



Documents for Podcast 006
Reimbursing Employee's Business Expenses
July 23, 2005



Feed address for Podcast subscription:
<http://feeds.feedburner.com/EdZollarsTaxUpdate>
Home page for Podcast: <http://ezollars.libsyn.com>
©2005, Edward K. Zollars, CPA

The TaxUpdate podcast is intended for tax professionals and is not designed for those not skilled in independent tax research. All readers and listeners are expected to do their own research to confirm items raised in this presentation before relying upon the positions presented.

The podcast and this document may be reproduced freely so long as no fee is charged for the use of the podcast or document and attribution of the source of the works is included with such distribution. Such prohibited use would include using this podcast or document as part of a CPE presentation for which a fee is charged with advance permission from the author.

A key issue that many CPAs deal with in working with small business clients is trying to handle the problem of reimbursing expenses of employees of their clients, including employees who have an ownership interest in the corporate entities.

The Issue

Employees face a less than wonderful tax result from unreimbursed expenses incurred in the course of their job. The good news is that employment is a trade or business, and employees generally get the benefit of the broad "ordinary and necessary" test in Section 162(a). But the good news pretty much ends there for employees.

The key problem begins with IRC Section 62, which defines what expenses are deductible in computing adjusted gross income. Section 62(a)(1) allows trade or business deductions in computing adjusted gross income except, generally, for expenses incurred as an employee.

That's not good news, as the deductions manage to "fall through" to become miscellaneous itemized deductions. Mechanically that happens because §67 defines that all deductions not allowed in computing adjusted gross income (which means those allowed by Section 62 above the line) are to be considered miscellaneous itemized

deductions subject to the 2% of adjusted gross income reduction.¹ The business deductions incurred by an employee are not one of the “blessed” itemized deductions listed at §67(b) allowed to escape the 2% haircut. Thus, unless the expenses, along with other miscellaneous itemized deductions, rise to a high enough level to clear that 2% hurdle no benefit will be obtained even if the taxpayer has sufficient deductions to clear the standard deduction that would have been allowed in any even.

If that weren't bad enough, Congress also denies any deduction for such miscellaneous itemized deductions in computing the alternative minimum tax.² Thus, as §67(a) penalizes employees who haven't incurred enough expenses, §56 places an effective upper limit on the amount of deduction that can be claimed.

Rescuing a Deduction

IRC Section 62(a)(2) does provide a list of employee business deductions that are allowed to be deducted above the line, thus avoiding the problem noted above. Five classes of expenses that are deductible in computing adjusted gross income are listed there, with four of the classes depending on the type of employment and one being available regardless of the nature of a person's employment.

The industry or job specific provisions are summarized below:

- *Certain expenses of performing artists.* Deductions allowed by Section 162 paid or incurred by a “qualified performing artist” in connection with the performance of services by him in the performing arts as an employee are allowed to be deducted in computing adjusted gross income.³ Note that the individual must meet the tests found at §62(b), which impose a number of hoops to jump through, tests that are meant to both deny the deduction to “casual” performing artists, those who do not incur sufficient expenses and those whose earnings exceed a relatively low amount. Suffice it to say this exception won't apply to very many taxpayers.
- *Certain expenses of public officials.* Deductions allowed by Section 162 paid or incurred by an official of a state or political subdivision of a state for position compensated in whole or in part on a fee basis.⁴
- *Certain expenses of elementary and secondary school teachers.* A very limited deduction (capped at \$250) is available for specified classroom expenses paid by an “eligible educator” (as defined at §62(d)(1)) not otherwise excluded under §§135, 529(c)(1) or 530(d)(2). The “eligible educator” is defined as a kindergarten through grade 12 teacher, instructor, counselor, principal or aide in a school (as defined under

1 §67(b)

2 §56(b)(1)(A)(i)

3 §62(a)(2)(B)

4 §62(a)(2)(C)

state law⁵) for at least 900 hours during a school year.

- *Certain expenses of members of the reserve components of the Armed Services.* A limited deduction is available for expenses (capped at the rate authorized for travel expenses for employees of agencies under federal law) incurred by a member who is more than 100 miles away from home in connection with his reserve services.⁶

Since most employees don't fall within those categories, and even some that do will find some of all of their expenses don't qualify for special treatment, the exclusion that we are generally most interested in is the one found at §62(b)(2)(A). That provision allows for the exclusion by an employee of expenses reimbursed by the employee's employer.

If you stop your reading at that point in Section 62, this appears to present a bonanza with few restrictions. But if you keep reading your joy will be short lived—there are conditions imposed at §62(c) that can result in the arrangement not being treated as a reimbursement arrangement for purposes of §62(b)(2)(A). Thus you find you are dealing with concept of an accountable plan.

Accountable Plans

IRC Section 62(c) provides:

62(c) *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.*

The substantiation requirements of the preceding sentence shall not apply to any expense to the extent that substantiation is not required under section 274(d) for such expense by reason of the regulations prescribed under the 2nd sentence thereof.

This relatively short piece of text has spawned a much larger regulation found at Regulation §1.62-2. Your first hint at the length of the regulation comes when you find that Regulation §1.62-2(a) consists solely of a table of contents for the rest of the regulation.

However, the Code is clear on two facts—for the plan to count as a reimbursement arrangement the employee must substantiate all expenses *and* the employee must agree to return any amount received in excess of the substantiated

5 §62(d)(1)(B)

6 §62(b)(2)(E)

amount.

Regulation §1.62-2(c)(1) outlines a three part test for the the plan, requiring the plan to meet

- a business connection test;
- a substantiation test; and
- a test regarding the return of amounts paid in excess of expenses.

The regulation points out that an employer may have multiple arrangements with the same employee—that is, you don't have to have a single overarching “plan” even just considering a single employee, but rather can operate a number of arrangements with that employee and/or be deemed to operate multiple arrangements (such as when the employer reimburses both deductible and nondeductible amounts as described in Regulation §1.62-2(d)(2)).

A plan that passes all three tests is defined as an accountable plan⁷ while arrangements that fail any of the tests are defined as a nonaccountable plan.⁸ Payments under accountable plans are excluded from an employee's gross income, are exempt from withholding and are not subject to FICA and FUTA tax.⁹ Payments under nonaccountable plans are included in an employee's gross income and W-2, are subject to tax withholding, FICA and FUTA. Expenses related to such payments that are otherwise deductible may still be deducted, but only as miscellaneous itemized deductions with the tax problems noted earlier.¹⁰

Business Connection

Regulation §1.62(d) outlines the business connection test for the arrangement. To be an accountable plan, the arrangement must reimburse only those expenses that are allowable deductions by part VI, subchapter B, chapter 1 of the Internal Revenue Code. The employer or an agent of the employer may actually make the payment, and can include amounts charged directly or indirectly to an employer (such as through a credit card). If paychecks include both wages and reimbursements (something that quite often happens), the reimbursement or expense allowance portion of the payment must be specifically identified.¹¹

If the plan provides for reimbursement of both items that are deductible and those that are not (say travel not away from home), then the employer is treated as having two arrangements—an accountable one for the deductible expenses (presuming all other

⁷ Regulation §1.62-2(c)(2)

⁸ Regulation §1.62-2(c)(3)

⁹ Regulation §1.62-2(c)(4) If applicable, the wages are also not subject to Railroad Retirement Tax Act or Railroad Unemployment Tax Act taxes.

¹⁰ Regulation §1.62-2(c)(5)

¹¹ Regulation §1.62-2(d)(1)

requirements are met) and a nonaccountable one for the other expenses, with the tax treatments described above.

The regulation specifically addresses the concept of "allowances" that are paid as a matter of right whether or not the expense is incurred, by providing that such payments are automatically considered paid in full under a nonaccountable plan.¹² Quite often clients want to use this sort of arrangement due to pressure from employees who don't want to be bothered with the work involved in keeping a detailed accounting. The employer will need to explain to those employees that if they aren't willing to account for the payments, the amounts will be considered taxable wages.

Substantiation Requirement

Different tests for adequate substantiation apply depending on whether the expense is one covered by the documentation requirements of §274(d).¹³ For those expenses covered by the §274(d) substantiation requirements, the plan will not be considered an accountable plan with regard to these expenses unless the employee is required to meet the specific requirements of §274(d) and the related regulations.

For other expenses, §1.62(e)(3) provides that an expense will only be treated as substantiated if the employee gives the employer enough information to identify the *specific* nature of each expense and to conclude that the expense is attributable to the

¹² Regulation §1.62-2(d)(3)(i)

¹³ IRC §274(d) provides:

SUBSTANTIATION REQUIRED. --

No deduction or credit shall be allowed --

- (1) under section 162 or 212 for any traveling expense (including meals and lodging while away from home),
- (2) for any item with respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, or with respect to a facility used in connection with such an activity,
- (3) for any expense for gifts, or
- (4) with respect to any listed property (as defined in section 280F(d)(4)),

unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating the taxpayer's own statement (A) the amount of such expense or other item, (B) the time and place of the travel, entertainment, amusement, recreation, or use of the facility or property, or the date and description of the gift, (C) the business purpose of the expense or other item, and (D) the business relationship to the taxpayer of persons entertained, using the facility or property, or receiving the gift. The Secretary may by regulations provide that some or all of the requirements of the preceding sentence shall not apply in the case of an expense which does not exceed an amount prescribed pursuant to such regulations. This subsection shall not apply to any qualified nonpersonal use vehicle (as defined in subsection (i)).

employer's trade or business. The regulation specifically labels as insufficient an aggregation of expenses into broad categories (the employee reports only that he/she spent \$500 on "travel" with no supporting detail) or reports individual expenses using only vague, nondescriptive terms (such as "miscellaneous business expenses").¹⁴ A plan that allows for such reporting will be a nonaccountable plan.

Returning Amounts in Excess of Expenses

Regulation §1.62-2(f)(1) provides the general outline of what is considered to be a plan that requires the return of amounts in excess of expenses. A plan must require the return of excess funds within a *reasonable period* of time any amounts received in excess of the amounts substantiated in order to be an accountable plan.¹⁵ If the plan advances funds before expenses are incurred, the amounts advanced must be reasonably calculated so that they are not expected to exceed the actual expense to be incurred. Such advance must also be made on a day within a *reasonable period* of the day when the actual expenditure is expected to be made.

That is, an employer cannot use this provision to make a large interest free loan to an employee in January of an amount double what the employer expects the employee will actually incur on a business trip to be taken in December. Both the amount of the advance and the time period the advance is made before expected payment need to be limited in order to comply with this part of the definition.

Regulation 1.62-2(g) spells out what exactly is meant by a reasonable period of time and the consequences of a plan that appears to be structured to overpay the advances. The general rule is that a *reasonable period of time* will be a facts and circumstances determination.¹⁶ However, two safe harbor methods are provided that employers can use to insure their plans meet the reasonable time requirements.

Fixed date method. The following time periods will be deemed reasonable under this safe harbor:

- Advances made no more than 30 days before an expense is paid or incurred;
- Substantiation made to the employer within 60 days after the expense is paid or incurred; and
- Repayment made within 120 days after the expense is paid or incurred

Or, in essence, there is no way that an employee could hold onto unspent funds for more than 150 days, and then only in the event the advance was made exactly 30 days before the expense was incurred.

Periodic statement method. Instead of the fixed date safe harbors, an employer

¹⁴ Regulation §1.62-2(e)(3)

¹⁵ Regulation §1.62-2(f)(1)

¹⁶ Regulation §1.62-2(g)(1)

can provide the employees with a statement no less frequently than quarterly showing the gross advances paid, the expenses substantiated through the statement date, and the net unsubstantiated expense amount, requesting that the employee either substantiate the expense or repay the excess within 120 days of the statement. Any expense substantiated or repaid within that period will be deemed to have taken place within a reasonable time.

Pattern of overpayment exception to safe harbors. The safe harbors will not apply, however, if the employer has a plan or *practice* to provide employees with an amount in excess of the substantiated expenses and to avoid reporting or withholding on such amounts. What that means is that if the employer continually grants excessive advances to employees, the plan may be deemed nonaccountable based on either its design or actual operation. The issue here appears to be to capture what could otherwise become “disguised loans” to employees through creative use of advances. You should warn clients that appear to quite often have made excessive advances that continuing to do so could jeopardize both the employee’s tax treatment for the expenses in question and the employer’s liability for payroll taxes.

Salary Reduction Issues

Some might want to try and just “fine tune” this by designating a portion of salary as reimbursement of business expenses at an amount the employee sees will equal his/her expenses. Looked at “straight on” such a program would immediately raise problems—if the employee was moving around funds that he/she had a right to receive as wages and just reclassifying them as “not wages” the transaction appears to fail—generally taxpayers cannot avoid income otherwise due to them by entering into an agreement to have it called something else. Specifically, recharacterizing wages would run afoul of the restrictive definition found in Section 62(c) that we’ve been discussing.

However, in 1999 the IRS issued a private letter ruling that suggested that an employer could do an “informal” salary reduction arrangement with an employee to get a tailored expense reimbursement plan for each employee. In Letter Ruling 199916011, the IRS indicated they had approved of a program where the employer each year would determine an amount that would be excluded from each employee’s salary for the year and treated as paid under an accountable plan, an amount that would be different for each employee. While not stated in the ruling, PPC’s *1040 Deskbook’s* authors suggest (and I agree) that it seems likely an employee would have had input on any real world implementation of this.¹⁷

However, the IRS shortly thereafter had a change of heart, and in Letter Ruling 200035012 held that the employer above could not rely on that ruling after June 30, 2000. This suggests that employers and employees who wish to avoid the wrath of the IRS should not take actions that appear to involve setting up an informal wage reduction plan

¹⁷ Key Issue 17B, *PPC 1120 Deskbook*, 2005 edition

to reclassify amounts that would otherwise be received as wages as reimbursements. Such an arrangement might be alleged if an employee agreed to wage cut while simultaneously receiving an expense allowance of a similar amount that just happened to be approximately equal to what was reported on the employee's Form 2106 in the prior year.

Suing the Employer—Can a Civil Court Judgement Create an Accountable Plan?

In a 2002 Tax Court reported case, a taxpayer attempted to get amounts paid by his employer for his legal fees incurred in a suit against the employer treated as paid under an accountable plan. The Tax Court held that in that case, the employee did not receive payments under an accountable plan because the expense failed the business connection requirement in the regulations, as it was not incurred on behalf of the employer, even if incurred *because* of the employer.¹⁸ As such it failed the test for an accountable plan and, as noted earlier, if it's not accountable then the amount received is income and the deduction moves to the miscellaneous itemized deduction category.

While the addition of §62(c)(19)'s exclusion of awards related to attorney's fees arising from discrimination and certain other suits renders this less of a problem, it still would be an issue for certain other payments that might be received from an employer as part of litigation.

¹⁸ *Biehl v. Commissioner*, 118 TC 467 (affd, CA9, 351 F3d 982, cert. denied)