BusinessManagement DAILY

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Lower tax through salary reduction plan

Suppose your employees regularly incur business expenses that aren't reimbursed by your company. For example, they might personally pay for business travel or tools. In that case, there's a way to save income tax for employees while cutting payroll taxes for your company.

Strategy: Set up a salary reduction plan. You set aside a small portion of employees' salaries and use it to reimburse them for out-of-pocket expenses.

To collect tax benefits for employees, the plan must be mandatory. Employees aren't allowed to have a choice in the matter. For instance, you can't let employees decide between having their salaries reduced and paying their own expenses.

Employees don't have to report the reimbursements as taxable income. So your employees will likely come out ahead on the deal.

Here's *why:* Unreimbursed employee business expenses that are paid out of an employee's own pocket must be treated as miscellaneous itemized deductions subject to a deduction threshold of 2% of adjusted gross income (AGI). Therefore, many taxpayers get little or no tax benefit from these expenses. Conversely, a salary reduction plan avoids the 2%-of-AGI deduction threshold and effectively allows an employee to pay the expenses with pretax dollars (equivalent to a deduction).

Note that highly paid employees with alternative minimum tax (AMT) concerns may also benefit from a salary reduction plan. *Reason:* Unreimbursed employee business expenses aren't deductible under the AMT calculation. A salary reduction plan reduces AMT exposure.

For its part, your company is relieved of payroll tax liability through this setup. Yet it can still deduct the reimbursements as business expenses.

But there's a downside. This system requires more work. You have to track the amount of each salary reduction, account for employee business expense claims and make the reimbursements.

Tip: Do this only if the tax savings outweigh the hassles and extra administrative cost.

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