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ASAP™
A Littler Mendelson **Time Sensitive** Newsletter

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The IRS recently announced a new cross divisional team aimed at cracking down on tool reimbursement plans marketed to the automotive, construction, aircraft, agriculture and other industries that use hand tools as a way to circumvent employment taxes. Employers should be careful to ensure full compliance with any expense reimbursement plan, particularly those that claim significant tax savings to both the employees and employers.

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Employment Taxes
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IRS Establishes Cross Divisional Team to Combat Improper Tool Reimbursement Plans

By William Hays Weissman

The IRS has established a new cross divisional team comprised of members from the audit examination, appeals and legal departments to address the IRS's ongoing efforts to combat improper tool reimbursement plans. This issue has drawn significant IRS scrutiny for the last several years due to the aggressive marketing of such plans to employers, particularly in industries such as automotive, construction, aircraft, agriculture and others that use significant hand tools. Employers should be wary of such plans and carefully determine whether they comply with IRS regulations.

IRS Rules on Reimbursement of Business Expenses Generally

Under IRS regulations, employers are not required to reimburse their employees for business-related expenses but may do so on a tax-free basis if they meet certain requirements.[1] In order for a business expense reimbursement to be tax-free to an employee, it must be made under an "accountable plan." There are three requirements to an accountable plan.

First, the expense must have a business connection, meaning that it was incurred in the course of the employee's performance of services for the employer.[2] This generally requires written substantiation sufficient to allow the employer to ascertain the business purpose of the expense.[3]

Second, an employee must adequately account for the expense to his or her employer within a reasonable period of time. A reasonable period of time is generally defined as 60 days, but circumstances may allow for a longer period.[4]

Third, the employee must return any excess payment within a reasonable period of time. For this requirement a reasonable period of time is considered 120 days, but, again, it may be longer if circumstances warrant.[5]

Unless all three requirements are met, any reimbursement for business expenses are treated as additional wages to the employee subject to all employment taxes. This is called a "nonaccountable plan." Thus, for example, if a plan provides employees with a flat amount each month for expenses without requiring receipts, the plan does not meet the requirements for an accountable plan, and the flat amount would be subject to tax.[6]

IRS Announcement on Tool Reimbursement Plans

In its recent announcement on tool reimbursement plans, the IRS stated:

> Many of the tool plans currently being marketed do not meet the requirements to be tax-favored accountable plans despite their claims to the contrary. In addition to its concerns with the lack of substantiation provided by the technicians to ensure that only expenses incurred for that employer are included in the plan, the Service is focusing on the fact that the majority of the plans being marketed are designed and operated around a structure that recharacterizes a portion of the employee's existing pay as a "reimbursement" for the employee's tools merely to generate tax savings for both the employer and the employee. In other words, the employee continues to receive the same gross pay but what was previously paid as taxable compensation is recharacterized

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as nontaxable reimbursement until the employee's alleged tool costs have been recovered, then the employee returns to his original amount of taxable compensation. The accountable plan rules make clear that amounts paid whether or not there are expenses incurred are not reimbursements and are not eligible for tax-favored treatment.[7]

The IRS has addressed tool reimbursement plans several times over the last few years. For example, in 2000 the IRS issued a Coordinated Issue Paper titled "Service Technicians' Tool Reimbursement Plans." The paper concluded that most reimbursement plans used for motor vehicle service technicians did not meet the requirements of an accountable plan and that this was true for other industries as well.

In Revenue Ruling 2005-52,[8] the IRS addressed a tool reimbursement plan that used a combination of data from a national survey of average tool expenses for automobile service technicians and specific information concerning tool-related expenses provided by employees in response to an annual questionnaire completed by all service technicians working for the employer at issue. The IRS held that the plan did not qualify as an accountable plan because it did not meet the substantiation and return of excess payments requirements.

The IRS addressed the issue again in late 2007 in a Chief Counsel Memorandum.[9] In that case, the IRS found defective a tool reimbursement plan that had been specifically marketed to the employer as a cost savings plan for both the employees and the employer. The plan basically converted taxable wages into reimbursable business expenses under the tool reimbursement plan. The IRS found that the plan failed all three requirements of an accountable plan.

Observations for Employers

Employers that require employees to use hand tools should be wary of "tool reimbursement plans" marketed to them that claim to provide significant tax savings for both the employees and employers, particularly if they do not result in any additional payments to employees. Employers should carefully scrutinize any reimbursement plan – whether for tools or any other business expense – to ensure that it meets the three requirements of an accountable plan. If not, employers may be liable for significant taxes, penalties and interest on the payments made to the employees that should have been treated as additional wages.

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[1] It is important to note that for employment law purposes, other rules may apply. For example, California requires employers to reimburse employees for all reasonable business expenses under California Labor Code section 2802. Employers should be aware of other laws that may apply to reimbursement of business expenses.

[2] Treas. Reg. § 1.62-2(d)(1).

[3] Treas. Reg. § 1.162-17(b)(4).

[4] Treas. Reg. §§ 1.62-2(e), (g).

[5] Treas. Reg. §§ 1.62-2(f), (g).

[6] In addition, if an employer evidences a pattern of abuse by not meeting the requirements for an accountable plan, the IRS may treat all payments as made under a nonaccountable plan. Treas. Reg. § 1.62-2(k); see also Rev. Rul. 2006-56.

[7] IRS Press Release, "IRS Convenes Cross Divisional Team to Consider Employee Tool & Equipment Plans," January 30, 2008, available at http://www.irs.gov/businesses/article/0,,id=178028,00.html.

[8] Rev. Rul. 2005-52, 2005-2 CB 423.

[9] Chief Counsel Mem. 200745018 (November 9, 2007), *available at* http://www.irs.ustreas.gov/pub/irs-wd/0745018.pdf.

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