

## IRS Targets Executive Compensation of Exempt Organizations

By Ralph DeJong, Bernadette Broccolo, David Fuller and Jerry Holmes

The IRS is conducting an audit initiative against tax-exempt organizations (EOs) to uncover abusive salaries and other potential "excess benefit transactions." It is ordering nearly 2,000 EOs to provide information and material to justify the levels of compensation and benefits paid to their executives and other individuals. The IRS began suspecting excessive salaries and benefits in nonprofit arena after discovering abusive compensation practices among the for-profit companies during executive compensation audits started last fall. (For more on IRS audits, see ¶1100 of the *Guide*; for more on the audit initiative, see Newsletter, February 2004, p. 1.)

In testimony before the Senate Finance Committee this past June, IRS Commissioner Mark Everson described the EO audits as "aggressive" and part of a "comprehensive enforcement project" spurred by concern that EOs have not been exercising sufficient diligence over their tax-exempt funds. Already, private class action lawsuits this summer against 40 exempt health care organizations have spotlighted potential abuse in the use of tax-exempt funds in favor of "persons of influence." To address this, the IRS has set a

See *Executive Compensation*, p. 2

## IRS Issues Guidance on Payment Cards

Payment card users and providers have a clearer picture of how to report payment card transactions, become qualified to collect and process information relevant to payment card use and determine whether payment card transactions are reportable. The IRS has provided this direction in Treasury Decision (T.D.) 9136 and Revenue Procedure (Rev. Proc.) 2004-42 and 2004-43, which both went into effect in July.

A payment card is a card or account that can be presented to a merchant or other payee representing an agreement by the cardholder to pay the merchant through the organization that issued the card.

T.D. 9136 provides final regulations on information-reporting requirements and penalties, backup withholding requirements for payment card transactions and the taxpayer identification number (TIN) matching program.

Rev. Proc. 2004-42 establishes a way for a payment card organization to request a determination that it is a qualified payment card agent (QPCA). A QPCA may act on behalf of cardholders in soliciting, collecting and validating merchants' names, TINs and corporate status and on behalf of merchants in furnishing their information to cardholders.

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■ Update SIFL rates. (¶105, ¶913)

■ Update discussion of local transportation expenses. (¶712)

### Coming Soon

■ The October supplement to the *Guide* will report on the 2005 CONUS per diem rates.

■ The IRS will soon begin releasing annual limits for 2005 affecting a variety of employee benefits.

■ Continuing coverage of the use of debit cards in relation to employee benefits and the latest developments regarding IRS guidance.

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## Employer's Guide to Fringe Benefit Rules

CONTRIBUTING EDITOR

DAVID FULLER  
McDERMOTT, WILL & EMERY

JERRY E. HOLMES  
McDERMOTT, WILL & EMERY

Washington, D.C.

JOHN ORTMAN  
EXECUTIVE EDITOR

ROD GARCIA  
SENIOR MANAGING EDITOR

JOHN F. IEKEL  
EDITOR

CAREY CAUTHEN  
ASSISTANT EDITOR

SHAWNE HICKS  
DESKTOP PUBLISHING SPECIALIST

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### *Executive Compensation* (continued from p. 1)

separate audit initiative against the health care industry's business practices.

## The IRS Soft Contact Reviews: Scope and Approach

The IRS is selecting nearly 2,000 EOs to include in soft contact reviews based on information they reported on their Form 990 annual information returns. The IRS will ask them to provide detailed support for the compensation and benefits provided to highly paid employees. Although the IRS will target a number of compensation-related issues with this information, the IRS will likely look at the following issues:

- (1) Did the board, or a board committee, review and approve all forms of compensation and benefits?
- (2) Are the board members who reviewed and approved compensation truly independent?
- (3) Did the board, or a board committee, rely on data showing the total compensation and benefits provided to individuals in similar positions at similarly situated organizations?
- (4) Did the board, or a board committee, go through all the steps necessary to qualify for the "rebuttable presumption of reasonableness" under the intermediate sanctions rules if applicable?
- (5) Did the EO properly report all forms of compensation and benefits on its Form 990 (Annual Information Return)?
- (6) Did the EO fail to check either "yes" or "no" in line 89b on the Form 990, indicating whether the organization has had or discovered an excess benefit transaction?

Commissioner Everson testified before the Senate Finance Committee that this project is designed primarily to help the IRS learn two things in particular: the methods and practices EOs are using to set compensation, and how EOs are reporting compensation to the IRS and the public. An Aug. 10 IRS press release states a third purpose: to increase IRS awareness of tax issues that will arise as organizations set compensation in the future. As with the IRS' initial round of 24 audits and subsequent broad expansion among for-profits, the EO compensation information the IRS gleans will determine IRS enforcement priorities and legislative proposals for the next several years.

## Need for Internal Review

As in the parallel executive compensation audits, it is important for EOs providing significant compensation and benefits packages to prepare for this level of scrutiny, particularly EOs that may be targets of these IRS investigations and private class-action lawsuits. To the extent they have not already done so, the best preparation would be to conduct an internal review of their compensation programs. The internal review should address the substance and level of the compensation and benefits arrangements, as well as the policies and procedures by which compensation and benefits are designed, reviewed, approved and implemented. Properly designing and scrupulously following such policies and procedures is critical to achieve compliance. (For previous coverage of preparing for an audit, see Newsletter, July 2004, p. 1.)

One of the most important aspects of an internal compliance review is to determine whether the organization has detailed data showing that the total compensation and benefits an EO provides to its executives is comparable to those provided by similarly situated organizations for like positions.

Also, to assess potential exposure to the intermediate sanction excise tax, the EO should determine whether it obtained a written opinion from its professional advisors concerning compliance under the intermediate sanctions provisions, including qualification for the rebuttable presumption of reasonableness.

EOs should also address the following legal questions before the IRS knocks on the door with its executive compensation checklist – many of which are inquiries currently being made by their for-profit counterparts in internal compliance reviews in response to the executive compensation audit initiative.


- If an IRS “soft contact” were to occur, exactly what documentation must, or should, be disclosed?
- What information is protected from disclosure by the attorney-client privilege, and will turning over a privileged document be considered a waiver of the privilege as to other compensation-related information that the organization would prefer not to disclose? In other words, as the result of turning over what the organization would like to disclose, what other (perhaps less favorable) information will have to be turned over?
- How strong is the organization’s argument that it has satisfied the IRS criteria for any rebuttable presumption or safe harbor protection?
- Has all compensation and benefits information (for officers and key employees) been properly reported? If not, is a corrected filing appropriate before the IRS initiates contact that could trigger application of the IRS’s position concerning automatic excess benefits?
- What is the most appropriate way to value and report deferred compensation arrangements?

If any compensation and benefits arrangements have not been adequately supported by appropriate documentation and an underlying legal rationale, is it prudent now to conduct a review and approval of future payments before an IRS “soft contact” occurs? In other

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### **Payment Cards** (continued from p. 1)

Rev. Proc. 2004-43 provides an optional procedure by which card users could determine whether payment card transactions are reportable under Code Section 6041 or 6041A. They or their authorized agents may also use this procedure in determining whether payment card transactions are reportable payments under the IRS TIN matching program.

The guidance could have an impact on accountable plan transactions under Code Section 62(c) (see ¶712 and ¶741 of the *Guide*). 

words, if the process and legal rationale by which compensation and benefits are reviewed and approved is lacking, should the substance of the arrangements be reviewed now to assess whether compensation and benefits would be considered reasonable and appropriate?

After completing the internal compliance review, the EO will need to determine how to address weaknesses identified in the structure, amount and corresponding support for compensation and benefits arrangements. Depending on the nature and extent of the weakness, options to consider in such cases range from prospective correction to voluntary disclosure to the IRS.

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### **Excess Benefits Transactions**

One significant issue for EOs will be how to address excess benefit transactions (such as the payment of unreasonable compensation or benefits to a senior executive). Identification of an excess benefit transaction requires full disclosure of the transaction, which, as part of the Form 990, is open to the public and will likely trigger IRS review of the transaction. Before making a required Form 990 disclosure of an excess benefit transaction, an EO should thoroughly analyze the transaction and should prepare and implement a complete correction plan.

In conducting this analysis, the EO as a general rule should examine every economic benefit it provides its officers, directors and key employees. Still, the IRS does consider certain types of economic benefits not to trigger an excess benefit transaction. Two of the most significant exceptions are for statutory fringe benefits and “accountable plan” payments. The former include (with some limitations) benefits such as:

- (1) working condition fringes;
- (2) no-additional-cost services;
- (3) qualified employee discounts;
- (4) de minimis fringes;
- (5) qualified transportation fringes;
- (6) qualified moving expenses reimbursements; and

*See Executive Compensation, p. 7*

### Business Travel May Be Increasing

Business travel hit a rocky road over the last few years amid heightened security concerns and a challenging economy. Two recent surveys suggest that business travel is coming back, however.

The National Business Travel Association (NBTA) in its “2004 Mid-year Travel Management Survey” has found a dramatic reversal in business travel spending in just the last year. In 2003, half of the employers the NBTA surveyed said their business travel spending was lower in 2003 than it had been in 2002; in 2004, less than half as many reported a drop in spending from the previous year. On the other hand, in 2003, approximately 30 percent of employers said they were spending more than in 2002; this year that number doubled. (See box).

According to the Society for Human Resource Management’s (SHRM) “2004 Benefits Survey Report,” many employers are willing to cover employees’ travel-related expenses and let them keep frequent flier miles they earn while traveling for their employers on business. (See ¶921 of the *Guide* for more on frequent flier miles).

More than half of employers provide per diems for meals during business travel, regardless of sector or size (see ¶754 and Appendix A for more on per diems). SHRM did find, however, that large employers were more likely to do so than medium-sized or small employers (75, 68 and 63 percent, respectively).


An employer’s business, not its size, may be more relevant to whether it is likely to let its employees keep their frequent flier miles. More than 50 percent of employers in most, but not all, sectors SHRM examined – finance, high

technology, manufacturing, service and wholesale/retail trade – allow their employees to keep the miles, but less than half of employers in the government and health care sectors do. Large majorities of small (1-99 employees), medium-sized (100-499 employees) and large employers (500 or more employees) allow retention.

### GSA to Release 2005 CONUS Per Diem Rates

The General Services Administration (GSA) is getting set to issue fiscal year 2005 lodging, meals and incidental expenses (M&IE) and maximum per diem rates for travel within the continental United States (CONUS). The GSA issues the rates around Sept. 1 and they go into effect on Oct. 1, the start of the new federal fiscal year. (See ¶750 and Appendix B of the *Guide*.) At press time, the GSA had not yet released the 2005 rates.

Each year, the GSA sets new CONUS rates for M&IE as well as lodging, and a maximum per diem that is computed by adding those rates together, for hundreds of locations in the United States.

The CONUS rates are intended for use by federal employers in reimbursing their employees’ business travel-related expenses; however, they are important to private employers as well. Since the rates cover hundreds of sites and account for differences in price between locations, it is convenient for private employers to use them; in addition, the rates form a threshold relevant to the tax treatment of private employers’ reimbursements of employees’ business travel-related expenses (see ¶752). 

## How Business Travel Spending Compares to the Previous Year

Spending Compared to Previous Year	2004	2003
<i>Decreases</i>		
Up to 5 percent	10.2 percent	12.3 percent
5-10 percent	8.6	15.3
>10 percent	3.6	23.3
Total decreases	22.4	50.9
<i>Increases</i>		
Up to 5 percent	25.7	17.8
5-10 percent	21.8	8.0
>10 percent	13.8	5.5
Total increases	61.3	31.3

Source: NBTA, 2004 Mid-year Travel Management Survey.

## Finding out More About Federal Travel Policy

Employers and plan administrators can obtain more information from the General Services Administration Office of Travel Management Policy about federal travel policy from the following sources:

#### On the Web

Go to [www.gsa.gov/travelpolicy](http://www.gsa.gov/travelpolicy)

#### By phone

Office of Travel Management Policy – (202) 501-1538

#### OTMP Officials:

Director Peggy DeProspero – (202) 501-2826

Deputy Director Jim Harte – (202) 501-0483

Travel Team Leader Ed Davis – (202) 208-7638

Federal Premier Lodging Program Manager Rick Freda – (202) 219-3500

### **Aircraft Owners Must Pay Transportation Excise Tax, Despite Using Own Aircraft**

An aircraft owner, even a fractional owner of aircraft, must pay excise tax on the fees it paid to an aircraft management company for services directly and indirectly related to maintaining and providing aircraft transportation, according to IRS Letter Ruling 200425048 (Technical Advice Memorandum 143115-03). Under Code Section 4261, a person paying for taxable transportation must pay an excise tax to be collected by the entity receiving the payment. Paying taxable transportation means paying someone else to provide the transportation – that is, someone else with the possession, control and command of the aircraft.

The IRS said that in this case, the aircraft owner essentially turned over the possession and control to the management company. This was because the aircraft management company supplied the crew and support personnel and was responsible for operations, maintenance and insurance expenses. This differs from the situation in which a corporate aircraft owner retains exclusive control over the aircraft and essentially deputized an airline company as an agent to operate and maintain the aircraft.

Here, the aircraft management company was responsible for inspecting, maintaining, repairing, overhauling and testing the aircraft at its own expense; for making all necessary take-off, flight and landing arrangements; applying trained and qualified pilots, pilot training, pilot medical exams and uniforms; and providing hangar space, general storage space, tie-down, in-flight catering, communications, flight planning and weather services. Also at its own expense, the management company was responsible in securing all-risk aircraft hull insurance and liability insurance, and for keeping appropriate

PLRs do not have the force and effect of law, nor are they official IRS guidance. Nonetheless, employers should be aware of the views the IRS expresses in PLRs since they suggest how the IRS interprets the law with regard to a specific situation and how the IRS may apply the law in similar scenarios.

logs and records as required by the Federal Aviation Agency (FAA).

Therefore, the monthly management fees and the variable rate (hourly rate for fractional use of the aircraft) fees are taxable as transportation costs. (For more on fractional ownership, see Newsletter, September 2002, p. 10.) The IRS conceded that certain services were not transportation services: cost of meals, passenger use of telephone or facsimile services, limousine or ground handling costs. Corresponding fees are not taxable as transportation expense.

### **Department of Transportation Issues New SIFL Rates**

The Department of Transportation (DOT) has issued the new standard industry fare level (SIFL) rates and terminal charges applicable during the second half of 2004. (See box; also see ¶105 and ¶913 of the *Guide*.)

Jack Schmidt, senior analyst at DOT's Office of Aviation Analysis, said that overall charges were 2 percent higher than those set for the first half of 2004. He said the largest factor affecting the SIFL rates was the price of fuel, which rose during the period used to set the rates.

The SIFL rates and terminal charges the DOT just issued will apply to flights taken between July 1 and Dec. 31 – the second half of 2004. In general, flights taken between July 1 through Dec. 31 of a calendar year should use the SIFL rates and terminal charges derived from conditions that existed in the first half of the year. Similarly, flights taken from Jan. 1 through June 30 of a calendar year should use the SIFL rates and terminal charges derived from conditions that existed at the end of the previous year.

The new rates are provided in this month's update. 🏠

### **SIFL Rates Applicable July 1-Dec. 31, 2004**

Terminal charge: \$35.21

Up to 500 miles = \$0.1926

501-1,500 miles = \$0.1469

Over 1,501 miles = \$0.1412

**Employers Feeling Better About Relocations, Studies Find**

More employers are now willing to relocate employees than last year, recent studies indicate. Employers that have large work forces and do business in certain sectors are particularly likely to relocate employees.

*The numbers*

One-third of employers told Atlas in its 37th annual relocation survey they expect to relocate more employees in 2004 than in the year before, a dramatic increase over the number that did in the previous two years. More than twice as many employers expect to increase their relocation budgets as did last year, and the number that expect to reduce relocations has dropped by almost half. (See Table 1.)

employees. While 51 percent of Atlas respondents overall said it was the top external factor affecting their relocations, 70 percent of large employers said so. A related internal factor, budget constraints, was twice as important to large employers than to any others.

Large employers are more concerned about the economy than smaller employers; nonetheless, a higher percentage of large employers expect to increase the number of relocations. In 2004, 44 percent of them told Atlas they expect more relocations; 30 percent of medium-sized employers (500-4,999 employees) and 27 percent of small employers (less than 500 employees) do.

Relocation assistance benefits (see ¶1000 of the *Guide*) are more plentiful among large employers as well, according to the Society of Human Resource

**Table 1  
Employers' Relocation Expectations**

Number of Relocations Will...	2002	2003	2004	Change, 2003-04
Grow	20	13	33	+20 percentage points
Remain the same	47	58	51	-7 percentage points
Shrink	33	29	16	-13 percentage points

Source: Atlas Van Lines, 36th Annual Corporate Relocation Survey and 37th Annual Corporate Relocation Survey.

Runzheimer International reports an even longer-term increase in relocations. Atlas may have found that far more employers expected the number of relocations in 2003 to stay the same or drop than expected them to increase, but Runzheimer found that employers relocated an average of 55 percent more employees in 2003 than in 2000.

*Workforce size matters...*

The more numerous the employees, the more likely economic concerns will influence whether to move an employee.

The economy matters most to large employers – which Atlas considers to be those with 5,000 or more

Management's (SHRM) 2004 Benefits Survey Report (see Table 2). The results of a Runzheimer study appear to support this finding. Almost three-fourths – 72 percent – of Runzheimer respondents have 1,000 or more employees; 83 percent of them help employees visit locations to which they are moving and sell their existing houses, and 42 percent provide spousal relocation assistance.

*...and sector's a factor*

Relocation is especially common among employees whose jobs involve sales. Runzheimer says 81 percent of the employers it studied transferred sales and marketing employees. SHRM found that employers in the

**Table 2  
Employers Offering Forms of Relocation Assistance, by Size\***

Benefit	Small	Medium	Large
Overall relocation fee	33	46	52
Location visit assistance	29	38	55
Spouse relocation assistance	13	21	31
Assistance selling house	9	19	38
Mortgage assistance	7	11	20
Downpayment assistance	2	8	16

\*Small: 1-99 employees; Medium-sized: 100-499 employees; Large: 500 or more employees.

Source: SHRM, 2004 Benefits Survey Report.

manufacturing sector – one requiring a good sales force – were the best at providing assistance with overall relocation fees, paying for visits to new locations, spousal relocation, selling existing houses, securing new mortgages and making downpayments (see ¶1012 and ¶1011 for more on spousal relocation and assistance in selling existing houses).

Employees who perform highly technical functions also appear especially likely to be relocated. Sixty-seven percent of employers told Runzheimer they relocated engineers, scientists and technicians, and SHRM found that employers in the high-tech sector were among the most likely to offer location visit assistance.

### GSA May Revamp Federal Relocation Policy

The General Services Administration (GSA) is continuing to examine federal relocation policies. Its effort could affect employers in the private as well as public sectors. (See ¶1000 of the *Guide* for more on relocation assistance.)

The GSA plans to create the Governmentwide Relocation Advisory Board to review relocation allowances and policies under federal travel regulations, share best practices and recommend changes to federal relocation policies. “The Board will undertake a process of research that will yield recommendations for improving the management of relocation and for establishing policy in the federal government,” according to Dr. Adlore Chaudier, who heads the lodging program run by the GSA’s Office of Governmentwide Policy.


To do that, the board will be comprised of a cross-section of government and industry. “GSA hopes to obtain the

benefits of insight, experience, and the multiple perspectives of relocation experts,” says Chaudier. And the GSA has already begun to find them, he reports. “We have identified a group of relocation experts from the public and private sectors [to serve] as board members.”

Although intending to apply private industry practices in providing relocation assistance, the GSA won’t engage in a blanket adoption, according to Chaudier. “One cannot always assume that what works well in one corporate environment will work well in another, and the same is true for the federal government (that is, a corporate practice may not necessarily work well within the federal government).”

For example, says Chaudier, “Corporations may manage relocation through an outsource solution or through an in-house program. Some corporations have lump sum allowance programs and some do not. Variations abound.” The diversity of employers’ needs explains the lack of uniformity in relocation practices and policies reflects, he says. “Comparing relocation policies across industry groups reveals clear differences in policy choices and programs.”

The new board will meet from this year through July 2005. This is not the first time the GSA has formed such a body. From September 2002 to March 2003, the GSA Relocation Best Practices Committee met to measure federal relocation policy against that of private employers.

Federal relocation policy primarily affects federal employees, but there is some overlap between public and private employers’ relocation assistance programs. At the very least, public and private-sector employers must follow the same thresholds and rules regarding tax treatment of relocation assistance benefits. 


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### Executive Compensation (continued from p. 3)

- (7) qualified retirement planning services. (See ¶400, ¶300, ¶200, ¶500, ¶600, ¶1000 and Code Section 132 in Appendix A for more on these benefits, respectively.)

Working condition fringes are by far the broadest of these and offer the most planning opportunity to avoid excess benefit transactions. The accountable plan payments include reimbursements or payments for reasonable and documented travel expenses (see ¶741), educational expenses and other trade or business expenses that are typically deductible under Section 162 by a taxable entity. Consequently, accountable plans also can provide a method to provide a broad range of benefits that will avoid excess benefit transactions.

When undertaking prospective correction of current arrangements and establishing new arrangements, the

EO should strive to qualify for the intermediate sanction rebuttable presumption of reasonableness and prepare appropriate documentation to that effect, including a written legal opinion. Obtaining a legal opinion will require close coordination of the legal analysis with those responsible for developing the appropriate comparability data. As part of this process, the EO should very carefully analyze the favorable impact of structuring benefits as statutory fringes or accountable plan payments. 

Ralph DeJong and Bernadette Broccolo are partners in the health law department of McDermott, Will & Emery’s Chicago office. David R. Fuller is a partner in, and Jerry E. Holmes is of counsel to, the tax department of MWE’s Washington, D.C. office. Fuller and Holmes are the contributing editors of the *Guide*.

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