Part I

Section 62(c) —Certain Arrangements Not Treated as Reimbursement Arrangements

26 CFR 1.62 -2(k): Reimbursements and other expense allowance arrangements: Anti-abuse provision

Rev. Rul. 2006-56

ISSUE

Whether, under an expense allowance arrangement which has no mechanism or process to determine when an allowance exceeds the amount that may be deemed substantiated and which routinely pays allowances in excess of the amount that may be deemed substantiated without requiring actual substantiation of all expenses or repayment of the excess amount, the failure to treat the excess allowances as wages for employment tax purposes causes all payments made under the expense allowance arrangement to be treated as made under a nonaccountable plan.

FACTS

Taxpayer is an employer of long-haul truck drivers in the transportation industry. Taxpayer uses a monthly payroll period and compensates its drivers for their services on a mileage basis. For 2006, Taxpayer pays its drivers compensation of X cents-per-mile driven during each month. Taxpayer reports the compensation on the drivers' Forms W-2 and treats the compensation as wages for Federal Insurance Contributions Act (FICA) tax, Federal Unemployment Tax Act (FUTA) tax, and Federal income tax withholding purposes (collectively, "employment taxes").

Taxpayer also reimburses its drivers for meal and incidental expenses (M&IE) paid or incurred while traveling away from home during the monthly payroll period. Taxpayer reimburses its drivers for these expenses through an allowance for each day the driver is away from home for Taxpayer's business. For 2006, the allowance is Y cents-per-mile driven. Taxpayer's industry commonly used this cents-per-mile driven method before December 12, 1989.

Taxpayer establishes the Y cents-per-mile rate based on its expectation of the amount of daily M&IE that will be paid or incurred, and its expectation of the average number of daily miles driven during the payroll period. Taxpayer bases its expectations on reliable industry data and on Taxpayer's own data from recent years. Based on Taxpayer's specific methodology and data, Taxpayer's projected allowance is reasonably calculated not to exceed the drivers' anticipated daily M&IE.

Taxpayer requires its drivers to provide logs to substantiate the time, place, and business purpose of the travel away from home for each day (or partial day). Taxpayer does not require its drivers to substantiate the amount of actual M&IE. Instead, for its drivers' substantiation of the amount of M&IE paid or incurred by the drivers, Taxpayer relies on administrative guidance published annually by the Internal Revenue Service under which the amount of ordinary and necessary business expenses of an employee for M&IE paid or incurred while traveling away from home is deemed substantiated when the employer provides a per diem allowance to cover the expenses. The guidance applicable for per diem allowances paid to an employee on or after October 1, 2005, with respect to travel away from home on or after October 1, 2005, is Rev. Proc. 2005-67, 2005 42 I.R.B. 729. For 2006 Taxpayer elects to treat $52 per day as the federal M&IE rate for all localities of travel pursuant to section 4.04 of Rev. Proc. 2005-67. Thus, for 2006, $52 or less per day of M&IE paid or incurred by a driver while traveling away from home may be deemed substantiated. The allowances paid by Taxpayer to many of its drivers for M&IE incurred on travel away from home during the monthly payroll period routinely exceed $52 per day, even when computed on a monthly basis pursuant to the periodic rule provided in section 4.04 of Rev. Proc. 2005-67.

Taxpayer requires its drivers to return any amounts paid to them for M&IE with respect to days they were not away from home on business travel. Taxpayer does not require drivers to return the portion of the allowance paid for days they were away from home on business travel that exceeds the $52 per day that may be deemed substantiated.

Neither the policies nor actual practices of Taxpayer's expense allowance arrangement include any process for tracking the amount of the cents-per-mile M&IE allowance paid to each driver on a per diem basis, nor is there any mechanism in place to determine when the allowances exceed the amount of expenses that may be deemed substantiated under Rev. Proc. 2005-67. Taxpayer does not treat the excess allowances over $52 per day as wages for withholding or employment tax purposes and does not report the excess allowances as wages on the drivers' Forms W-2.

LAW AND ANALYSIS

Section 62(a)(2)(A) of the Internal Revenue Code provides that, for purposes of determining adjusted gross income, an employee may deduct certain business expenses paid by the employee in connection with the performance of services as an employee of the employer under a reimbursement or other expense allowance arrangement.

Section 62(c) provides that, for purposes of § 62(a)(2)(A), an arrangement will not be treated as a reimbursement or other expense allowance arrangement if (1) the arrangement does not require the employee to substantiate the expenses covered by the arrangement to the person providing the reimbursement, or (2) the arrangement provides the employee the right to retain any amount in excess of the substantiated expenses covered under the arrangement.

Section 1.62-2(c)(1) of the Income Tax Regulations provides that a reimbursement or other expense allowance arrangement satisfies the requirements of

§ 62(c) if it meets the requirements of business connection, substantiation, and returning amounts in excess of substantiated expenses. If an arrangement meets these requirements, all amounts paid under the arrangement are treated as paid under an accountable plan. *See* § 1.62-2(c)(2). Amounts treated as paid under an accountable plan are excluded from the employee's gross income, are not reported as wages or other compensation on the employee's Form W-2, and are exempt from the withholding and payment of employment taxes. *See* § 1.62-(2)(c)(4). Conversely, if the arrangement fails any one of these requirements, amounts paid under the arrangement are treated as paid under a nonaccountable plan and are included in the employee's gross income, must be reported as wages or other compensation on the employee's Form W-2, and are subject to withholding and payment of employment taxes. *See* § 1.62-2(c)(3) and (5).

With regard to the business connection requirement, under § 1.62-2(d)(3)(ii) an arrangement providing a per diem allowance that is computed on a basis similar to that used in computing the employee's wages or other compensation (such as the number of hours worked, miles traveled, or pieces produced) meets the business connection requirement only if, on December 12, 1989, the per diem allowance was identified by the payor either by making a separate payment or by specifically identifying the amount of the per diem allowance, or a per diem allowance computed on that basis was commonly used in the industry in which the employee is employed.

With regard to the substantiation requirement, pursuant to Rev. Proc. 2005-67, the amount of M&IE that is deemed substantiated for each calendar day is equal to the lesser of the per diem allowance for that day or the amount computed at the federal

M&IE rate. *See* section 3.01(3) of Rev. Proc. 2005-67. Under these rules, employees must continue to actually substantiate the elements of time, place, and business purpose relating to the travel expenses. *See* section 7.01 of Rev. Proc. 2005-67. Section 4.04 of Rev. Proc. 2005-67 provides special rules for the transportation industry under which $52 per day may be treated as the federal M&IE rate and the amount deemed substantiated may be computed on a periodic basis (but not less frequently than monthly) rather than daily.

For purposes of the return of excess requirement, § 1.62-2(f)(2) permits the Commissioner to prescribe rules under which an arrangement that provides a per diem allowance is treated as satisfying the requirement of returning amounts in excess of expenses so long as the allowance is reasonably calculated not to exceed the amount of the employee's expenses and the employee is required to return any portion that relates to days of travel not substantiated. However, the portion of the allowance that exceeds the amount deemed substantiated will be treated as paid under a nonaccountable plan, must be reported as wages or other compensation, and is subject to withholding and payment of employment taxes. *See* § 1.62-2(c)(5).

Section 1.62-2(h)(2)(i)(B)(*1*) provides that if a payor pays a per diem allowance that meets the requirements of § 1.62-2(c)(1), the portion, if any, of the allowance that relates to days of travel substantiated in accordance with § 1.62-2(e) and that exceeds the amount of the employee's expenses deemed substantiated for the travel pursuant to rules prescribed under § 274(d) and the relevant regulations is treated as paid under a nonaccountable plan. Such amount is wages subject to withholding and payment of

employment taxes. *See* § 1.62-2(c)(5). *See also* §§ 31.3121(a)-3(b)(1)(ii), 31.3306(b)-2(b)(1)(ii), and 31.3401(a)-4(b)(1)(ii) of the Employment Tax Regulations.

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 § 62(c) and the regulations thereunder, all payments made under the arrangement are treated as made under a nonaccountable plan. Thus, these payments are included in the employee's gross income, are reported as wages or other compensation on the employee's Form W-2, and are subject to withholding and payment of employment taxes. *See* § 1.62-2(c)(5), and (h)(2).

If an arrangement satisfies all three requirements of an accountable plan, but an allowance is paid under the arrangement that exceeds the amount that may be deemed substantiated, no actual substantiation is provided for the M&IE covered by the allowance, and the excess allowance is not returned, the excess allowance is treated as wages. *See* § 1. 62-2(h)(2)(B)*(1)*. However, if the facts and circumstances evidence a pattern of abuse of the rules of § 62(c) and the regulations thereunder, including the rule to treat excess allowances as wages, all payments made under the arrangement are treated as wages. *See* § 1.62-2(k).

Under the facts set forth above, the arrangement to reimburse Taxpayer's drivers for M&IE paid or incurred while traveling away from home meets the business connection requirement. Taxpayer is permitted to compute a per diem allowance based upon the number of miles driven during the payroll period as that method was commonly used in Taxpayer's industry before December 12, 1989.

For purposes of satisfying the substantiation requirements of § 1.62-2(e) for 2006, Taxpayer relies on the deemed substantiation rules provided in Rev. Proc. 2005-67, including the special rules for the transportation industry found in section 4.04 of Rev. Proc. 2005-67.

With respect to the return of excess requirement, the regulations and Rev. Proc. 2005-67 permit Taxpayer to pay per diem allowances for M&IE paid or incurred while traveling away from home that exceed the deemed substantiated amount without requiring return of the excess. *See* § 1.62-2(f)(2) and section 7.02 of Rev. Proc. 2005-67. Under these rules, however, Taxpayer must take steps to ensure that the excess allowances are tracked and treated as wages subject to withholding and payment of employment taxes and reporting on Forms W-2.

In implementing its expense allowance arrangement for 2006, Taxpayer has not included any mechanism or process that tracks allowances and permits it to determine when the allowances paid to its drivers, computed on a per diem basis, exceed the $52 per day that may be deemed substantiated. Taxpayer does not receive actual substantiation for the M&IE covered by the allowances. Taxpayer neither requires repayment of the excess allowances nor treats the excess allowances as wages for purposes of withholding and payment of employment taxes and reporting on Forms W-2.

As operated in 2006, Taxpayer's expense allowance arrangement routinely results in payment of excess allowances that are not repaid or treated as wages. Taxpayer's failure to track the excess allowances and its routine payment of excess allowances that are not repaid or treated as wages evidence a pattern of abuse under

§ 1.62-2(k). Although the excess allowances that have not been repaid or treated as wages may be small in comparison to the total allowance paid to an individual driver, to the amount that may be deemed substantiated for any given period of travel away from home, and to the aggregate allowances paid to all of Taxpayer's drivers, Taxpayer's arrangement is neither structured nor operated to meet the requirements of the accountable plan regulations for per diem allowance arrangements. As a result, Taxpayer has more than a failure to account for a particular driver's excess allowance or excess allowances paid to drivers for a particular period of travel. Taxpayer's arrangement evidences a pattern of abuse of the accountable plan rules.

Accordingly, even if Taxpayer's expense allowance arrangement otherwise meets the business connection, substantiation, and return of excess requirements of an accountable plan for the allowances paid to Taxpayer's drivers up to the amount that may be deemed substantiated, all payments made under Taxpayer's expense allowance arrangement are treated as paid under a nonaccountable plan. Taxpayer must include all amounts paid under the arrangement to reimburse drivers' M&IE, not just the excess allowances, in the drivers' wages on Forms W-2 and must treat all these amounts as wages for the withholding and payment of employment taxes.

HOLDING

Where an expense allowance arrangement has no mechanism or process to determine when an allowance exceeds the amount that may be deemed substantiated and the arrangement routinely pays allowances in excess of the amount that may be

deemed substantiated without requiring actual substantiation of all the expenses or repayment of the excess amount, the failure of the arrangement to treat the excess allowances as wages for employment tax purposes causes all payments made under the arrangement to be treated as made under a nonaccountable plan.

DRAFTING INFORMATION

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