TOOL PLANS REMAIN ON THE IRS HIT LIST

For years, we have advised clients to steer clear of the tool reimbursement plans that have been highly promoted. The latest IRS Letter Ruling is not boding well for those dealers that signed on with these types of programs. Private Letter Ruling 200745018 was released on November 14, 2007, and it appears to put the taxpayer back in the position they were prior to signing on with the tool plan program with the potential for abuse to be part of the conclusion. The Letter Ruling is not too dissimilar from the Revenue Ruling 2005-52 conclusions where the IRS addressed the tax consequences of a tool plan.

Background

Tool plans have been marketed as a tax savings strategy to reduce the amount of payroll tax and withholding while at the same time not changing the amount of compensation paid to a service technician.

Reimbursements are tax free to employees and are not subject to withholding or payroll taxes if made under an accountable plan. To qualify under the accountable plan rules the plan must meet all the following criteria:

- Business connection. The reimbursement must be paid or incurred in connection with performing services as an employee of the employer and must be for business expenses that are allowable as deductions.
- Substantiation. The employee must adequately account for the expenses so the employer can identify the specific nature of each expense and determine that the expense is in connection with the business activity.
- Amounts in excess of incurred expenses must be returned. The employer must require the employee to return any reimbursements that exceed actual expenses incurred within a reasonable period of time.

Facts of the Letter Ruling

The taxpayer's employees, service technicians, were required to provide their own tools as a condition of employment. The tools ranged from simple wrenches to sophisticated power tools and computer analysis equipment. The tool plan promoter approached the taxpayer about implementing a program as a tax savings opportunity for the reimbursement of the technicians' tool expenses without requiring the taxpayer to pay to the technicians any additional cash over their current hourly wages. The tool plan enrollment form required the technicians to list the tools they were required to provide for purposes of their job and to provide the cost of each category of tool. In addition, technicians signed a statement that they only used the listed tools and equipment for their employer's business related activities and, at least in some cases, indicated they hadn't recovered any tool costs through depreciation or previous reimbursement. The taxpayer did not show that it had attempted to verify these statements. In addition, the taxpayer did not provide any evidence that it ever requested or obtained receipts to substantiate acquisition costs. Using the plan, a technician's tool benefit was paid to him as an hourly reimbursement rate over a determined number of reimbursement hours. It was determined under the formula: (tool inventory + 10% fee) ÷ tool rate = reimbursement hours. The tool rate was based on 35% of the technician's current hourly wage, but it couldn't exceed $8.00 per hour and couldn't be an amount that caused the technician's remaining hourly wages to be below the legal minimum wage. To pay the tool benefit, the taxpayer divided the technician's compensation into two components: the hourly wage and the hourly tool rate. The sum of the two components equaled the technician's previous hourly wage.

IRS Conclusion

The IRS concluded that the tool plan as designed failed each of the three requirements for an accountable plan. The IRS took the stance that the tool plan merely recharacterizes a portion of the technician's compensation and labeled it as a reimbursement. The technician received the same hourly rate regardless of whether they incurred expenses. According to the Ruling, the accountable plan violations were not isolated errors with regard to a particular technician, time period or tool. The errors were routine and

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fundamental to the design of the plan, where the goal was to ensure that the gross pay of each technician never changed. This was believed to be a pattern of abuse by the taxpayer. According to the Ruling:

"The accountable plan rules were not meant to allow taxpayers to avoid paying taxes on their wages, even if for a short period of time, in the guise of expense reimbursement. The routine reimbursement of unsubstantiated expenses and the practice of recharacterizing wages as reimbursement until expenses are reimbursed, only to reinstate the original compensation amount at that point, evidence an abuse of the accountable plan rules."

Because of these failures and a possible pattern of abuse, the taxpayer's reimbursements to its employee technicians had to be included in their gross income and reported as wages or other compensation on their Form W-2, and were subject to withholding and payment of federal employment taxes.

If you have a tool plan in place, we recommend a thorough review of your plan. We suggest reviewing the Letter Ruling to compare the design of that plan to yours. If you have a plan that might be in question, you should communicate with your service provider to see how your plan addresses the concern the IRS brings to light in the Letter Ruling.

For further information, please contact your local AutoTeam America Member today.

ABOVE THE LINE DEDUCTIONS

The IRS has clarified the rules regarding the deduction by two-percent shareholder-employees of S corporations for health insurance premiums paid or reimbursed by an S corporation and included in the shareholders' income. A two-percent shareholder-employee may deduct amounts paid for insurance under Code Section 162(l) if the insurance plan was established by the S corporation. A plan is considered to be established by the S corporation if the S corporation makes the premium payments in the current tax year or the two-percent shareholder makes the premium payments and is, then, reimbursed by the S corporation in the current tax year. Payments, whether made directly by the S corporation or reimbursed by the S corporation, must be included in the shareholder's wages and reported on the shareholder's Form W-2, Wage and Tax Statement.

This is excellent news for the numerous shareholders who currently purchase their own health insurance.

For further information, please contact your local AutoTeam America member today.

✓ QUICK CHECK

Are special order parts contributing to gross profits? Or are they languishing on the shelf?

It's important for the dealer to review the follow up procedures for special order parts with the parts department manager on a periodic basis.

Too often, procedures are not followed and the dealership misses the opportunity to return the special order part to the factory with no penalty—or fails to get the customer back into the dealership to install or pick up the part.

This is an area that can add to obsolescence problems in the parts inventory and unnecessarily consume working capital.

TAX TIP

Tax Breaks For Qualifying Relatives are Limited

A taxpayer is entitled to a deduction equal to the exemption amount for each person who qualifies as his "dependent."

A person qualifies as the taxpayer's dependent if the person is the taxpayer's qualifying child or qualifying relative. The terms "qualifying child" and "qualifying relative" were added to Code Section 152 by the Working Families Tax Relief Act of 2004 (WFTRA), effective for tax years beginning after 2004. WFTRA established a uniform definition of a "qualifying child" for determining whether a taxpayer may claim certain child-related tax benefits. It established the term "qualifying relative" to identify individuals (other than a qualifying child) for whom a dependency exemption deduction may also be allowed.

A "qualifying child" of a taxpayer is an individual who: (A) bears a certain relationship to the taxpayer (son, daughter, stepchild, eligible foster child, grandchild) (B) has the same principal place of abode as the taxpayer for more than one-half of the tax year, (C) meets certain age requirements (under age 19 at the end of the year, under age 24 at the end of the year and a full-time student), and (D) has not provided over one-half of his or her own support for the calendar year.

A "qualifying relative" is an individual: (A) lives in taxpayer's household for entire year or who bears a specified relationship to the taxpayer (child, stepchild, eligible foster child, grandchild, brother, sister, half-brother or sister, father, mother, grandparent); (B) whose gross income for the calendar year in which that tax year begins is less than the exemption amount ($3,400); (C) with respect to whom the taxpayer provides over one-half of his or her support for the calendar year in which that tax year begins; and (D) who isn't a qualifying child of that taxpayer or of any other taxpayer for the calendar year in which that tax year begins.

An individual need not be technically related to a person to qualify as the person's qualifying relative. That's because, the specified relationships include in-laws and an individual who, has his principal place of abode as the home of the taxpayer and is a member of the taxpayer's household.

An individual may be a qualifying relative of a taxpayer as long as that individual is not a qualifying child of "any other taxpayer". If the individual is not required to file an income tax return and (i) does not file an income tax return, or (ii) files an income tax return solely to obtain a refund of withheld income taxes. A taxpayer may claim a dependency exemption deduction for an unrelated child of an unrelated individual who lived with the taxpayer as a member of the taxpayer's household for the entire year.

Example: Andrew supports as members of his household for the tax year an unrelated friend, Betty, and her 3-year-old child, Carole. Betty has no gross income, is not required to file an income tax return, and does not file an income tax return for the tax year. Accordingly, because Betty does not have a filing requirement and did not file an income tax return, Carole is not treated as a qualifying child of Betty or any other taxpayer, and Andrew may claim both Betty and Carole as his qualifying relatives.

Thus, many taxpayers may not avail themselves of the opportunity to claim a dependency exemption for individuals they support. You should consult with your ATA representative in evaluating who meets the dependency test.