

Business Expenses: Accountable vs. Nonaccountable Reimbursement



ARTICLE 10.06.20 VICTOR EVANS, ROSS WALKER

Employees frequently incur expenses in the course of their employment. Some expenses may be reimbursed by the employer, while others may be the expense of the employees.

The type of reimbursement plan administered by the employer is important for employees because it can have a significant impact on the employees' tax liability. The Tax Cuts and Jobs Act (TCJA) redefined the deductibility of business expenses, resulting in disallowed deductions for out-of-pocket expenses paid by employees on their personal tax return. Additionally, the TCJA increased the standard deduction amount, leading to fewer individuals itemizing deductions.

A business may have either an accountable or a nonaccountable plan. If the reimbursement plan does not meet all criteria for an accountable plan, it will be a nonaccountable plan.

Accountable plans

An accountable plan has three required features:

1. The expenses must have a business connection. They must be incurred while the employee is performing services for the employer or on behalf of the employer.
2. The employee must adequately account to the employer for the expenses within a reasonable period of time.
3. The employee must return any excess reimbursement within a reasonable period of time.

These features need explanation to assure that the plan meets the stated requirements.

Business connection– The expenses must be incurred in the course of employment. Personal expenses are not deductible (or reimbursable) business expenses. Personal expenses are personal, living or family expenses.

If an expense is partially business and partially personal, it must be allocated between the two. A common example is a personal vehicle that is also used for business purposes. The business use of the vehicle is a deductible (or reimbursable) expense.

Under the TCJA, the reimbursement of an expense does not change the deductibility of the expense itself. One such expense, Entertainment, is now no longer deductible under the new tax law. If an employer were to reimburse an employee for Entertainment expenses, then the reimbursement would need to be included as wages to that employee.

Adequate accounting – Employees must make an adequate accounting within a reasonable period of time.

What constitutes an “adequate accounting”? Employees must show that they spent the money for legitimate business reasons.

Third-party evidence, such as receipts will normally suffice. If not evident on the face of the document, the employee should record business purpose, reason for the expenditure, the date, the location, and other parties involved, such as when providing meals or entertainment.

There are four exceptions to the rule that documentation must be provided:

1. Individual outlays of less than \$75 for expenses, other than lodging, do not require a receipt.
2. If the employer is reimbursing for meals or lodging using the IRS per diem amounts, no receipt is required. It should be noted that a company may reimburse an employee for lodging at the General Services Administration per diem amounts, but the employee may not use the per diem for deducting unreimbursed lodging.
3. Because of the difficulty of obtaining a receipt for transportation, such as taxi, subway or bus, the IRS is more lenient in requiring a receipt. However, an employee should maintain a log book of expenditures.
4. Obviously, there is no receipt for mileage when driving a vehicle. To justify reimbursement, the employee should maintain a contemporaneous log indicating the destination, purpose, date of travel, persons visited and number of miles traveled. Beginning and ending odometer readings are mentioned by the IRS, but few keep such detail.

Reimbursement may not exceed the IRS rate for business travel. Parking and tolls are additional deductions since they are not included in the standard mileage rate.

What is a “reasonable period of time”? The IRS states that it is a facts-and-circumstances situation. However, it has guidelines that specify what constitutes a reasonable period of time.

If the employee received an advance, it must have been given within 30 days of the travel date. The expense must be substantiated within 60 days after the expense is paid.

Excess reimbursement– Any excess reimbursement must be returned within 120 days of receipt of a statement from the employer that lists outstanding advances.

These are IRS guidelines, and a company is free to implement more restrictive rules. For example, the company may require substantiation for expenditures over \$25, rather than the IRS \$75 limit.

Likewise, the company may pay for mileage at a rate less than the IRS standard rate. Reimbursements under an accountable plan are not taxable income to employees and are not shown on employees’ 1040s. Nonreimbursed expenses may no longer be deducted by the employees.

Nonaccountable plans

The alternative to an accountable plan is an allowance or nonaccountable plan. By definition, a nonaccountable plan is one that does not meet the requirements of an accountable plan.

Routinely these plans involve the employer providing a set amount, or an allowance, to the employee for travel. The employee does not account to the employer for the expenditure of these funds.

The allowance amount is taxable income and should be included on the employee’s W-2. As mentioned above, the TCJA has significantly changed the effect of out-of-pocket expenses on an employee’s return, as they are no longer deductible as an itemized deduction.

This increases the importance of reviewing reimbursement plans and ensuring that employees are aware of how these changes may affect them

Ordinary and necessary

Whether an expense is reimbursed by the employer or falls on the employee, the same IRS guidelines apply. An expense must be ordinary and necessary under IRS rules.

The terms “ordinary” and “necessary” carry specific meanings for tax purposes, and the common use of these words is not applicable here.

Ordinary expenses are expenses that are commonly used and accepted by general industry standards – that is, expenses for things typically needed to run a business. An expense is necessary if it is helpful and appropriate in running the business.

Focus on the word “helpful.” The expense is helpful, but not required, for conducting an occupation or business properly.

What is ordinary and necessary also depends on the individual situation. It may be ordinary and necessary to discuss business with a client at an expensive restaurant and provide limousine service in negotiating a multimillion dollar contract. By contrast, doing the same for a customer who purchases \$500 annually would not be considered ordinary and necessary.

An expense must be both ordinary and necessary to be deductible or reimbursable. The IRS also has the right to apply a “lavish” criteria to business expenses and may disallow any expenses that it deems lavish or extravagant. This criteria is normally applied only in extreme circumstances.

It's important from an IRS perspective, as well as from an ethical standpoint, that all employee reimbursements be properly and equitably handled. This area can easily be abused. Setting and following policies for these expenditures is a necessity to allow a business to be financially accountable and avoid IRS inquiries.