DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

August 5, 1999

Number: **200006005**
Release Date: 2/11/2000
PLR 103059-99/CC:EBEO:B2
UILC: 62.02-05

MEMORANDUM FOR

FROM: Chief, Branch 2
Associate Chief Counsel (Employee Benefits and Exempt Organizations)

SUBJECT: PLR 103059-99

LEGEND: X
Y
Date A
Date B

In accordance with Section 8.07(2)(c) of Revenue Procedure 99-1, 1991-I.R.B. 6 this is to advise you that X withdrew his Date A request for a private letter ruling after this office advised X of its tentatively adverse position. Following is a brief discussion of the issue, facts, applicable law and the reasons for this office's tentative adverse position. X's request and subsequent submissions are attached.

ISSUE

Whether amounts Y proposes to pay its employees for the use of the employees' tools are subject to Federal employment taxes?

CONCLUSION

Y has not established an accountable plan to pay its employees for the use of the employees' tools. Accordingly, such amounts are wages subject to Federal employment taxes.

FACTS

X intends to construct Y, an automotive repair facility. X anticipates operating Y as a sole proprietorship. As explained in its Date B submission, X plans to hire two automotive technicians as employees of Y. As a condition of employment, each technician must agree to provide his or own tools with which to perform repair

services for Y. X plans to compensate one technician in the amount of $13.33 per hour. X will treat $8.55 of that amount as wages, subject to Federal employment taxes and reported on Form W-2 as wages. The remaining $4.77 per hour is intended to reimburse the employee for the use of the employee's tools.[1] It will not be reported to the employee as wages on Form W-2. Typically, this office refers to compensation arrangements that allegedly reimburse employees for the use of tools as "tool rentals."

X represents that tool rentals are common in the automotive industry. Further, X asserted both in its Date B submission and at its conference of right that it was financially beneficial for Y to compensate its employees with tool rentals because it would cost Y more to purchase or rent similar tools. X stated that it determined the tool rental amount based upon various factors, including the hourly rate X would pay an employee without tools, replacement cost value of the employees' tools, and expenses Y would incur to rent the same tools from a third party. X requested a ruling that the tool rentals were not subject to Federal employment taxes. In other words, X requested a ruling that the tool rentals were paid under an accountable plan, as defined by I.R.C. § 62 of the Internal Revenue Code (the Code).

LAW AND ANALYSIS

Whether amounts are paid under an accountable plan is governed by I.R.C. § 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 expenses 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. § 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 Treas. reg. § 1.62-2(c)(1), a reimbursement or other expense allowance arrangement satisfies the requirements of I.R.C. § 62(c), if it meets the three requirements of business connection, substantiation, and returning amounts in excess of expenses, set forth in paragraphs (d), (e), and (f), respectively, of Treas. reg. § 1.62-2 ("the three requirements").

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[1]The second technician would be similarly compensated, but at increased hourly rates.

If an arrangement meets the three requirements, all amounts paid under the arrangement are treated as paid under an "accountable plan." Treas. reg. § 1.62-2(c)(2)(i). 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. Treas. Reg. §§ 1.62-2(c)(5), 31.3121(a)-3(b)(2), 31.3306(b)-2(b)(2) and 31.3401(a)-4(b)(2).[2]

An arrangement meets the business connection requirement of Treas. reg. § 1.62-2(d) if it provides advances, allowances (including per diem allowances, allowances for meals and incidental expense, and mileage allowances), or reimbursements for business expenses that are allowable as deductions by Part VI (section 161 through section 196), 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. 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).

Section 1.62-2(e) of the regulations 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 Treas. reg. § 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.

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[2]Section 62(c) of the Code was enacted by the Family Support Act of 1988, Pub. L. 100-485. Through enactment of section 67 of the Code by section 132 of the Tax Reform Act of 1986, (1986 Act), Pub. L. 99-514, 1986-3 C.B. (vol 1) 30, the Congress sharpened the distinction between the tax treatment of unreimbursed and reimbursed employee business expenses. Among other changes, unreimbursed employee business expenses plus other miscellaneous itemized deductions generally were made subject to a two-percent floor. At the same time, the Congress decided to retain the above-the-line deduction treatment for reimbursements received by an employee pursuant to a reimbursement arrangement. This rationale for allowing the employee an above-the-line deduction to offset true reimbursement amounts does not apply in the case of nonaccountable plans. Under these plans, the amount received by the employee from the employer is not determined by the actual amount of expenses incurred by the employee during the year.

Section 1.62-2(k) provides that if a payor's reimbursement or other expense allowance arrangement evidences a pattern of abuse of the rules of section 62(c) and the regulation sections, all payments made under the arrangement will be treated as made under a nonaccountable plan.

Although X raises various arguments in his submissions, X failed to address with specificity how the tool rentals would satisfy the accountable plan requirements. In particular, X apparently overlooks the statutory language of I.R.C. § 62(a)(2)(A) which, as below stated, allows an employee an above the line deduction only for certain reimbursed employee business expenses:

> *Reimbursed Expenses of Employees*, -- The deductions allowed by Part VI (section 161 and following) which consist of ***expenses paid or incurred by the taxpayer, in connection with the performance by him of services as an employee,*** under a reimbursement or other expenses allowance arrangement with his employer.

Under X's proposed arrangement, Y will employ only employees that have their own tools and pay them an hourly amount for tool rental. The hourly tool rental bears no relationship to the expenses the employee incurs related to the tools. In fact, X will pay an employee the tool rental, regardless of whether the employee incurred expenses related to those tools while an employee of Y. That does not satisfy the business connection requirement specified in Treas. reg. §1.62-2(d)(3) because X will pay the tool rental regardless of whether the employee is reasonably expected to incur a deductible business expense or other bona fide expense. X took the position at his conference of right that it was not necessary that the employee actually incur an expense. We disagree; I.R.C. § 62(a)(2)(A) requires the employee incur an expense in connection with the performance of services as an employee of his employer.

The tool rental arrangement proposed by X is not a reimbursement or other expense allowance described in I.R.C. § 62(c). It is an arrangement described in Treas. reg. §1.62-2(k), that is, a reimbursement or other expense allowance arrangement that evidences a pattern of abuse of the rules of I.R.C. § 62(c). 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.[3] If you have any questions, please call me at (202) 622-6040

JERRY E. HOLMES

[3] It was not necessary to consider whether X met the substantiation and return of excess to conclude the tool rentals were not paid pursuant to an accountable plan.