation rate and an hourly tool rate. Employer A treats the reduced hourly compensation as taxable wages. Employer A treats the hourly tool rate as a nontaxable reimbursement. The hourly tool rate plus the reduced hourly compensation rate approximately equal the pre-tool plan compensation rate. The tool plan tracks the hourly tool rate up to the amount of substantiated tool and equipment expenses. Once a technician has received tool plan payments for the total amount of his or her tool and equipment expenses, Employer A ceases paying the technician an hourly tool rate but increases the technician’s hourly compensation to the pre-tool plan hourly compensation rate.

Situation 2.

Employer B, a staffing contractor, employs nurses and provides their services to hospitals throughout the country for short-term assignments. Employer B compensates all of the nurses on an hourly basis and the hourly compensation amount does not vary depending on whether the hospital is located away from the assigned nurse’s tax home.

When Employer B sends nurses on assignment to hospitals that require them to travel away from their tax home and incur deductible expenses in connection with Employer B’s business, Employer B treats a portion of the nurses' hourly compensation as a nontaxable
per diem allowance for lodging, meals, and incidental expenses under Employer B's per diem plan; Employer B treats the remaining portion of the nurses' hourly compensation as taxable wages. When Employer B sends the nurses on assignment to hospitals within commuting distance of their tax home, Employer B treats all of the nurses' compensation as taxable wages. In each case, the nurses receive the same total compensation per hour.

Situation 3.

Employer C, a construction firm, employs workers to build commercial buildings throughout a major metropolitan area. As part of their duties, some of Employer C's workers are required to travel between construction sites or otherwise use their personal vehicles for business purposes. These workers incur deductible business expenses in operating their personal vehicles in connection with their employment with Employer C. Employer C compensates all of its workers for their services on an hourly basis, which Employer C treats as taxable wages. Employer C also pays all of its workers, including those who are not required to travel or otherwise use their personal vehicles for Employer C's business, a flat amount per pay period that Employer C treats as a nontaxable mileage reimbursement.

Situation 4.

Employer D, a cleaning services company, employs cleaning professionals to perform house cleaning services for Employer D's clients. Employee cleaning professionals are required to provide the cleaning products and equipment necessary to complete the cleaning service jobs to which they are assigned.

Employer D compensates its employees on an hourly basis, which takes into account that employees are required to provide their own cleaning products and equipment. Employer D decides to begin reimbursing its employees for their cleaning and equipment expenses through a reimbursement arrangement.

Employer D prospectively alters its compensation structure by reducing the hourly compensation paid to all employees. Under Employer D's new reimbursement arrangement, employees can substantiate to Employer D the actual amount of deductible expenses incurred in purchasing their cleaning products and equipment in connection with performing services for Employer D. Employer D reimburses its employees for substantiated expenses incurred in performing services for Employer D. Any reimbursement paid under Employer D's reimbursement arrangement is paid in addition to the hourly compensation paid for the employees' services. Employees who do not incur expenses for cleaning products and equipment in connection with their jobs for Employer D, or who do not properly substantiate such expenses to Employer D, continue to receive the lower hourly compensation and do not receive any reimbursement and are not compensated in another way (for example, with a bonus) to substitute for the reduction in the hourly compensation. Employer D treats the hourly compensation as taxable wages. Employer D treats reimbursements for cleaning and equipment expenses as nontaxable reimbursements.
Section 61 of the Internal Revenue Code (Code) defines gross income as all income from whatever source derived. Section 62(a) defines adjusted gross income as gross income minus certain deductions. Section 62(a)(2)(A) provides that, for purposes of determining adjusted gross income, an employee may deduct certain business expenses paid by the employee in connection with the performance of services as an employee of the employer under a reimbursement or other expense allowance arrangement. Section 62(c) provides that, for purposes of § 62(a)(2)(A), an arrangement will not be treated as a reimbursement or other expense allowance arrangement if (1) the arrangement does not require the employee to substantiate the expenses covered by the arrangement to the person providing the reimbursement, or (2) the arrangement provides the employee the right to retain any amount in excess of the substantiated expenses covered under the arrangement.

Under section 1.62-2(c) of the Income Tax Regulations, if a reimbursement or other expense allowance arrangement meets the requirements of business connection, substantiation, and returning amounts in excess of substantiated expenses, all amounts paid under the arrangement are treated as paid under an accountable plan. Amounts treated as paid under an accountable plan are excluded from an employee's gross income, are exempt from withholding and payment of employment taxes, and are not reported as wages on the employee's Form W-2. If the arrangement fails any one of these requirements, amounts paid under the arrangement are treated as paid under a nonaccountable plan, must be included in the employee’s gross income for the taxable year, are subject to withholding and payment of employment taxes, and must be reported as wages or other compensation on the employee's Form W-2.

Section 1.62-2(d)(1) provides that an arrangement satisfies the business connection requirement if it provides advances, allowances, or reimbursements only for business expenses that are allowable as deductions by part VI, subchapter B, chapter 1 of the Code, and that are paid or incurred by the employee in connection with the performance of services as an employee of the employer. Thus, not only must an employee actually pay or incur a deductible business expense, but the expense must arise in connection with the employment for that employer.

Section 1.62-2(d)(3)(i) provides that the business connection requirement will not be satisfied if a payor pays an amount to an employee regardless of whether the employee incurs or is reasonably expected to incur deductible business expenses. Failure to meet this reimbursement requirement of business connection is referred to as wage recharacterization because the amount being paid is not an expense reimbursement but rather a substitute for an amount that would otherwise be paid as wages.

Section 1.62-2(j) Example 1 provides an illustration of a case in which the reimbursement requirement is not satisfied. In this example, 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. On all other days, the engineer receives the full $200 as taxable wages. Because Employer S would pay an engineer $200 a day regardless of whether the engineer was traveling away from home, the $50 Employer S redesignates as travel expense reimbursement on days the
engineer is away from home on business is not a reimbursement and the arrangement does not satisfy the reimbursement requirement of § 1.62-2(d)(3)(i). Thus, no part of the $50 Employer S designated as a reimbursement is treated as paid under an accountable plan. Rather, all payments under the arrangement are treated as paid under a nonaccountable plan. Employer S must report the entire $200 as wages or other compensation on the employees' Forms W-2, and must withhold and pay employment taxes on the entire $200 when paid.

Section 1.62-2(j) Example 3 also illustrates a failure to satisfy the reimbursement requirement. In this example, Corporation R pays all its salespersons a salary. Corporation R also pays a travel allowance under an arrangement that otherwise meets the requirements of business connection, substantiation, and returning amounts in excess of substantiated expenses. The allowance is paid to all salespersons, including salespersons that Corporation R knows, or has reason to know, do not travel away from their offices on Corporation R business and would not be reasonably expected to incur travel expenses. Because the allowance is not paid only to those employees who incur (or are reasonably expected to incur) expenses of the type described in § 1.62-2(d)(1) or (d)(2), the arrangement does not satisfy the reimbursement requirement of § 1.62-2(d)(3)(i). Thus, no part of the allowance Corporation R 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. Corporation R must report all payments under the arrangement as wages or other compensation on the employees' Forms W-2 and must withhold and pay employment taxes on the payments when paid.

In Rev. Rul. 2004-1, 2004-1 C.B. 325, drivers of a courier company were paid a mileage allowance for local transportation expenses. In situation 1 of the ruling, the employer paid the couriers a commission equal to X percent of the per package charge (based on location, time of day, type of service, mileage between pickup and delivery, and other factors), known as the tag rate, and a mileage allowance equal to Y percent of the tag rate. In situation 2, the employer paid the couriers 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 standard mileage rate. The revenue ruling concludes that the reimbursement arrangement in situation 1, which pays a mileage allowance as a fixed percentage of the tag rate, meets the business connection requirement. In contrast, the revenue ruling concludes that the reimbursement arrangement in situation 2, which subtracts a mileage allowance (calculated at the standard business mileage rate) from the driver's set commission rate and treats only the remaining commission as wages, fails the business connection requirement. The variable allocation between commission and mileage allowance in situation 2 ensures that each driver always receives the same gross amount regardless of the amount of deductible employee business expenses incurred by the courier by varying the amount treated as wages in light of the mileage allowance paid. Accordingly, the arrangement effectively recharacterizes amounts otherwise payable as a taxable commission as a non-taxable mileage allowance. The ruling provides that a bona fide reimbursement arrangement must preclude the recharacterization as a mileage allowance of amounts otherwise payable as commission. See Shotgun Delivery v. United States, 269 F.3d 969 (9th Cir. 2001) (holding that a plan guaranteeing that employee drivers always received 40% of the tag rate with a variable allocation between taxable wages and nontaxable mileage reimbursement was nonaccountable, and
noting that "the evidence suggests that the plan's primary purpose was to treat the least amount possible of the driver's commission as taxable wages").

The legislative history of § 62(c) indicates that a taxpayer should not be able to recharacterize an amount that would have been paid as wages as a nontaxable reimbursement in order to avoid the two-percent of adjusted gross income limitation (two-percent floor), enacted by the Tax Reform Act of 1986, for deducting most employee business expenses. Specifically, the Tax Reform Act of 1986 significantly changed rules for deduction of employee business expenses by converting most of these expenses into itemized deductions that an employee could only deduct if the aggregate of such expenses exceeded the two-percent floor. However, the 1986 Act left in place the ability of a taxpayer to deduct from gross income and without regard to the two-percent floor, pursuant to § 62(a)(2)(A), employee business expenses incurred by a taxpayer as part of a reimbursement or other expense allowance arrangement with his or her employer. After enactment of the 1986 Act, tax practitioners proposed that employers could use reimbursement and expense allowance arrangements to (1) eliminate the effect of the two-percent floor on deductible employee expenses, and (2) save both employer and employee employment taxes by restructuring their compensation packages to convert a portion of an employee's compensation into a nontaxable reimbursement. This restructuring would permit employers to pay a lesser total amount while increasing employees' after-tax compensation.

Congress responded by enacting § 62(c) in § 702 of the Family Support Act of 1988, 100 P.L. 485, 102 Stat. 2343 (1988). In describing the conference agreement, the House-Senate Conference Committee Report on that Act states that "[i]f an above-the-line deduction is allowed for expenses incurred pursuant to a nonaccountable plan, the two-percent floor enacted in the [Tax Reform Act of 1986] could be circumvented solely by restructuring the form of the employee's compensation so that the salary amount is decreased, but the employee receives an equivalent nonaccountable expense allowance." H.R. Rep. No. 100-998, at 203, 100th Cong., 2nd Sess. (Sept. 28, 1988). Section 62(c) was enacted to prevent such restructuring of compensation arrangements and permit an above-the-line deduction only for expenses reimbursed under what legislative history referred to as an accountable plan.

Consistent with legislative history, the preamble to Treasury Decision 8324, 55 FR 51688, 1991-1 C.B. 20, 21 (1990), states:

Some practitioners have asked whether a portion of an employee's salary may be recharacterized as being paid under a reimbursement arrangement. The final regulations clarify that if a payor arranges to pay an amount to an employee regardless of whether the employee incurs (or is reasonably expected to incur) deductible business expenses or other bona fide expenses related to the employer's business that are not deductible, the arrangement does not meet the business connection requirement of § 1.62-2(d) of the regulations and all amounts paid under the arrangement are treated as paid under a nonaccountable plan. . . . Thus, no part of an employee's salary may be recharacterized as being paid under a reimbursement arrangement or other expense allowance arrangement.
While an employer may establish or modify its compensation structure to include nontaxable reimbursements under an accountable plan, recharacterizing as nontaxable reimbursements amounts that would otherwise be paid as wages violates the business connection requirement of § 1.62-2(d), and more specifically the reimbursement requirement of § 1.62-2(d)(3)(i). This is true even if an employee actually incurs a deductible expense in connection with employment with the employer.

The presence of wage recharacterization is based on the totality of facts and circumstances. Generally, wage recharacterization is present when the employer structures compensation so that the employee receives the same or a substantially similar amount whether or not the employee has incurred deductible business expenses related to the employer’s business. Wage recharacterization may occur in different situations. For example, an employer recharacterizes wages if it temporarily reduces taxable wages, substituting the reduction in wages with a payment that is treated as a nontaxable reimbursement and then, after total expenses have been reimbursed, increases taxable wages to the prior wage level. Similarly, an employer recharacterizes wages if it pays a higher amount as wages to an employee only when the employee does not receive an amount treated as nontaxable reimbursement and pays a lower amount as wages to an employee only when the employee also receives an amount treated as nontaxable reimbursement. An employer also recharacterizes wages if it routinely pays an amount treated as a nontaxable reimbursement to an employee who has not incurred bona fide business expenses.

HOLDINGS

Situation 1.

Employer A’s tool plan does not satisfy the business connection requirement of the accountable plan rules because the employer pays the same gross amount to a technician regardless of whether the technician incurs (or is reasonably expected to incur) expenses related to Employer A’s business. Specifically, Employer A’s tool plan ensures that a technician receives approximately the same gross hourly amount by substituting a portion of what was paid as taxable wages with a tool rate amount that is treated as nontaxable reimbursement, and then increasing the wages again once all tool expenses have been reimbursed. Accordingly, the purported tool reimbursements are merely a recharacterization of wages because approximately the same amount is paid in all circumstances. The fact that a technician actually incurs a deductible expense in connection with employment does not cure the incidence of wage recharacterization. The arrangement fails to satisfy the business connection requirement of § 1.62-2(d). Therefore, without regard to whether it meets the other requirements of an accountable plan as set forth in § 1.62-2, Employer A’s tool plan is not an accountable plan under § 62(c) and the applicable regulations.

Situation 2.

Employer B's per diem plan does not satisfy the business connection requirement of the accountable plan rules because Employer B pays the same gross amount to nurses regardless of whether the nurses incur (or are reasonably expected to incur) travel expenses.
expenses related to Employer B's business. Specifically, Employer B pays the same gross compensation to nurses, but a portion of the hourly compensation is treated as nontaxable per diem when a nurse is traveling away from his or her tax home on assignment. For nurses traveling away from their tax home on assignment, Employer B reduces the amount of the nurses' compensation treated as taxable wages and treats an amount equal to the reduction in compensation as a nontaxable per diem. For nurses assigned to hospitals within commuting distance of their tax homes, Employer B treats all compensation as taxable wages. Accordingly, the purported per diem payments are merely recharacterized wages because nurses receive the same gross compensation per hour regardless of whether travel expenses are incurred (or are reasonably expected to be incurred). The fact that a nurse traveling away from his or her tax home actually incurs a deductible expense in connection with employment does not cure the incidence of wage recharacterization. The arrangement fails to satisfy the business connection requirement of § 1.62-2(d). Therefore, without regard to whether it meets the other requirements of an accountable plan as set forth in § 1.62-2, Employer B's per diem plan is not an accountable plan under § 62(c) and the applicable regulations.

**Situation 3.**

Employer C's mileage reimbursement plan does not satisfy the business connection requirement of the accountable plan rules because it operates to routinely pay an amount as a mileage reimbursement to workers who have not incurred (and are not reasonably expected to incur) deductible business expenses in connection with Employer C's business. The purported mileage reimbursement is merely recharacterized wages because all workers receive an amount as a mileage reimbursement regardless of whether they incur (or are reasonably expected to incur) mileage expenses. The arrangement fails to satisfy the business connection requirement of § 1.62-2(d). Therefore, without regard to whether it meets the other requirements of an accountable plan as set forth in § 1.62-2, Employer C's mileage reimbursement plan is not an accountable plan under § 62(c) and the applicable regulations.

**Situation 4.**

Employer D's reimbursement arrangement satisfies the business connection requirement of the accountable plan rules. Employer D's plan only reimburses employees when a deductible business expense has been incurred in connection with performing services for Employer D and the reimbursement is not in lieu of wages that the employees would otherwise receive. Although Employer D has reduced the amount of compensation it pays all of its employees, the reduction in compensation is a substantive change in Employer D's compensation structure. Under Employer D's arrangement, reimbursement amounts are not guaranteed and employees who do not incur expenses in connection with Employer D's business, or who do not properly substantiate such expenses, continue to receive the reduced hourly compensation amount. These employees do not receive any reimbursement and are not compensated in another way to make up for the reduction in the hourly compensation. Employer D's reimbursement arrangement does not operate to pay the same or a substantially similar gross amount to an employee regardless of whether the employee incurs (or is reasonably expected to incur) expenses related to Employer D's business. The reimbursement is paid in addition to the employees' wages rather than as a
substitute for wages that would otherwise be paid. Accordingly, Employer D's reimbursement arrangement satisfies the business connection requirement of § 1.62-2(d). Therefore, as long as the substantiation and return of excess amounts requirements are also met, Employer D's reimbursement arrangement is an accountable plan under § 62(c) and the applicable regulations.

DRAFTING INFORMATION

The principal author of this revenue ruling is Kelly Morrison-Lee of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt & Government Entities). For further information regarding this revenue ruling, contact Kelly Morrison-Lee at (202) 622-0047 (not a toll-free call).