Alaska State Legislature
Legislative Council

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MEMORANDUM

TO: Legislative Council Members

FROM: Representative Mike Hawker
Chairman, Legislative Council

DATE: November 15, 2013

RE: Allowance Account Options Analysis

Attached is an analysis of options regarding our office expense allowance accounts prepared by Deloitte Tax LLP. This memo builds on the analyses that were distributed to the legislature and available to the previous Council in determining the allowance account policy dated December 13, 2013. I have also attached this policy and the underlying statute for your reference.

This rather technical memorandum is fairly consistent with the findings the Council relied on in establishing that policy. This memo does go a step further and identifies a 'cafeteria' concept and its implications.

In short we have three options, given that we do not make any changes in legislative salaries, which are outside the scope of authority of the Council.

1. A fully accountable plan for everyone, with the current differential amounts for Senate and House members. Under this option, legislators submit receipts for acceptable business expenditures to the Legislative Affairs Agency for payment or reimbursement. At the end of the calendar year, any unspent funds lapse and are no longer available to legislators. This option poses no tax consequences to individual legislators.

2. A fully non-accountable plan for everyone. This was the option chosen for 2013. Every legislator would receive their office allowance amount as additional taxable personal income at the beginning of the year with no further substantiation requirement.

3. The Deloitte Tax memo also discusses a cafeteria concept where each individual legislator can make an election before the end of 2013 between option 1 and 2. As the memo discusses, this alternative is likely grudgingly permitted by the IRS, if for no other reason than the 2007 proposed regulations in the cafeteria plan guidance haven't been finalized. When they are finalized, it is likely that continuing this avenue would pose an uphill battle to the point that it's an unworkable solution on a long-term go-forward basis.

I would like all Council members to consider our options and be prepared to select among them for 2014 at our upcoming meeting on November 21, 2013.

Thank you for your attention to this matter.

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Memo

Date: November 11, 2013

To: State of Alaska Legislative Affairs Agency Tax File

From: Jason E. Russell, (415) 783-5376 & Stephen LaGarde, (202) 879-5608

Subject: U.S. Federal Employment Tax Treatment of Legislators' Business Expense Reimbursements

Scope

This memo addresses the U.S. federal employment tax treatment of business expenses incurred by certain employees ("Legislators") of The State of Alaska Legislative Affairs Agency ("Agency"). We have not considered any other U.S. federal tax, or state, local or foreign income tax consequences, and, therefore, do not express any opinion regarding the treatment that would be given by federal authorities other than with respect to U.S. federal employment tax or by the applicable authorities on any state, local or foreign tax issues. We also express no opinion on nontax issues. We express no opinion other than that as stated immediately above, and neither this memo nor any prior statements are intended to imply or to be an opinion on any other matters.

The analysis contained herein is based on the facts and assumptions you have provided to us. We have assumed that these facts and assumptions are complete and accurate. A misstatement or omission of any fact or a change or amendment in any of the facts, assumptions or representations we have relied upon may require a modification of all or a part of this memo.

This memo is as of November 11, 2013, and we have no responsibility to update this memo for events, transactions, circumstances, or changes in any of the facts, assumptions, or representations occurring after this date. The discussion and conclusions set forth herein are based upon the Internal Revenue Code, Treasury Regulations, and existing administrative and judicial interpretations thereof, as of October 9, 2013, all of which are subject to change. If there is a change, including a change having retroactive effect, in the Internal Revenue Code, Treasury Regulations, Internal Revenue Service rulings or releases, or in the prevailing judicial interpretation of the foregoing, the conclusions contained herein would necessarily have to be re-evaluated in light of any such changes. We have no responsibility to update this memo for any such changes occurring after the date of this letter.

The conclusions expressed herein are not binding on the Internal Revenue Service and there can be no assurance that the Internal Revenue Service will not take a position contrary to any of the conclusions expressed herein.

This memo is solely for the Agency's benefit and may not be relied upon by anyone other than the Agency.

Facts

The Agency is "the vehicle for execution of Legislative Council policy and the carrying out of other statutory and rule assignments made by the Legislature"[1] for the State of Alaska. For U.S. federal employment tax purposes, the Agency is the employer of the Legislators, who are elected members of the Alaska Legislature.

Historically, the Agency has made an expense reimbursement arrangement available to the Legislators. Under this arrangement, an annual amount is made available to each Legislator for business expenses incurred in connection with the Legislators' employment by the Agency. Properly substantiated business expenses have been treated as excludable from the Legislators' wages, and unsubstantiated amounts have been treated as wages. In other words, the same amount is paid to each Legislator and only the portion treated as includable or excludable from wages varies.

Issues

1. What are the U.S. federal employment tax consequences of the Agency's expense reimbursement arrangement as it has historically been operated?

2. If the Agency's expense reimbursement arrangement were changed, could reimbursements under it be excludable from Legislators' wages?

Executive Summary

1. All reimbursements under the arrangement as it has historically been operated should be treated as wages, regardless of whether business expenses were substantiated by the Legislators, because unspent expense funds were provided to the Legislators as taxable compensation.

2. The expense reimbursement arrangement could be revised such that substantiated reimbursements should be excludable from Legislators' wages, even taking into account that the Agency is a non-taxable governmental entity.

3. Different levels of reimbursement for different houses within the Legislature would be permissible.

4. Permitting a Legislator to choose prior to the calendar year of reimbursement an amount to set aside for reimbursement of substantiated business expenses may be permitted by relevant tax

[1] http://w3.legis.state.ak.us/laa/laa.php.

law (even to the extent that different Legislators choose different amounts); however, should the IRS choose to finalize the 2007 proposed regulations in the cafeteria plan guidance, this mechanism is likely to be unsustainable beyond the point that the cafeteria plan regulations are finalized.

Law and Analysis

1. *All reimbursements under the arrangement as it has historically been operated should be treated as wages, regardless of whether business expenses were substantiated by the Legislators.*

Expense reimbursements treated as paid under an accountable plan are excludable from "wages" for U.S. federal employment tax purposes.[2] Conversely, expense reimbursements treated as paid under a nonaccountable plan are includible in "wages" for U.S. federal employment tax purposes.[3]

To be treated as paid under an accountable plan, an expense reimbursement arrangement must satisfy three basic requirements:[4]

- *Business connection*. The advances, allowances, or reimbursements provided under the arrangement must be for expenses that are business expenses for which a deduction is allowable under section 161 of the Code, *et seq*., and must be incurred by the employee in connection with the performance of services by the employee for the employer.

- *Substantiation*. The arrangement must require the employee to substantiate the expense.

- *Return of Excess*. The arrangement must require the employee to return any amounts in excess of actual expenses within a reasonable time.

The accountable plan rules contemplate that an arrangement may reimburse both deductible and nondeductible expenses. In that situation the portion of the payment that reimburses nondeductible expenses is treated as reimbursed under a nonaccountable plan, and the portion that reimburses deductible expenses is treated as reimbursed under an accountable plan.[5] Importantly, however, this bifurcated approach is not available when an employee receives a fixed payment regardless of whether any business expenses are incurred.[6] For example, if an employee is paid $200 per day regardless of whether he travels away from home for business and the employer designates $50 of the $200 as paid to reimburse the employee's travel expenses on those days when the employee does travel away from home on business, then the entire $200 per day is includible in the employee's wages and no amount paid under the arrangement is treated as paid under an accountable plan.[7] The IRS and Treasury Department have explained that the purpose of this rule is to prevent "an employee's salary from being

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[2] Treas. Reg. § 1.62-2(c)(4).
[3] Treas. Reg. § 1.62-2(c)(5).
[4] Treas. Reg. § 1.62-2(d), (e), (f).
[5] *See* Treas. Reg. § 1.62-2(d)(2).
[6] Treas. Reg. § 1.62-2(d)(3)(i). *See also Shotgun Delivery v. United States*, 269 F.3d 969 (9th Cir. 2001); Rev. Rul. 2004-1; 2004-4 I.R.B. 325; Rev. Rul. 2012-25 2012-37 I.R.B. 337.
[7] *See, e.g.*, Treas. Reg. § 1.62-2(j), example (1).

recharacterized as being paid under a reimbursement arrangement or other expense allowance arrangement."[8]

In this case, the Agency is paying a fixed amount to each Legislator regardless of whether the Legislator actually incurs business expenses in connection with his or her employment by the Agency. Accordingly, the bifurcated approach—treating some reimbursements as taxable and other reimbursements as nontaxable—should not be available. Instead, all of the expenses reimbursed under the Agency's historical expense reimbursement plan should be treated as wages for U.S. federal employment tax purposes.

2. *The expense reimbursement arrangement could be revised such that substantiated reimbursements should be excludable from Legislators' wages.*

Perhaps the most straightforward accountable plan design is one that does not link the amount of reimbursable business expenses to employees' compensation in any way. The types of expenses that are eligible for reimbursement may be identified in the employer's policies, but typically there are no specific dollar limitations on the overall amount of reimbursable expenses. If the Agency were to revise its reimbursement arrangement in this manner, properly substantiated reimbursements should be excludable from Legislators' wages. A disadvantage of this approach is that it may increase the Agency's liability for reimbursements. This disadvantage can be mitigated through caps on reimbursements consistent with the levels permitted now (or other Agency-selected amount), provided that only substantiated covered expenses are reimbursed; amounts in excess of reimbursed expenses but under the cap would not be paid and would revert the State of Alaska's general fund, for example. Differing caps on reimbursement for different houses of the Legislature would be acceptable. Residual unspent funds within the cap cannot be refunded to the Legislators as taxable compensation; that would taint the entire pool for the Legislator, just as if the entire allowance had been paid to the Legislator with no requirement to account for the amounts spent would be taxable as compensation.

Other alternatives would combine an adjustment in compensation with implementation of the separate reimbursement process: the compensation payable to all Legislators could be reduced unilaterally to make a greater amount available for expense reimbursements, or the amount of compensation could be raised, with a cap imposed on reimbursable expenses. In 2012, the IRS published guidance that "clarifies that an arrangement that recharacterizes taxable wages as nontaxable reimbursements or allowances does not satisfy the business connection requirement of the accountable plan rules . . . and the applicable regulations." [9] This guidance asserts that the presence of wage recharacterization is based on the totality of facts and circumstances, but it also states a general rule: "wage recharacterization is present when the employer structures compensation so that the employee receives the same or a substantially similar amount whether or not the employee has incurred deductible business expenses related to the employer's business."

The IRS then applies this rule to four situations. In the first three situations, the IRS concludes that the business purpose requirement is not satisfied, because employees receive substantially similar (or exactly the same) compensation regardless of whether they incur deductible business expenses related to the employer's business. In the fourth situation, however, the employer unilaterally reduces employees' prospective compensation and makes business expense reimbursements available only to

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9 Rev. Rul. 2012-25 2012-37 I.R.B. 337.

the extent they are properly substantiated. The IRS concludes that in this situation the business requirement is satisfied, reasoning as follows:

> Although Employer D has reduced the amount of compensation it pays all of its employees, the reduction in compensation is a substantive change in Employer D's compensation structure. Under Employer D's arrangement, reimbursement amounts are not guaranteed and employees who do not incur expenses in connection with Employer D's business, or who do not properly substantiate such expenses, continue to receive the reduced hourly compensation amount. These employees do not receive any reimbursement and are not compensated in another way to make up for the reduction in the hourly compensation. Employer D's reimbursement arrangement does not operate to pay the same or a substantially similar gross amount to an employee regardless of whether the employee incurs (or is reasonably expected to incur) expenses related to Employer D's business. The reimbursement is paid in addition to the employees' wages rather than as a substitute for wages that would otherwise be paid.[10]

Using this IRS guidance as a model, each Legislator's compensation might be adjusted unilaterally, with a separate amount set that would then be available to reimburse the Legislator's properly substantiated business expenses. To the extent a Legislator properly substantiated business expenses, those expenses could be reimbursed and should be excluded from wages; otherwise, no reimbursement would be paid. Rather than using a single amount for all Legislators, the amount available for reimbursement might differ based on classes of Legislators defined by the Agency or even houses of the Legislature.

Another alternative would be to allow employees to choose the amount available for reimbursement. This approach has not been approved by the IRS. In fact, since 2001 the annual list of issues on which the IRS will not issue letter rulings or determination letters has included "[w]hether amounts related to a salary reduction and paid under a purported reimbursement or other expense allowance arrangement will be treated as paid under an "accountable plan" in accordance with § 1.62-2(c)(2)."[11] If this alternative were to be pursued, it would be important to take into account the "constructive receipt doctrine." Though it has a long history, dating back to the Revenue Act of 1914,[12] it is currently codified as follows:

> Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.[13]

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[10] *Id.*

[11] Rev. Proc. 2001-3, 2001-1 I.R.B. 111; Rev. Proc. 2002-3, 2002-1 I.R.B. 117; Rev. Proc. 2003-3, 2003-1 I.R.B. 113; Rev. Proc. 2004-3, 2004-1 I.R.B. 114; Rev. Proc. 2005-3, 2005-1 I.R.B. 118; Rev. Proc. 2006-3, 2006-1 I.R.B. 122; Rev. Proc. 2007-3, 2007-1 I.R.B. 108; Rev. Proc. 2008-3, 2008-1 C.B. 110; Rev. Proc. 2009-3, 2009-1 C.B. 107; Rev. Proc. 2010-3, 2010-1 C.B. 110; Rev. Proc. 2011-3, 2011-1 C.B. 111; Rev. Proc. 2012-3, 2012-1 C.B. 113; Rev. Proc. 2013-3, 2013-1 C.B. 113.

[12] Tariff Act of 1913, Ch. 16 § 2B, 38 Stat. 114, 167 (1913).

[13] Treas. Reg. § 1.451-2(a).

In 1992, the IRS published rules regarding its willingness to rule on the constructive receipt doctrine in the context of deferred compensation plans.[14] The IRS ruled that it would not apply the constructive receipt doctrine to employee elections made before the calendar year in which the related services are performed or those made within 30 days after the date the plan is effective or an individual employee becomes eligible.[15] These 1992 rules were consistent with a 1968 IRS ruling, which held that the election by an employee, prior to January 1 of a given year, to have all or part of any bonus awarded him for that year paid to him in stock of his employer corporation that was subject to restrictions which had a significant effect on its value, would result in the realization of compensation by the employee at the time the restrictions on the stock lapsed, or the stock was sold in an arm's length transaction, whichever event occurred earlier.[16] While this ruling specifically addressed only restricted stock, its holding would be inconsistent with applying the constructive receipt doctrine to amounts an employee negotiates with his employer to receive in one form over another.[17]

In August 2007, the IRS published new proposed cafeteria plan regulations, which state that the cafeteria plan rules are "the exclusive means by which an employer can offer employees an election between taxable and nontaxable benefits without the election itself resulting in inclusion in gross income by the employees"[18] and that "an employee who has an election among nontaxable benefits and taxable benefits (including cash) that is not through a cafeteria plan . . . must include in gross income the value of the taxable benefit with the greatest value that the employee could have elected to receive . . . ."[19] Expense reimbursements are not among the permissible nontaxable benefits permitted under a cafeteria plan.[20] The preamble to the new proposed regulations states that they "clarify and amplify the general rule in the prior proposed regulations."[21] It is unclear when these proposed regulations will be finalized or whether this language will retained in the final regulations. The proposed regulations do suggest, however, that the IRS and the Treasury Department may view annual elections by employees as impermissible under the cafeteria plan rules.

In sum, the Agency's expense reimbursement arrangement could be revised such that substantiated reimbursements should be excludable from Legislators' wages. Although it may be possible, consistent with the constructive receipt doctrine, for each Legislator to choose an individualized amount of compensation reduction/available expense reimbursement, the IRS has not approved this type of design and might challenge it. Other designs, however—such as unilaterally changing Legislators' wages or not linking maximum reimbursement amounts to compensation reductions—should allow properly substantiated business expense reimbursements to be excluded from wages.

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[14] Rev. Proc. 92-65, 1992-2 C.B. 428.

[15] IRC § 409A enacted as part of the Americans Job Creation Act of 2004, incorporates many of these rules as statutory requirements for nonqualified deferred compensation deferred after December 31, 2004. Although the Agency's reimbursement arrangement is not nonqualified deferred compensation, the constructive receipt rules applied in that context may be applied by analogy.

[16] Rev. Rul. 68-86, 1968-1 C.B. 184.

[17] Despite the subsequent enactment of IRC § 83, Rev. Rul. 68-86 has been cited repeatedly by the IRS and its rationale remains valid. *See, e.g.,* Rev. Proc. 92-65, 1992-2 C.B. 428; PLR 9023085 (March 14, 1990).

[18] Prop. Treas. Reg. § 1.125-1(b)(1), 72 Fed. Reg. 43,938, 43,946 (Aug. 6, 2007).

[19] *Id.*

[20] Prop. Treas. Reg. § 1.125-1(a)(3), 72 Fed. Reg. 43,938, 43,946 (Aug. 6, 2007).

[21] 72 Fed. Reg. 43,938, 43,939 (Aug. 6, 2007).

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Any tax advice included in this written communication was not intended or written to be used, and it cannot be used by the taxpayer, for the purpose of avoiding any penalties that may be imposed by any governmental taxing authority or agency.

Allowance Policy
Approved by Legislative Council December 13, 2012,
Effective January 1, 2013

The Legislative Allowance set out in AS 24.10.110 is an allowance for postage, stationery, stenographic services, and other expenses. Legislative Council policy of December 13, 2012 provides that all Legislators' allowance will be administered as a non accountable allowance. The Legislative Council sets the amount of the annual allowance, currently \$16,000 for Representatives and \$20,000 for Senators. A legislator may decline the increase to the annual Legislative Allowance authorized by the Legislative Council on February 24, 2011. Such option may be exercised on an annual basis.

Legislators leaving office before December 31 of a calendar year must reimburse the Legislative Affairs Agency a pro rata share of the allowance amount for the remaining year. If a Legislator dies in office, the reimbursement rule does not apply. Legislators appointed to fill a term of office are entitled to a prorated allowance amount at the rate of [up to \$1,333 for the House and \$1,667 for the Senate] for each month remaining in the calendar year. Occasionally, a Legislator will be appointed to a vacant seat in the other house. When this occurs, the Legislator is entitled to a pro rata share of the allowance amount for each house, determined by the time served in each body.

Alaska Statute

Title 24. LEGISLATURE AND LOBBYING
Chapter 24.10. OFFICERS, EMPLOYEES, AND COMPENSATION
Article 03. COMPENSATION OF LEGISLATORS

Sec. 24.10.100. Salary of legislators.

Legislators shall receive a monthly salary under AS 39.23. The president of the senate and the speaker of the house of representatives may receive additional compensation under AS 39.23 during tenure of office.

Sec. 24.10.110. Additional allowances.

In addition, each member of the legislature is entitled to an annual allowance prescribed in accordance with AS 39.23 for postage, stationery, stenographic services, and other expenses.