Reimbursements Made To Employees Under An Accountable Plan

Introduction

Under Reg. §1.62-2(c)(4), reimbursements to employees that are treated as paid under an accountable plan are excluded from an employee's gross income, are not reported as wages or other compensation on the employee's W-2 and are exempt from the withholding and payment of employment taxes. In order to be considered an accountable plan, an organization's reimbursement arrangement must meet three requirements (Reg. §1.62-2(c)(2)(i)):

1. the amounts reimbursed must have a business connection,
2. any amounts paid under the reimbursement arrangement which are in excess of the actual expenses incurred must be returned by the employee to the employer within a reasonable time, and
3. the reimbursed expenses must be properly substantiated.

If any of these requirements are not met, then the reimbursements are treated as if they were made under a nonaccountable plan (discussed further below).

Business Connection

A reimbursement arrangement meets the "business connection" requirement if the plan pays reimbursements and allowances only for otherwise deductible business expenses (such as travel, lodging, or meal expenses incurred while away overnight on business). (Reg. §1.62-2(d)(1).) If a plan provides reimbursements for other bona fide expenses related to the organization's business that are not deductible (e.g., travel while not away from home, certain spouse/guest travel, etc.), the organization is treated as maintaining two plans: an accountable plan for the reimbursement of expenses that are otherwise deductible and a nonaccountable plan for other bona fide business expenses that are not otherwise deductible. (Reg. §1.62-2(d)(2).) See below for a discussion of reimbursement of expenses under a nonaccountable plan.

In general, the deduction for otherwise deductible meals and entertainment expenses is limited to 50% of the amount paid. (IRC §274(n).) However, this limitation does not apply to expenses incurred by a taxpayer in connection with the performance of services for an employer under a reimbursement or other expense allowance arrangement in which the expense is not treated as compensation. (IRC §274(n)(2)(A).) Therefore, an employer may reimburse employees for 100% of otherwise deductible meals and entertainment expenses and none of the reimbursement is includible in the employee's gross income (assuming the substantiation and return of excess requirements are met). However, the percentage limitation on the deduction (if applicable) for those expenses applies to the employer making the reimbursement. (S Rept No. 99-313 (PL 99-514) p. 71.)

IRC §274(m)(3) generally disallows a deduction for travel expenses paid or incurred with respect to a spouse, dependent or other individual accompanying the employee on business travel unless: (1) the spouse, dependent, or other individual is also an employee of the employer, (2) the travel of the spouse, dependent, or other individual is for a bona fide business purpose, and (3) the expenses would otherwise be deductible by the spouse, dependent or other individual. This rule effectively disallows a deduction for payments for spouse travel notwithstanding that business reasons may require the spouse or other individual to accompany the employee and that such spouse travel expenses would, absent this rule, be otherwise deductible as an ordinary and necessary business expense. In the context of a reimbursement arrangement, since the exclusion of a reimbursement from an employee's income depends upon the deductibility of the item if incurred by the employee, the disallowance under IRC §274(m)(3) effectively disallows an employer's deduction, requires inclusion in the employee's income and disallows an employee's deduction for the spouse travel. To prevent this result, the IRS issued a regulation which allows the reimbursement by an employer of spouse travel expenses to be excluded from an employee's income if it can be adequately shown that the spouse's presence on the business trip has a bona fide business purpose, and if the employee properly substantiates the expenses. (Reg. §1.132-5(t)(1).) The IRS further clarified that the payment of spouse travel expenses by a tax-exempt employer is also eligible for exclusion from the employee's income, assuming the business purpose and substantiation requirements are met. (Reg. §1.132-5(t)(2)).
Returning Amounts in Excess of Expenses

Generally, a reimbursement arrangement meets the “returning amounts in excess of expenses” requirement if it requires the reimbursed individual to return to the organization within a reasonable time period any amount paid in excess of the substantiated expenses (the type of substantiation required is outlined below). (Reg. §1.62-2(g)(1).) While the determination of a “reasonable time period” depends upon all the facts and circumstances, the regulations provide two safe harbors: (1) the fixed date method, and (2) the periodic statement method.

Fixed Date Method: Under the “fixed date method,” the reasonable time requirements are met if: (1) no advance is made sooner than 30 days before the covered expense is paid or incurred, (2) the expense is substantiated within 60 days after it is paid or incurred, and (3) an advance in excess of substantiated expenses is repaid within 120 days after the expenses are paid or incurred. (Reg. §1.62-2(g)(2)(i).)

Periodic Statement Method: The second safe harbor focuses on the use of a periodic statement to inform the payee of any excess advances or other unsubstantiated amounts. Here, the timeliness requirement is met if the organization provides a statement of the amount of excess advance not yet substantiated and requests any excess advance or unsubstantiated amount either be (1) substantiated or (2) returned to the organization within 120 days of the statement. The organization must issue a periodic statement on at least a quarterly basis in order to meet this safe harbor. (Reg. §1.62-2(g)(2)(ii).)

Proper Substantiation

Finally, a reimbursement arrangement will be considered an “accountable plan” if it requires each business expense to be substantiated with adequate records to the organization within a reasonable time. (Reg. §1.62-2(e)(1).)

Elements to be substantiated: Adequate substantiation must include the following elements:

1. the amount paid,
2. the date paid,
3. the place traveled or a description of the item/service purchased,
4. the essential character of the expense (i.e., the business purpose for the expenditure),
5. for meals, entertainment and gift expenses, the occupations or other information (such as names, titles or other designations) about the recipients that shows their business relationship to the organization, and
6. for meals, proof that an officer or employee was present during the meal.

Adequate records: Generally, to meet the adequate records requirement for proper substantiation, the following must be kept: (1) an account book, diary, log, statement of expense, trip sheet, or similar record, and (2) documentary evidence, which, in combination, are sufficient to establish each element of an expenditure. The account book, diary, log, statement of expense, trip sheet, or similar record must be recorded “at or near the time of the expenditure,” which means at such time as the individual making the expenditure has full present knowledge of each element of the expenditure. A written statement of business purpose is generally required. However, the degree of substantiation necessary to establish business purpose will vary depending upon the facts and circumstances. For example, in the case of a business meal, if the business purpose of the meal is evident from the business relationship of the persons entertained and other surrounding circumstances, a written explanation of the business purpose is not required. (Reg. §1.274-5T(c)(2); Reg. §1.274-5(f)(4).)

Documentary evidence required: Generally, documentary evidence to support an expense (such as receipts, paid bills or other evidence) is required in order for an expense to be considered adequately substantiated. (However, see below for instances in which documentary evidence is not required.) Ordinarily, documentary evidence will be considered adequate to support an expenditure if it includes sufficient information to establish the amount, date, place, and the essential character of the expense. Examples provided in the Treasury Regulations indicate that a hotel receipt is sufficient documentary evidence if it contains the name and location of the hotel, date, and separate amounts for charges such as lodging, meals and telephone. Similarly, a restaurant receipt is sufficient to support an expenditure for a business meal if it contains the name and location of the restaurant, the date and amount of the expenditure, the number of people served and an indication of any charges for items other than meals and beverages. (Reg. §1.274-5(c)(2)(iii).)
Documentary evidence **NOT** required: In certain cases involving travel, entertainment, gift and car expenses, receipts are not required. Receipts are not required if any of the following conditions apply, as long as the elements listed above are adequately substantiated (Reg. §1.274-5(c)(2)(iii)(A)):

1. Reimbursements for travel and car expenses, calculated using established federal rates (see below),
2. Reimbursements for travel (other than lodging), meals, entertainment, gifts and car expenses, of less than $75, or
3. Reimbursements for transportation expenses for which a receipt is not readily available (e.g. tolls, cab fare).

Established federal rates: Reimbursements may be made using established federal rates rather than reimbursing employees for actual expenses incurred. The federal rate can be figured using one of the following methods:

1. For travel, meals and incidental expenses (per diem amounts):
   a. The regular federal per diem rates
      The regular federal per diem rates may be used to reimburse lodging, meals and incidental expenses or meals and incidental expenses only. The rates vary depending upon the city/county where the travel takes place. The rates for cities/counties in the continental U.S. can be accessed online at [www.gsa.gov/perdiem](http://www.gsa.gov/perdiem) and foreign city rates can be accessed at [http://aoprals.state.gov/content.asp?content_id=184&menu_id=78](http://aoprals.state.gov/content.asp?content_id=184&menu_id=78). As of October 1, 2015, the rate is $140 per day (including $51 for meals and incidental expenses) for all cities located in the continental U.S. that are not specifically listed. (The rate for 10/1/14 – 9/30/15 was $129 per day (including $46 for meals and incidental expenses).)
   
   b. The high-low rates
      This is a simplified method of computing the federal per diem rate for travel in the continental United States. It eliminates the need to keep a current list of the per diem rates for each city/county. As of October 1, 2015, the per diem rate for high cost locations is $275 (including $68 for meals and incidental expenses) and for all other locations is $185 (including $57 for meals and incidental expenses). IRS Notice 2015-63, 2015-40 IRB, 09/16/2015 provides an updated list of locations eligible for the high cost rate. This method may be used even if **only** meals and incidental expenses are being reimbursed. (Rev. Proc. 2011-47, Sec. 5.01.) (The rates for 10/1/14 – 9/30/15 were $259 (including $65 for meals and incidental expenses) and $172 (including $52 for meals and incidental expenses) for high and low cost locations, respectively.) Generally, employers may choose to continue to use the old rates through December 31st of each year, but must do so consistently for all employees reimbursed using this method.
      
      An employer who reimburses an employee during the calendar year under either of the above methods must use that same method for all reimbursements made to that employee during the calendar year. (Rev. Proc. 2011-47, 2011-42 IRB 520, 09/30/2011; IRS Publication 1542.)

      Employers who use either the federal per diem rate or high-low rate method for travel within the continental United States may choose to reimburse travel outside of the continental United States using either the actual expenses method or the per diem method (either for lodging, meals and incidental expenses or for meals and incidental expenses only).

In determining the established federal reimbursement rates allowable, the full applicable meals and incidental expense (M&IE) federal rate is available for a full day of travel from 12:01 a.m. to 12:00 midnight. For employers who pay a per diem allowance in lieu of reimbursing actual lodging, meal, and incidental expenses (or in lieu of reimbursing actual meals and incidental expenses only), either of the following methods may be used to prorate the federal M&IE rate for partial days of travel. (For employees and self-employed individuals who are using the federal per diem rate in lieu of using actual expenses to compute the amount allowable as a deduction for ordinary and necessary meal and incidental expenses paid or incurred for travel away from home, only method (1) below may be used.)

(1) The rate may be prorated using the method prescribed by the Federal Travel Regulations. Currently the Federal Travel Regulations allow three-fourths of the applicable federal M&IE rate for each partial day during which the employee or self-employed individual is traveling away from home in connection with the performance of services as an employee or self-employed individual; or (2) The rate may be prorated using any method that is consistently applied and in accordance with reasonable business practice. For example, if
an employee travels away from home from 9 a.m. one day to 5 p.m. the next day, a method of proration that results in an amount equal to two times the federal M&IE rate will be treated as being in accordance with reasonable business practice (even though only one and a half times the federal M&IE rate would be allowed under the Federal Travel Regulations).

2. For car expenses, the standard mileage rate may be used, which is 54 cents per mile for 2016. (The rate for 2015 was 57.5 cents per mile.)

**Reimbursements Made To Employees Under A Nonaccountable Plan**

If expenses reimbursed under a reimbursement plan do not satisfy one or more of the requirements noted above for payments made under an accountable plan (e.g., the organization reimburses for bona fide business expenses that are not deductible or reimbursed expenses are not properly substantiated within a reasonable time period), such amounts are treated as paid under a nonaccountable plan. Any amounts treated as paid under a nonaccountable plan are included in the income of the recipient, must be reported as wages on an employee's Form W-2 and are subject to withholding and payment of income and FICA taxes (if applicable). Expenses attributable to amounts included in gross income may be deducted by the reimbursed individual, provided the individual can substantiate the full amount of his or her expenses (both the expenses reimbursed under the accountable plan and the expenses the individual is claiming as a deduction), but are subject to the 50% limit on meals and entertainment expenses and the 2% floor for unreimbursed employee business expenses.

**Examples**

**Example 1: Separate arrangement for travel and miscellaneous expenses.**

Under an arrangement that meets the requirements of an accountable plan, ABC Charity reimburses its employees for lodging and meal expenses incurred when they travel away from home on business. For its own convenience, ABC Charity also separately pays certain of its employees a $25 monthly allowance to cover the cost of small miscellaneous office expenses. ABC Charity does not require its employees to substantiate these miscellaneous expenses and does not require them to return the amounts by which the monthly allowance exceeds the miscellaneous expenses.

The monthly allowance arrangement is a nonaccountable plan. ABC Charity must report the monthly allowances as wages or other compensation on the employees’ Forms W-2 and must withhold and pay employment taxes on the monthly allowances when paid. The nonaccountable plan providing the monthly allowances is treated as separate from the accountable plan providing reimbursements for lodging and meal expenses incurred for travel away from home on ABC Charity business.

**Example 2: Excess per diem reimbursement.**

Under an arrangement that meets the requirements of an accountable plan, XYZ Church pays its employees a per diem allowance to cover lodging, meal, and incidental expenses incurred for travel away from home on XYZ Church business at a rate equal to 120 percent of the federal per diem rates to the localities to which the employees travel. XYZ Church does not require the employees to return the 20 percent by which the reimbursement for those expenses exceeds the amount deemed substantiated for each day of travel substantiated. Employee C substantiates six days of business travel away from home: Two days in a locality for which the amount deemed substantiated is $100 a day and four days in a locality for which the amount deemed substantiated is $125 a day. XYZ Church reimburses Employee C $840 for the six days of travel away from home (2 × (120% × $100) + 4 × (120% × $125)), and does not require Employee C to return the excess portion ($140 excess portion = (2 days × $20 ($120 − $100) + 4 days × $25 ($150 − $125)).

For the payroll period in which XYZ Church reimburses the expenses, XYZ Church must withhold and pay employment taxes on $140. XYZ Church must also include the $140 in the Employee C’s gross income reported on Form W-2.
Example 3: Timely substantiation.

Employer Z provides a $500 advance to Employee D for a trip away from home on Employer Z business. Employee D incurs $500 in business expenses on the trip. Employer Z uses the periodic statement method safe harbor. At the end of the quarter during which the trip occurred, Employer Z sends a quarterly statement to Employee D stating that $500 was advanced to Employee D during the quarter and that no expenses were substantiated and no excess amounts returned. The statement advises Employee D that Employee D must substantiate any additional business expenses within 120 days of the date of the statement, and must return any unsubstantiated excess within the 120-day period. Employee D fails to substantiate any expenses or to return the excess within the 120-day period. Employer Z treats the $500 as wages and withholds and pays employment taxes on the $500. After the 120-day period has expired, Employee D substantiates the $500 in travel expenses.

Employer Z properly reported and withheld and paid employment taxes on the $500 and no adjustments may be made. Employee D must include the $500 in gross income and may deduct the $500 of expenses as a miscellaneous itemized deduction subject to the 2-percent floor provided in IRC §67.