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

OFFICE OF
CHIEF COUNSEL

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280F.05-05; 280F.05-06; 4221.07-07

The Honorable [redacted]
U.S. Senate
Washington, D.C. 20510-1803

Attention: [redacted]

Dear [redacted]:

This letter is in response to your inquiry (copy enclosed) dated June 26, 2001, to Mr. Floyd Williams, National Director for Legislative Affairs, IRS, in which you requested information on the Federal tax issue relating to [redacted] reimbursing operational expenses to employee school bus drivers. Your letter to the IRS was in response to concerns raised by your constituent, [redacted].

[redacted] stated in a letter to your office that [redacted] have treated expense reimbursements to school bus drivers as wages since 1992. (As wages, these amounts are subject to federal employment taxes.) [redacted] opined that school districts began treating expense reimbursements as wages based on an IRS determination that the reimbursement plans were nonaccountable plans. [redacted] also stated that three school bus drivers have successfully challenged the treatment of these amounts as wages in U.S. Tax Court and another driver obtained a refund from an IRS appeals office based on the reasoning of the three Tax Court opinions. [redacted] detailed the impact on the school districts and drivers resulting from the treatment of these amounts as wages and raised some concerns.

The issue of whether the expense reimbursements constitute wages to school bus drivers in the cases 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] The cases being contested by the IRS involve issues relating to the proper treatment and reporting of the expense reimbursement payments for employment tax purposes.

To assist your office in understanding how this Federal tax issue affects [redacted] school bus drivers requires that I provide your office with a general discussion of the accountable plan rules and briefly discuss the three Tax Court summary opinions referenced by [redacted].

Accountable Plans

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 Internal Revenue Code (Code) and regulations thereunder].

1. Business Connection Requirement. An arrangement meets the business connection requirement if it provides 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. Substantiation Requirement. In order to meet the substantiation requirement, the payor must require the employee to substantiate his or her expenses, within a reasonable period of time. To the extent the expenses are covered by section 274(d) of Code, the employee must meet the substantiation requirements of that section. For example, because travel expenses are governed by section 274(d), an employee must generally substantiate the *amount*, *time*, *place*, and *business purpose* of the expense. For the convenience of employees and employers, the IRS has provided optional simplified methods, known as "deemed substantiation" methods, to substantiate the *amount* of an expense governed by section 274(d). Revenue Procedure 2000-48

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[1]The term "employment taxes" generally refers to income tax withholding under sections 3401-3406 of the 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. However, for purposes of the FUTA tax, section 3306(c)(7) excludes from the definition of "employment" the services performed in the employ of a state, political subdivision, or wholly-owned instrumentality. Therefore, to the extent that a [redacted] school bus driver is an employee of the state, political subdivision, or wholly-owned instrumentality, the relevant employment taxes would include only those imposed under FICA and income tax withholding.

explains these “deemed substantiation” methods. The procedures in Revenue Procedure 2000-48 are optional; a taxpayer can use actual allowable expenses if he or she maintains adequate records. However, “deemed substantiation” methods do not apply to school buses.[2]

Because the “deemed substantiation” methods do not apply to school buses, an employer must require substantiation of actual expenses. Specifically, the employee must provide 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 must be substantiated to the payor. It is not sufficient if the employee merely aggregates expenses into broad categories or reports individual expenses using vague, nondescriptive terms, such as miscellaneous business expenses.

3. Return of Excess Requirement. The requirement that amounts in excess of expenses be returned to the payor is met if the arrangement requires the employee to return to the payor, within a reasonable period of time, amounts in excess of substantiated expenses.

In the cases being contested by the IRS, an issue as to whether the expense reimbursements have been made under an accountable plan usually exists, and, therefore, whether they are included in a driver’s wages. The [redacted] generally pay a specific amount per mile to the school bus drivers regardless of the actual expenses incurred by the employees. Further, the employing [redacted] [redacted] generally do not require the employees to actually substantiate expenses. Rather, an amount is generally paid based on assigned routes, regardless of actual miles driven or expenses incurred. Indeed, [redacted]

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[2]Section 274(d) does not apply to any “qualified nonpersonal use vehicle” as defined in section 274(i). Section 274(i) defines a qualified nonpersonal use vehicle as a vehicle that, by reason of its nature, is not likely to be used for personal use more than a de minimis amount. Section 1.274-5T(k) of the Income Tax Regulations specifically includes school buses, as defined by section 4221(d)(7)(C), in the definition of qualified nonpersonal use vehicle. Section 4221(d)(7)(C) defines school buses as “any automobile bus substantially all the use of which is in transporting students and employees of schools.” Thus, section 274(d) does not apply to school buses.

Further, section 3.02 of Rev. Proc. 2000-48 explains that “listed property” (one of the areas the deemed substantiation provisions apply to) is defined by section 280F(d)(4), which includes “passenger automobiles” and other “means of transportation.” Section 1.280F-6T(b) of the Temporary Income Tax Regulations excepts from the definition of “listed property” any qualified nonpersonal use vehicle as defined in section 274(i) of the Code or section 1.274-5T(k) of the Temporary Income Tax Regulations.

[redacted]. Additionally, the [redacted] may not require employees to return amounts in excess of substantiated expenses in the cases the IRS is pursuing.

Employers must establish accountable plans

It is in the sole discretion of an employer whether to establish an accountable plan. An employer is not required to establish an accountable plan to reimburse employee business expenses. Additionally, an employer is also free to choose which expenses it reimburses through its accountable plan. For example, an employer may choose to use its funds to reimburse travel expenses, but not subscriptions to professional journals because those expenses have a significant personal benefit to the employee. Employers may elect to establish an accountable plan for the obvious tax advantages—amounts paid under accountable plans are exempt from the withholding and payment of federal employment taxes, are excluded from the employee's gross income, and are not reported as wages or other compensation on a Form W-2.

However, an employee cannot unilaterally create an accountable plan. Indeed, section 1.62-2(c)(3) of the Income Tax Regulations provide that, "[i]f a payor provides a nonaccountable plan, an employee who receives payments under the plan cannot compel the payor to treat the payments as paid under an accountable plan by voluntarily substantiating the expenses or returning the excess to the payor."

Legislative background of accountable plans

The Congress introduced section 67 of the Code as part of the Tax Reform Act of 1986 in order to limit miscellaneous itemized deduction to amounts exceeding 2 percent of adjusted gross income. This sharpened the distinction between the tax treatment of unreimbursed and reimbursed employee business expenses. Unreimbursed employee business expenses (plus other miscellaneous itemized deductions) generally were made subject to a two-percent floor, while the Congress decided to retain the above-the-line deduction treatment for reimbursements received by an employee under a reimbursement arrangement.

Two years later, as part of the Family Support Act of 1988, the Congress added section 62(c) to the Code to prevent an employee from avoiding the 2 percent limit on miscellaneous itemized deductions by the mere fact that the employee's employer maintained a nonaccountable expense reimbursement arrangement. After section 62(c) was enacted, employees receiving reimbursement of expenses under a nonaccountable plan are subject to the 2 percent limit on miscellaneous itemized deductions, as are employees that paid their own expenses and did not receive any

reimbursement from their employer.

Recently, U.S. Representative David Vitter of Louisiana introduced H.R. 2067, which would amend section 62(a)(2) by allowing school bus owner-operators to deduct, as above-the-line business expenses, costs related to driving a school bus as an employee.

Small Tax Cases

The following [redacted] U.S. Tax Court opinions address many issues, including whether employee expense reimbursement arrangements of [redacted] that reimburse operational expenses of [redacted] school bus drivers satisfy the requirements of section 62(c): *Carroll v. Commissioner*, T.C. Summ. Op. 1998-39 (Feb. 26, 1998); *Reeves v. Commissioner*, T.C. Summ. Op. 1998-41 (Feb. 26, 1998); and *Walls v. Commissioner*, T.C. Summ. Op. 1998-86 (May 5, 1998). These opinions were issued under section 7463(b) of the Code, which provides simplified procedures for small tax cases. Opinions in small tax cases are not precedent for any other case and cannot be appealed.

In these cases, the Tax Court treated the school buses as if they were personal use automobiles, by analogy, rather than as qualified nonpersonal use vehicles. It then applied the special rules under section 274(d) (allowing for "deemed substantiation" of amounts) rather than the rules under section 62(c) (requiring actual substantiation of amounts) and held that the reimbursements were deemed substantiated and were paid under an accountable plan. The Tax Court noted that, although a school bus is excepted from the definition of "passenger automobile" by section 280F(d)(5) of the Code, revenue procedures that provide rules for "deemed substantiated" amounts related to passenger automobiles do not direct the reader to section 280F(d)(5) or otherwise define passenger automobile.

I do not believe the Tax Court opinions in these cases properly apply the law. Further, as these are summary opinions issued under the small tax procedures of section 7463(b), the opinions are not precedent for any other case.

Other

I would be happy to facilitate contact between any interested [redacted] and our Federal, State, and Local Government (FSLG) organization in order to answer any specific questions that the school districts might have on the establishment of accountable plans. The mission of FSLG includes providing our customers top quality service by helping them understand and comply with applicable tax laws and to protect the public interest by applying the tax law with integrity and fairness.

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

I hope this information will be helpful. If you have any further questions, please call me at (202) 622-6010 or [redacted] of my staff at (202) 622-6040.

Sincerely,

Mary Oppenheimer
Assistant Chief Counsel
(Exempt Organizations/Employment Tax/
Government Entities)
Office of the Division Counsel/
Associate Chief Counsel
(Tax Exempt and Government Entities)

Enclosure