

Letter of Findings: 08-0257
State and County Withholding Tax
For the Years 2004, 2005, and 2006

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ISSUE

I. Tool Allowance Plan – Withholding Tax.

Authority: IC § 6-8.1-5-1(c); [45 IAC 3.1-1-97](#); I.R.C. § 61; I.R.C. § 62; I.R.C. § 62(a)(2)(A); Treas. Reg. § 1.62-2(c)(1); Treas. Reg. § 1.62-2(c)(3); Treas. Reg. § 1.62-2(c)(5).

Taxpayer disagrees with the Department of Revenue's audit adjustment assessing and requiring taxpayer to withhold additional Indiana adjusted gross and Vigo County adjusted gross income tax.

STATEMENT OF FACT

Taxpayer is in the business of servicing and repairing automobiles. On occasion, taxpayer also sells used cars. In November 2004, taxpayer began paying a portion of its employees' wages as a "tool allowance." Taxpayer did not withhold state or county taxes on the amounts paid under the "tool allowance" provision. Taxpayer did so at the behest of a third-party tax advisor. Beginning in 2007, the Department of Revenue (Department) conducted an audit review of taxpayer's business records. After reviewing taxpayer's "tool allowance" arrangement, the audit concluded that the arrangement did not comport with the relevant law. As a result, taxpayer was assessed additional state and county withholding tax. Taxpayer disagreed with the decision and submitted a protest to that effect. An administrative hearing was conducted during which taxpayer's representative explained the basis for the protest. This Letter of Findings results.

I. Tool Allowance Plan – Withholding Tax.

DISCUSSION

Taxpayer argues that it was not required to withhold the additional state and county tax on the ground that its "tool allowance" initiative complied with the relevant law.

[45 IAC 3.1-1-97](#) states that:

Withholding agents who are required to withhold Indiana Adjusted Gross Income Tax and County Adjusted Gross Income tax... shall make return of and payment to the Department monthly whenever the amount of tax due, for either County and State, exceeds an aggregate of \$50 per month with such payment due on the thirtieth [] day of the following month.

However, taxpayer indicates that certain amounts paid to its employees are not subject to withholding tax because the amounts consist of "tool allowances."

I.R.C. § 61 defines gross income as all income from whatever source derived. I.R.C. § 62 defines "adjusted gross income" as gross income minus certain "above the line deductions." I.R.C. § 62(a)(2)(A) allows an employee an "above-the-line" deduction by providing that – for purposes of determining adjusted gross income – an employee may deduct certain business expenses paid by the employee in connection with performance of services as the employer's employee under reimbursement or other expense allowance arrangement.

I.R.C. 62(c) provides as follows:

Certain arrangements not treated as reimbursement arrangements. For purposes of subsection (a)(2)(A), an arrangement shall in no event be treated as a reimbursement or other expense allowance arrangement 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 the right to retain any amount in excess of the substantiated expenses covered under the arrangement. (Emphasis added).

Treas. Reg. § 1.62-2(c)(1) provides that a reimbursement of a qualified expense allowance arrangement satisfies the requirements of I.R.C. § 62(c) if it meets the three requirements of "business connection," "substantiation," and "returning amounts in excess of substantiated expenses." If an arrangement meets these requirements, all amounts paid under the arrangement are treated as paid under an "accountable plan." Amounts treated as paid under an accountable plan are excluded from the employees' gross income, are not reported as wages on the employees' Form W-2, and are exempt from withholding and payment of employment taxes. However, Treas. Reg. § 1.62-2(c)(3) provides that if any part of the expense allowance plan fails any of the three listed requirements, "all amounts paid under the arrangement are treated as paid under a 'nonaccountable plan.'" Any amounts paid under such a nonaccountable plan, "are included in the employee's gross income, must be reported as wages or other compensation on the employee's Form W-2, and are subject to withholding and payment of employment taxes...." Treas. Reg. § 1.62-2(c)(5).

Therefore, the issue is whether the amount taxpayer paid to its employees fall within the definition of an "accountable plan," or a "nonaccountable plan."

As a threshold issue, it is the taxpayer's responsibility to establish that the tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made."

During the time the audit was being conducted, taxpayer was asked to provide records necessary to establish that it was paying its employees under an "accountable plan" but failed to do so. During the administrative hearing, taxpayer was asked and agreed to provide the same records but failed to follow through and actually provide the requested documentation.

The audit took the position that taxpayer was simply attempting to re-characterize the wages it paid its employees and that taxpayer's plan failed to meet the three essential requirements set out in Treas. Reg. § 1.62-2(c)(1). The audit's conclusion was correct and taxpayer has failed to provide anything which rebuts that conclusion.

FINDING

Taxpayer's protest is respectfully denied.

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