# Handling Business Expenses

## Accountable Reimbursement Plan Rules

The most advantageous way for employers to handle business expenses of employees is to reimburse them directly under an ***accountable reimbursement plan*** (ARP), avoiding the requirement for the payments to be reported as taxable income.

Outside an ARP, payments for expenses must be reported as taxable income to the employee. While the employee may then report the reimbursed expenses as miscellaneous itemized deductions by filing Form 2106 and Schedule A along with their personal income tax return, the reimbursed expenses are only deductible to the extent they exceed 2% of the employee's adjusted gross income.

### Reportable Payments

The following must be reported at year end as income to an employee on their Form W-2:

- Payments for expenses that were *not* reimbursed under an accountable reimbursement plan.
- Payments of employee personal expenses or taxable fringe benefits.
- Payments in excess of *actual* employee business expenses.
- Payments in excess of *allowable* IRS limits.

Payments such as these may also be subject to withholding requirements, including FICA and Medicare taxes.

### Non-reportable Business Expense Reimbursements

Expense reimbursements paid to an employee must meet the requirements of an ARP, or they must be added to the employee's wages for income and social security tax purposes. The amounts paid are then subject to tax withholding requirements.

**Accountable reimbursement plan requirements:**

1. **Employer-established**
   The employer must establish and operate the ARP. An employee cannot be reimbursed tax-free simply because they submit expense records. While a plan does not have to be in writing, having a formally established, written plan facilitates proving its existence to the IRS, if challenged, and provides a structure for describing employer-specific requirements.

2. **Reimbursement of expenses**
   The ARP must reimburse expenses in addition to compensation. An employer and employee cannot simply substitute tax-free reimbursements for taxable compensation the employee otherwise would have received. Even informal agreements that an employee will receive whatever is not used for expenses or will have their compensation reduced by expenses may invalidate the ARP. An invalid ARP will result in taxable reimbursement of expenses that are otherwise not reportable.

**Accountable reimbursement plan requirements, continued:**

**Business connection (deductible business expenses)**

The ARP must only reimburse for deductible business expenses and specifically identify the reimbursement or expense payment, keeping these amounts separate from other amounts (such as wages).

***Deductible business expenses – tax-free reimbursement***

If an expense would qualify as a business expense tax deduction of an employee, it can also qualify as a tax-free reimbursement under an ARP. For meals and entertainment expenses, an ARP may reimburse expenses at 100% that would only be deductible at 50%. Since tax deduction and tax-free reimbursement (if there is an ARP) are the same, this article generally refers to "tax deduction" or simply "deduction," even though it is a reimbursement.

Deductions for entertainment, transportation, office, and other customary business expenses are appropriate whenever they meet the "*ordinary and necessary*" test (Code Sec. 162). This means that the expense must be "ordinary and necessary" in the employee's day-to-day employment. The determination of what is "ordinary and necessary" is based on a factual examination of the particular expense. Basically, expenses are held to be "ordinary and necessary" if they can be expected to arise in the particular business and are appropriate and helpful to the development or conduct of a business.

Commuting expenses between a taxpayer's residence and a business location within the area of his tax home are never deductible. However, transportation from an employee's residence to temporary, minor assignments may be deductible. Spousal travel expenses are not deductible and reimbursements for these should be reported as income to the employee (or the employee's spouse if the reimbursement is made to the employee's spouse), unless the traveling spouse is performing assigned duties for the employer that are bona fide and significant.

***Travel Expenses: Transportation, meals, and lodging***

The following three conditions must be satisfied for traveling expenses, such as transportation, meals, and lodging, to be considered a deductible business expense:

a. The expense is ordinary (reasonable) and necessary as a traveling expense.
b. Food and lodging expenses are incurred while away from home (away from the general area of his tax home for a period substantially longer than an ordinary day's work, reasonably requiring rest or sleep).
c. The expense is incurred in the pursuit of business (Code Sec. 162(a)(2), Reg. Sec. 1.162-2).

***Business use of personally owned autos***

A self-employed individual or an employee who uses his personal car for business purposes can generally deduct the actual cost allocable to business use or use the optional standard mileage rate.

**Accountable reimbursement plan requirements, continued:**

3. **Business connection (deductible business expenses), continued**

   The optional maximum standard mileage rate is 53.5 cents per mile for 2017. This method includes a provision for straight-line depreciation on the car and cannot be used if depreciation was claimed on the car under any method other than the straight-line method in the past, or if the special expensing deduction of Code Sec. 179 has been utilized.

   An employer may reimburse for an employee's use of a personally owned vehicle at the same rate.

   ***Entertainment Expenses: Meals & Gifts***
   An employee's or contractor's meal with a client or business prospect may be deducted along with the meal of the other person. It should be noted that business meals are only deductible if they are "*directly related*" or "*associated with*" the active conduct of a taxpayer's trade or business. The standards for these are slightly different, but both require that the employee be present with the client.

   Gifts to clients or business prospects may also be deductible. The current tax deductible limit is $25. While everyone knows of business gifts with a greater value, such gifts are not tax deductible. An employee cannot reimburse a gift for a greater value under an accountable reimbursement plan, since expenses under such a plan are only tax free if the employee could claim it as tax deduction.

   ***Business Meals & Entertainment Limit***
   The deduction for business meals, including meals while traveling, and business entertainment is now limited to 50% of the actual cost. However, an employer may reimburse the employee tax-free under an ARP at 100%, as long as the employer only claims a deduction for 50% against the employer's taxable income. Unless the expense is associated with UBI, an exempt organization would not have any taxable income, but an exempt organization can still reimburse tax-free at 100% under an ARP.

4. **Substantiation (adequate accounting and documentation)**
   The employee must provide an adequate *accounting* with *documentation*, within a reasonable period of time. As a guideline for what is a reasonable period of time, the IRS has set a safe harbor rule for substantiation of 60 days after expenses are paid or incurred.

   ***Adequate accounting is required***
   For there to be "adequate accounting," the records must include:

   a. Amount.
   b. Date (and time for some purposes) and place of the travel, meal or transportation.
   c. Business purpose of the expense.
   d. Business relationship of persons entertained or fed.

   A fuller description is provided in Appendix A, which is excerpted from IRS Publication 463.

**Accountable reimbursement plan requirements, continued:**

4. **Substantiation (adequate accounting and documentation), continued**

***Documentation requirements***

Some common documentation issues and requirements are:

a. All lodging expenses must be documented by a receipt, unless a per diem plan is used.
b. Receipts are required for any other expense of $75 or more.
c. Credit card statements may be used to provide key elements of the accounting, such as the place and date and replace the receipt requirement. For a tax-free ARP, however, the employee must supplement the statement with documentation of other elements.

***Adequate records for auto use***

An account book, diary, log, statement or expense, trip sheet, or similar record prepared at or near the time of expenditure or use is certainly the best method of substantiating the business use of a vehicle and the best method of maximizing and protecting this deduction.

***Meal per diems***

The IRS has established standard per day amounts that taxpayers may use as an optional deduction for meal expenses incurred while away from home on business travel. U.S. rates are listed in IRS Publication 1542 and are available on the internet at: www.gsa.gov. Foreign rates are on the Internet at: http://aoprals.state.gov/content.asp?content_id=184&menu_id=81.

The use of the allowance is optional and does not relieve taxpayers of the obligation to document the time, place, and business purpose of the travel.

***Meal and lodging per diems***

The IRS has also established standard per day amounts for combined meal and lodging expenses. Rates for specific locations are listed in Publication 1542, or the websites listed above. For combination meal and lodging per diems in the US, the IRS has also established a simpler two tier system. If the simpler high-low method is used for an employee in a tax year, it must be used for that employee the entire tax year.

The daily amounts for 2017 are $282 in high-cost areas and $189 for all other locations. (See IRS Publication 1542 for a listing of high-cost areas.)

Documentation must still include time, place, and business purpose of the travel.

When using a per diem, or mileage for automobile usage, an employer may adopt a lower amount than the maximum IRS authorized amount.

5. **Return of excess amounts**

The ARP must require that excess amounts advanced, allowed, or reimbursed be returned within a reasonable period of time. As a guideline for what is a reasonable period of time, the IRS has set a safe harbor rule for advances, not more than 30 days before the anticipated expenses are paid or incurred, and for the return of excess amounts, within 120 days after expenses are paid or incurred.

**APPENDIX A**
**Table 5-1: How to Prove Certain Business Expenses**

| IF you have expenses for… | THEN you must keep records that show details of the following elements… | | | |
|---|---|---|---|---|
| | **Amount** | **Time** | **Place or Description** | **Business Purpose Business Relationship** |
| **Travel** | Cost of each separate expense for travel, lodging, and meals. Incidental expenses may be totaled in reasonable categories such as taxis, fees, and tips, etc. | Dates you left and returned for each trip and number of days spent on business. | Destination or area of your travel (name of city, town, or other designation). | Purpose: Business purpose for the expense or the business benefit gained or expected to be gained.<br>Relationship: N/A |
| **Entertainment** | Cost of each separate expense. Incidental expenses such as taxis, telephones, etc., may be totaled on a daily basis. | Date of entertainment. (Also see *Business Purpose*.) | Name and address or location of place of entertainment. Type of entertainment if not otherwise apparent. (Also see *Business Purpose*.) | Purpose: Business purpose for the expense or the business benefit gained or expected to be gained. For entertainment, the nature of the business discussion or activity. If the entertainment was directly before or after a business discussion: the date, place, nature, and duration of the business discussion, and the identities of the persons who took part in both the business discussion and the entertainment activity.<br>Relationship: Occupations or other information (such as names, titles, or other designations) about the recipients that shows their business relationship to you. For entertainment, you must also prove that you or your employee was present if the entertainment was a business meal. |
| **Gifts** | Cost of the gift. | Date of the gift. | Description of the gift. | |
| **Transportation** | Cost of each separate expense. For car expenses, the cost of the car and any improvements, the date you started using it for business, the mileage for each business use, and the total miles for the year. | Date of the expense. For car expenses, the date of the use of the car. | Your business destination. | Purpose: Business purpose for the expense.<br>Relationship: N/A |