

Internal Revenue Service

Department of the Treasury

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Person to Contact:

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Number: **199916011**

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CC:EBEO:Br2-PLR-105270-98

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January 11, 1999

Legend

Company =

Plan =

Dear

This is in response to your letter of February 18, 1998, requesting a ruling concerning the income and employment tax consequences of an arrangement that the Company proposes to implement to reimburse certain employee business expenses incurred by certain of its employees (the "Plan").

Company is a broker/dealer in mutual fund products and listed and unlisted securities. Company employs investment consultants (ICs) who incur travel and other employee business expenses in connection with the performance of services for the Company.

Company proposes to implement the Plan to provide for the reimbursement of employee business expenses incurred by ICs. Once implemented, the Plan will be mandatory for all ICs within all of the Company's offices. Under the Plan, ICs may be reimbursed for those employee business expenses that would be deductible under section 162 of the Code.

Under the Plan, prior to the start of a calendar year, an IC's branch manager (or regional manager in the case of a branch manager) will determine the amount, if any, to be excluded from the IC's commissions in the succeeding year. If management

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reduces an IC's commissions, such amount will be no less than \$600 and no more than the reimbursement cap. The reimbursement cap equals the greater of \$10,000 or 2.5% of the IC's commissions in the prior year. The amount of reimbursement that an IC may receive under the Plan in a calendar year will not exceed the lesser of the actual expenses or the reimbursement cap.

If an IC's expenses are less than the reimbursement cap, the difference between the IC's expenses and the reimbursement cap will not be received by the IC and will not be carried over from one calendar year to the next. If an IC does not request reimbursement under the Plan, the IC will receive nothing in lieu of reimbursements and will continue to be subject to the base compensation reduction.

Under the Plan, all ICs requesting reimbursement are required to prepare an expense report within 45 days after the expense is incurred. In preparing an expense report, the IC must enter, in detail, the elements of each expense. For business travel expenses, an IC must show the business purpose, the amount of each separate expense, when the expense was incurred, and the travel locations. For other employee business expenses, the IC must show the business purpose, amount, and date of each expense item. ICs must submit a receipt for any expense item exceeding \$25 (this amount may be increased from time to time up to the applicable legal limit of \$75). Business mileage will be substantiated by a record or log indicating when the expense was incurred and the business purpose for the transportation expense.

The Company will examine all expense reports prior to payment to determine if the business purpose set forth on the report is reasonable and if the amounts claimed are reasonable. The Company will approve, deny or ask for additional information within 15 days of receiving the request for reimbursement. If additional information is requested, the IC must provide it within 15 days, or the request will be denied.

The Company requests a ruling that the Plan satisfies the applicable reporting and substantiation requirements under Code sections 62(c) and 274. Accordingly, the Company asks for a ruling that (1) the amounts reimbursed under the Plan will be fully deductible by the Company, and excludible from gross income of the ICs; and (2) that the amounts reimbursed are not wages subject to employment taxes (FICA, FUTA, and income tax withholding), and need not be reported on Form W-2.

Section 62 of the Code 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 expense allowance arrangement with his or her employer.

Section 62(c) of the Code provides that an arrangement will not be treated as a

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reimbursement or other expense allowance arrangement for purposes of section 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 section 1.62-2(c)(1) of the regulations, a reimbursement or other expense allowance arrangement satisfies the requirements of section 62(c) of the Code, 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 section 1.62-2 of the regulations ("the three requirements").

If an arrangement meets the three requirements, section 1.62-2(c)(2)(i) of the regulations provides that all amounts paid under the arrangement are treated as paid under an "accountable plan." Under section 1.62-2(c)(4) of the regulations, amounts treated as paid under an accountable plan are excluded from the employee's gross income, are not required to be reported on the employee's Form W-2, and are exempt from the withholding and payment of employment taxes. See sections 31.3121(a)-3, 31.3306(b)-2, and 31.3401(a)-4, respectively, of the Employment Tax Regulations, and section 1.6041-3(i) of the Income Tax Regulations.

On the other hand, section 1.62-2(c)(3)(i) of the regulations provides that if an arrangement does not satisfy one or more of the three requirements, all amounts paid under the arrangement are treated as paid under a "nonaccountable plan." Under section 1.62-2(c)(5) of the regulations, amounts treated as 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 the withholding and payment of employment taxes.

An arrangement meets the business connection requirement of section 1.62-2(d) of the regulations if it provides advances, allowances (including per diem allowances, allowances for meals and incidental expenses, and mileage allowances), or reimbursements for business expenses that are allowable as deductions under sections 161 through 198 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) imposes a reimbursement requirement, which 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 allowable business expenses.

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. An arrangement that reimburses business expenses governed by section 274(d) of the Code meets the substantiation requirement if the information submitted to the payor

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sufficiently substantiates the requisite elements of each expenditure or use. For example, when substantiating expenses for travel away from home, section 1.274-5T(b)(2) of the temporary regulations requires that information sufficiently substantiating the amount, time, place and business purpose of the expense must be submitted.

If an arrangement covers expenses not governed by section 274(d) of the Code, section 1.62-2(e)(3) of the regulations provides that the substantiation requirement will be satisfied if information sufficient to enable the payor to identify the specific nature of each expense and to conclude that the expense is attributable to the payor's business activities. Each element of an expenditure or use must be substantiated to the payor. It is not sufficient if an employee merely aggregates expenses into broad categories or reports individual expenses using vague, nondescriptive terms, such as miscellaneous business expenses.

With respect to the third requirement that amounts in excess of expenses must be returned to the payor, the general rule of section 1.62-2(f) of the regulations 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.

The terms of the Plan satisfy the business connection and substantiation requirements. With respect to the return of excess requirement, because the Plan is a reimbursement arrangement, the amount reimbursed should not exceed the amount substantiated; thus, there should not be an excess to return. Because the Plan satisfies the three requirements under sections 1.62-2(d), (e), and (f) of the regulations, the amounts paid under the Plan may be treated as paid under an accountable plan.

Accordingly, based on the information submitted, and provided the expenses are properly deductible and substantiated, we rule as follows:

1) Reimbursements made to an IC under the Plan are deductible by the Company (subject to the limitations under section 274(n)) and may be excluded from the IC's income as payments made under an accountable plan.

2) Reimbursements made to an IC under the Plan are not wages subject to employment taxes, and are not reportable on the IC's Form W-2.

Except as specifically ruled on above, no opinion is expressed as to the federal tax consequences of the transaction described above under any other provision of the Code. This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of

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the Code provides that it may not be used or cited as precedent.

Sincerely,

JERRY E. HOLMES
Chief, Branch 2
Office of the Associate
Chief Counsel
(Employee Benefits and
Exempt Organizations)