DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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OFFICE OF
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Date Signed: May 12, 2003
Signed By: Catherine E. Livingston

Dear :

This letter is in response to your inquiry of April 3, 2003, on behalf of a small business constituent who wrote about the use of Revenue Procedure 2002-41 as an optional expense substantiation rule in reimbursing certain expenses related to the use of welding and mechanics rigs.

The constituent information you forwarded primarily included questions about the definition of “eligible employer” provided in Revenue Procedure 2002-41 and the result of reimbursing rig-related expenses to employees without using that revenue procedure, specifically when these reimbursements can be excluded from wages.

Whether the expense reimbursements constitute wages is generally controlled by whether the expense reimbursements are received under an accountable plan. Payments received under an accountable plan are excluded from an employee’s wages and gross income, are not required to be reported on the employee’s Form W-2 (Wage and Tax Statement), and are not subject to employment taxes. However, payments received under a nonaccountable plan are included in the employee’s wages and gross income, are required to be reported on the employee’s Form W-2, and are subject to applicable employment taxes.[1]

To help you understand how this federal tax issue affects the pipeline industry, I provided a general discussion of the accountable plan rules and related rules for the pipeline industry.

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[1] The term "employment taxes" generally refers to income tax withholding under sections 3401-3406 of the Internal Revenue Code (Code), the taxes imposed by the Federal Insurance Contributions Act (FICA) under sections 3101-3128 of the Code, and the tax imposed by the Federal Unemployment Tax Act (FUTA) under sections 3301-3311 of the Code.

<u>Accountable Plan Requirements</u>

A reimbursement or other expense allowance arrangement will qualify as an "accountable plan" if it meets the requirements of: 1) *business connection*, 2) *substantiation*, and 3) *returning amounts in excess of expenses* [section 62(c) of the Code and regulations thereunder].

1. <u>Business Connection Requirement</u>. To meet the business connection requirement, an arrangement must provide advances, allowances, or reimbursements for certain deductible business expenses that are paid or incurred by the employee in connection with the performance of his services as an employee. The arrangement will not meet this requirement if the payor arranges to pay an amount regardless of whether the employee incurs or is reasonably expected to incur deductible business expenses.

2. <u>Substantiation Requirement</u>. The payor must require the employee to substantiate his or her expenses, within a reasonable time. An employee must generally substantiate the *amount*, *time*, *place*, and *business purpose* of the expense.

3. <u>Return of Excess Requirement</u>. The arrangement must require the employee to return to the payor, within a reasonable time, amounts in excess of substantiated expenses.

<u>Revenue Procedure 2002-41 Provides for Optional Deemed Substantiation</u>

The IRS developed Revenue Procedure 2002-41 under the Industry Issue Resolution (IIR) Pilot Program, which was designed to resolve frequently disputed or burdensome tax issues submitted by taxpayers, associations, and other groups representing businesses. As part of this 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 services. At issue was whether the amounts should be treated as reimbursement of expenses subject to the accountable plan requirements. As a result, the IRS issued Revenue Procedure 2002-41, which any "eligible employer" can use. Generally, an eligible employer is one who hires employee rig welders or heavy equipment mechanics and requires, as a condition of employment, that the employees provide a welding or mechanics rig and use the rig to perform services as an employee in the construction, repair, or maintenance of transportation mainline pipeline.

Revenue Procedure 2002-41 provides an optional, simplified expense substantiation method, known as "deemed substantiation," to substantiate the *amount* of rig-related expenses (time, place, and business purpose are not deemed substantiated). The employer's reimbursement arrangement must still meet the business connection requirement and otherwise satisfy the additional accountable plan requirements.

The IRS also issued Revenue Ruling 2002-35, which clarifies that payments to employees for equipment they must provide as a condition of employment are wages for federal employment tax purposes, unless such amounts are paid under an accountable plan. Revenue Ruling 2002-35 also revoked Revenue Ruling 68-624, which provided that payments to the worker for use of a heavy truck were not wages for federal employment tax purposes. Thus, an employer may no longer rely on Revenue Ruling 68-624 to exclude payments for the use of employee owned equipment from wages.

Additionally, the procedures in Revenue Procedure 2002-41 are optional; an employer could opt to reimburse actual expenses under an accountable plan (i.e., reimbursements not treated as wages). To reimburse rig-related expenses without the use of the revenue procedure, the employee must provide sufficient information so the payor can identify the specific nature of each expense and determine the expense is attributable to the payor's business activities. The employee must substantiate each element of an expenditure to the payor. It is not sufficient if the employee merely totals expenses into broad categories or reports individual expenses using vague, nondescriptive terms, such as miscellaneous business expenses.

Future Guidance for Other Industries that use Accountable Plans

Although Revenue Procedure 2002-41 applies only to eligible employers, we recognize non-eligible employers may similarly provide payments to employees for providing equipment the employees used in the performance of services. Therefore, in Revenue Procedure 2002-41 we requested comments from other industries facing similar issues in implementing accountable plans, especially when the nature of the industry results in employees working for multiple employers during the year. Your constituent is welcome to submit a comment to the address provided in Revenue Procedure 2002-41.

Further, we have recently issued Revenue Procedure 2003-36, which describes the application process under the permanent IIR Program. Applications for the IIR program may be submitted at any time during the year and will be reviewed semi-annually, generally after March 31 and August 31 of each year. However, the application deadline for issues under the IIR program we will consider including on the Treasury Department's and the IRS's Guidance Priority List for 2003-2004 is May 15, 2003.

This letter will be available for public inspection after we delete any identifying information, including names and addresses, under the Freedom of Information Act.

I hope this information is helpful. If you have any further questions, please call me at
or of my staff at

Sincerely,

Catherine E. Livingston
Assistant Chief Counsel
(Exempt Organizations/Employment Tax/
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