

To Withhold or Not on Tool Reimbursements?

BY ROBERT W. WOOD

While one of the classic signs that a worker is an independent contractor is that he or she supplies his or her own tools and equipment, the mere fact that a worker does so does not make him or her an independent contractor.

Conversely, when an employer provides all tools, equipment, and supplies necessary for the work, it generally suggests that the worker is an employee. Who supplies the tools is simply one relevant factor in determining the worker's status.

When an employer pays for or reimburses an employee for tools and supplies, the company and the worker may not consider how the reimbursement should be treated for tax purposes.

Both should.

Plainly, if an employer treats a worker as an employee by withholding income and employment taxes, there will be no question whether the worker is an employee. But it can still be very important who pays for the tools and equipment. When an employer pays for or reimburses an employee for tools and supplies, the company and the worker may not consider how the re-

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imbursement should be treated for tax purposes. Both should.

Are reimbursements a company makes to employees for tools, equipment, and supplies they use during their work income? Are they wages? This may appear to be a small issue. It is not, because many companies employing service technicians in a variety of fields require the workers to provide their own tools and equipment. Many such requirements go on to specify that the tools and equipment must be kept on the employers' premises.

Again, we are talking about employees, not independent contractors. Independent contractors in some cases are recharacterized as employees based in part on such factors as whether the worker or the company pays for the tools or supplies. Plainly, tool and equipment reimbursement plans can be issues in that context. They can even influence the decision whether the worker is an employee.

Here, though, we are addressing only employees explicitly treated as such. If the worker is an employee, the question is whether the company's reimbursement for necessary tools and supplies will be income or wages to the employee. Both the company and the worker would prefer to have the payment treated as a straight reimbursement, not income to the employee, and with no tax withholding. The reimbursement would not be included as part of the employee's reportable pay.

But is this favorable tax treatment possible? As is so often true in the tax world, it depends. Reimbursements are tax-free to the employee and are not subject to withholding or payroll taxes if the reimbursements are made under an "accountable plan." To be treated as made under an accountable plan, a reimbursement must meet all of the following requirements:

- the reimbursed expense must be allowable as a deduction and must be paid or incurred in connection with performing services as an employee of the employer¹;
- each reimbursed expense must be adequately accounted for to the employer within a reasonable period of time²; and

¹ Regulations Section 1.62-2(d)(1).

² Reg. Section 1.62-2(e).

■ any amount in excess of expenses must be returned within a reasonable period of time.³

If any one of these requirements is not met, reimbursements are treated as made under a non-accountable plan. That makes them subject to income tax withholding and employment taxes.

Business Connection?

The requirement that the expense must be paid or incurred in connection with the employee's performance of services for the employer might seem to be satisfied in every case. However, the regulations cross-reference the business expense rules and therefore have decided limits.

An arrangement will satisfy the business connection requirement if it provides advances, allowances, or reimbursements only for business expenses that are allowable as deductions, and that are paid or incurred by the employee "in connection with the performance of services as an employee of the employer."⁴ Thus, this requirement will not be satisfied if the company reimburses the employee regardless of whether the employee incurs deductible business expenses.⁵

IRS and Case Law Authority

As further evidence that the tool reimbursement question is not a small or unimportant issue, the Internal Revenue Service has repeatedly addressed it, as have the courts. Tool and equipment reimbursement plans were the subject of an IRS Industry Specialization Paper,⁶ something that generally signals that IRS views it as important. IRS has also reviewed such arrangements in revenue rulings and other guidance.

Revenue Ruling 2005-52⁷ deals with a tool allowance based on a combination of data from a national survey of average industry tool and expenses, and specific information from technicians based on a written survey. Chief Counsel Advice 200745018 considers wages recharacterized as tool reimbursements tied to an hours-worked formula. Employee tool and equipment plans that purported to be valid accountable plans also were targets of an IRS cross-divisional team set up to target faulty plans.

The courts have also considered such arrangements. In *Shotgun Delivery Inc. v. United States*,⁸ a federal district court held that a delivery company's expense reimbursements to its drivers were not paid under an accountable plan. They had to be treated as wages subject to payroll taxes and income tax withholding. The reimbursements did not meet the accountable-plan business connection requirement because they were paid whether or not drivers incurred business expenses.

In CCA 201120021, an employer participated in a tool plan administered by a third party. The plan was de-

signed to reimburse employees for the use of their tools and equipment. Tool payments were made to employees as purportedly nontaxable reimbursements for the cost of tools they were required to provide as a condition of employment.

However, neither the employer nor the plan administrator was obligated to verify that the tools claimed by the employees were actually required in the performance of services for the employer. Before enrolling in the plan, the employer compensated each employee on an hourly wage basis. There was no specific amount attributed to the provision of tools or equipment.

After enrolling in the plan, an employee's hourly wage was split into two components. He or she received a reduced hourly wage and a tool plan payment. The latter was calculated as a set percentage of the employee's hourly wage. The employer issued separate checks to each employee. One check was for the reduced hourly wage amount. A second check was for the tool plan payment. The company did not withhold on it or subject it to employment taxes. Although the amount was split into two portions, each employee continued to receive essentially the same amount per hour as he or she did before the tool plan was implemented.

An employee could receive an amount equal to the total to be "reimbursed" under the tool plan (i.e., the value or estimated cost of the employee's tool and equipment inventory). At that point, payments under the tool plan would stop. The employee would return to the regular pay at the hourly wage rate he or she earned before the tool plan was implemented. The amount "reimbursed" would be determined by taking an inventory of each employee's tools and equipment.

IRS concluded in CCA 201120021 that a tool reimbursement plan failed the accountable-plan business connection requirement where it impermissibly recharacterized wages and reimbursed employees for tool expenses incurred before the start of employment.

The tool plan administrator would ask each employee for a list of tools and equipment, and for any available receipts. The inventory included tools and equipment the employee acquired before being employed with the current employer. Purchases made after implementation of the tool plan were generally determined at actual cost and required receipts. However, procedures were lax for previously acquired tools and equipment. An employee without receipts to establish cost could simply use estimates of the price he or she paid, valuation publications, or current price lists.

Notably, the tool plan did not take into account whether or not the purchasing employee had claimed any depreciation for the tools in inventory. The plan also did not take into account any prior reimbursements. In the IRS view, information would be necessary to determine the expenses actually incurred by employees in performing services for the employer.

³ Reg. Section 1.62-2(f).

⁴ Reg. Section 1.62-2(c)(1).

⁵ Reg. Section 1.62-2(d)(3).

⁶ ISP Coordinated Issue—Motor Vehicle Industry; Service Technician Tool Reimbursements, UIL 62.15-00 (7/21/00).

⁷ 2005-2 C.B. 423.

⁸ *Shotgun Delivery Inc. v. United States*, 85 F. Supp.2d 962, 85 AFTR 2d 2000-875 (N.D. Cal. 2000), *affirmed in part, reversed in part Shotgun Delivery Inc. v. United States*, 269 F.3d 969, 88 AFTR 2d 2001-6391 (9th Cir. 2001).

In CCA 201120021, IRS concluded that the described tool reimbursement plan failed the accountable-plan business connection requirement. It impermissibly re-characterized wages and reimbursed employees for tool expenses incurred before the start of employment. As a result, amounts paid under the plan had to be included in the employee-participants' gross incomes and reported as wages on their Forms W-2. That meant they were subject to withholding and employment taxes.

The chief counsel advice reiterates IRS's long-standing position. When a plan calls an amount a reimbursement allowance, but the amount is paid even if no expenses are incurred or reasonably expected to be incurred, the amount paid will not be treated as made under an accountable plan. An employer cannot structure its compensation arrangement to avoid the payment of employment taxes by substituting reimbursements and expense allowances for an amount that would otherwise be paid as wages.

The plan considered in this ruling made it possible that an employee could receive the same amount regardless of whether he or she incurred the expenses or reasonably could have been expected to incur them. The chief counsel advice states that this potential re-characterization of what should be wages violates the business connection requirement of the regulations.⁹

⁹ Reg. Section 1.62-2(c).

The Chief Counsel Advice also reiterates the IRS view that to satisfy the business connection requirement, it is not enough for an employee to pay or incur a deductible business expense. The expense must also "arise in connection with the employment." Here, the tool plan allowed the employer to reimburse tool expenses that the employee paid or incurred prior to employment. That meant the reimbursement arrangement did not meet the business connection requirement.

Conclusion

Who pays for tools and equipment tends to be a hot button item when discussing whether a worker should be treated as an employee or an independent contractor. In fact, it is sometimes elevated to extreme importance in worker status disputes. In contrast, once a worker is explicitly treated as an employee, very little attention is often paid to the nature of tool and equipment reimbursements.

As the authorities in this area show, that can be a mistake. It can hurt the workers and employers, and can potentially lead to tax assessments and disputes. If an employer fails to withhold on wages, the penalty liability to IRS can be severe. In fact, in the realm of IRS penalties, it can be one of the larger and more expensive issues to address. Companies and their employees can both benefit from reviewing this issue before it becomes a problem.