T&E expenses: IRS compliance tips

Employees can be reimbursed for their travel and entertainment expenses (T&E) on a tax-free basis. However, if a T&E policy does not meet the IRS standards, or employees do not adequately substantiate their business expenses, their reimbursements are fully taxable. These standards are commonly referred to as the **accountable plan rules**.

Under these rules, employees must adequately account for their business expenses (e.g., by submitting receipts and an expense report) within a reasonable period of time, and return excess reimbursements or unused advances within a reasonable period of time. Under a *de minimis* rule, employees need not submit receipts for expenses under $75.

The accountable plan rules require that employees' expenses have a **business connection**. To have such a business connection, employees expenses' must either be **directly related** to business, or **associated with** business. In other words, expenses must be in connection with business, and not simply arise from, or have its origins in, the employee's trade or business.

Employees must **adequately account** to you within a reasonable period of time for their expenses. Under an IRS safe harbor, it is reasonable for employees to:

- receive an advance within 30 days of the time they incur an expense;
- adequately account for that expense within 60 days after an expense was paid or incurred; and
- return excess reimbursements or unused advances within 120 days after an expense was paid or incurred.

Alternatively, you can give employees periodic statements (at least quarterly) that ask them to either return or adequately account for outstanding amounts. If they comply within 120 days, the amounts are considered adequately accounted for or returned within a reasonable period of time.

Employees adequately account to you by providing you with documentary evidence—receipts, canceled checks, and bills—of their business expenses, along with a detailed itemized statement of expenses, account book, diary, or similar record of where they incurred each expense, at or near the time they incurred it. This latter requirement is commonly satisfied by submitting an expense report.

Even if all the accountable plan rules are met, the following reimbursements are taxable:

- Excess reimbursements employees fail to return.
- Reimbursements of nondeductible expenses related to your business.

Plans that fail one or more parts of the accountable plan rules (i.e., no business connection, employees fail to submit receipts/reports, employees fail to return excess amounts) are **non-accountable plans**. All reimbursements or advances made to employees under non-accountable plans are fully taxable. Plans that purport to reimburse employees by reducing their taxable pay are non-accountable plans.

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Meal and entertainment expenses

The accountable plan rules set the framework for reimbursing employees for their business expenses. In addition to being directly related to or associated with business, meal and entertainment expenses are reimbursable if they're ordinary and necessary and not lavish. As a rule, reimbursing employees for the cost of spouses' meals and entertainment is taxable. An exception exists if employees have a substantiated business reason for their spouse's presence.

The tax code doesn't subsidize taxpayers' personal activities, such as eating or commuting. Therefore, two special rules apply to reimbursing employees for their meal and entertainment expenses.

- **Employees who aren't traveling overnight must pick up someone else's tab.** That individual can't be a fellow employee, but must be a client, prospective client, or someone with a business connection to the expense.

- **Meals may be reimbursed tax-free only if employees must sleep or rest during the trip**. Employees don't necessarily have to be away overnight, but a catnap in a car doesn't count for this purpose.

Overnight travel

There are prerequisites employees must satisfy before you reimburse them tax-free for their overnight travel expenses.

- **Employees' travel must be temporary, rather than indefinite.** Employees who take week-long business trips are temporarily away from home; their reimbursements are tax-free. Employees who are away for one year or longer, or whom you expect to be away for one year or longer (even if they return within the one-year limit), are away indefinitely; their reimbursements are taxable.

- **The main purpose of the trip must be business.** Employees who travel into a locality a day or two before business are still traveling on business. However, if employees extend their stay to vacation, only their business expenses can be reimbursed tax-free. Employees generally can't be reimbursed tax-free for expenses related to their spouses, unless they have a business reason for their spouses to travel with them.

There are two ways employees are reimbursed for their out-of-pocket travel expenses. They can be reimbursed in full, if they've adequately accounted to you for every expense.

Alternatively, you may use per diem allowances. Per diems are flat sums you pay each day employees are traveling away from home. They cover meals, lodging, and incidental expenses, but not transportation. The IRS publishes a list of per diem rates in Pub. 1542.

If your per diems don't exceed the IRS' rates, employees don't have to account to you for the amount of the expense; it's considered proved. Employees must still provide you with an adequate accounting of the time, place, and business purpose of the trip, and they must submit receipts for expenses the per diems don't cover. If your per diems don't exceed the IRS' rates, the entire reimbursement is tax-free.

If your per diems exceed the IRS' rates, only the excess is taxable. Special W-2 rules apply when per diem reimbursements exceed the IRS' rates.

The high-low method is a simplified and shorter method of computing per diem rates used for high-cost localities. The IRS announces the high-low locations every year in a revenue procedure. The high-low method comes with significant restrictions, however. You may only use it if you're paying for lodging, meals and incidental expenses. Also, if you use the high-low method with respect to one employee, you must continue to use it every time that employee incurs traveling expenses for the entire year.

Non-overnight travel

Employees may drive their own cars on business, or they may drive company cars. Either way, they're entitled to be reimbursed for their business expenses. Commuting isn't business travel. Traveling from home to a temporary business location may be reimbursed if certain conditions are met:

- Employees travel between their homes and temporary work locations outside the metropolitan areas where they normally live and work.
- Regardless of distance, employees travel between their homes and temporary work locations, if they have at least one permanent work location away from their homes.
- Employees' work at these temporary locations is realistically expected to last, and does last, for one year or less.

You may reimburse employees who drive their own cars on business for tolls, parking and mileage, provided they submit receipts and meet the accountable plan rules' standards for substantiation and adequate accounting. The IRS has a standard mileage rate, which values miles on a cents-per-mile basis, that's used for this purpose. The IRS updates this mileage allowance every year. As with other per diem allowances, provided your per-mile reimbursement doesn't exceed the IRS' standard mileage rate, the entire reimbursement is tax-free. If your per-mile reimbursement exceeds the IRS' rate, only the excess is taxable.

On the other hand, employees may drive company cars. Business miles driven in company cars are tax-free. Employees are taxable on their personal miles. For convenience, you may consider all of the employees' miles to be personal (and, therefore, taxable). While they need not account to you for their business/personal miles, treating 100% of their use as personal use puts the burden on them to value and deduct their business miles on their 1040s. As another convenience, the tax code allows you to forgo withholding income taxes; FICA taxes must still be withheld. You must provide employees with a notice of your decision to not withhold income taxes by the later of January 31 or 30 days after the company car goes into service.

If you choose to value employees' personal miles, you have three options.

1. **The general valuation method**. To use this method, determine the car's fair market value by figuring out how much it costs to lease the same or comparable car on equivalent terms from a disinterested third party. Then multiply that amount by the ratio of personal miles to total miles. The result is the taxable value of employees' personal use.
2. **The lease valuation method**. Under this method, you first determine the fair market value of a leased car (see the general valuation method). Next, apply that figure to the IRS table, which lists the annual lease value. Finally, multiply that amount by the ratio of personal miles to total miles. The result is the taxable value of employees' personal use.
3. **The standard mileage rate method.** This is the same mileage rate you use to reimburse employees who drive their own cars on business. However, because this method is limited to extremely low-priced cars and SUVs, it's not a practical method to value employees' personal miles.

FAQs about T&E expenses

1. An employee traveled to Australia on business. He cashed in his frequent flyer miles, so the plane ticket ended up costing $35, instead of $650. However, he claimed the full $650 on his T&E form. What amount do we reimburse him—$35 or $650?

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You should reimburse the employee for his out-of-pocket expenses, or $35. Under the accountable plan rules, you may reimburse employees, tax-free, for expenses they actually incur.

2. The company offers employees who live 25 miles from the office a $50 monthly car allowance. The allowance is taxed, one-half every semimonthly pay period. Employees who drive their own cars on business receive a mileage allowance of 48 cents per mile, which isn't taxable or included on their pay stubs. Is this OK?

Yes, the company is treating both allowances properly. The $50 monthly allowance is taxable. To help employees understand why their taxable wages are more than their cash pay, it's a good idea to include the allowances on their pay stubs. Mileage reimbursements aren't taxable, provided employees account to you for the time, place, and business purpose of their trips. Since they're not taxable, you don't have to include them on employees' pay stubs.

3. An employee would like to trade his year-end bonus for an equal amount payable as travel expenses. We've never encountered this situation before; is it legal?

Probably not. It seems as if the employee is trying to evade taxes by having his taxable bonus paid as non-taxable travel reimbursements. Under the accountable plan rules, no travel expenses can be reimbursed on a tax-free basis unless the employee submits receipts and substantiates the time, place, and business purpose of the expense.

4. We're creating a cell phone reimbursement policy. What goes into such a policy?

Any company policy on cell phones should at least cover these points:

- Employees must timely submit detailed proof that their calls were business-related, whom they called (or who called), and the business discussed.
- Notations on monthly bills will suffice, provided the notations contain the requisite detail.
- After substantiation, employees will be reimbursed for their business calls.

5. The company hired an employee to work at a remote location for about a year. Since he won't be working anywhere near his current home, the company will pay him a per diem, pegged to the government's rate for the locality. Since our per diem doesn't exceed the government's rates, there's no withholding, right?

Wrong. The payment is taxable. *Per diems* and other reimbursements compensate employees for their out-of-pocket traveling expenses. But this employee isn't traveling. Instead, he's changing his tax home. A tax home is generally, but not always, the exact locale of employees' principal place of employment.

The company could, however, pick up his moving expenses and even help him sell his home tax-free.