

Business Expense Reimbursement Excerpts of IRS Tax Code

For Additional Information Only

Accountable Plan (IRS code section 62 pp. 1663)

An accountable plan is any reimbursement or other expense allowance arrangement that meets all of the following requirements:

1. Business connection

The arrangement provides advances, allowances or reimbursements of an employee's business expenses paid or incurred in the performance of services as an employee.

2. Substantiation

The employee must submit information to the payer sufficient to satisfy the "adequate accounting rules" with respect to travel, entertainment, business gifts, or use of listed property. For other reimbursed expenses, information must be submitted that is sufficient to enable the payer to identify the specific nature of each expense and to conclude that the expense is an employee business expense. Each of the elements of an expenditure or use must be substantiated.

3. Return of excess amounts

The arrangement must require that an employee return to the payer within a reasonable time the amount of the reimbursement or allowance that exceeds the substantiated expenses. A reasonable period of time is defined under a safe harbor as an expense or advance substantiated within 60 days and any excess advance returned within 120 days of when the expense is paid or incurred.

If an employee fails to return amounts in excess of the substantiated amounts within a reasonable time, only the amounts not in excess of the substantiated amounts are excludable from gross income. The unsubstantiated amounts are considered gross income subject to withholding and must be reported on Form W-2.

Substantiation Rules (IRS code sec 62 pp. 3591)

Generally, a taxpayer must be able to substantiate claimed expenses by adequate records or sufficient evidence corroborating the taxpayer's own written or oral statements as to 1) amount, 2) time and place, 3) business purpose, and 4) business relationship of the entertained person(s).

Adequate Records and Sufficient Evidence (IRS pp. 3593)

To prove expenses for entertainment, travel, gifts, and listed property by "adequate record", a detailed record must be kept, such as a diary, an account book or some other statement of expense. A taxpayer, however, does not have to record information in an account book, etc. that duplicates information reflected on a receipt so long as the two forms of evidence complement each other.

In addition to the diary or account book, the taxpayer must have documentary evidence (a receipt) for any lodging while traveling away from home and for any other expenditure over \$75 or more.

Time of recording

Expenses should be recorded at or near the time when paid, when the taxpayer has full present knowledge of each element of the expenditure.

Substantiation of business purpose

A written statement of business purpose should be included in the diary or expense account record. But, when the business purpose is obvious from the surrounding facts and circumstances, such as sales representative's calling on customers on an established sales route, a written statement is not necessary.

Proof of Entertainment and Meal Expenses (IRS code pp. 3595)

Generally, in order to deduct an entertainment or meal expense, a taxpayer must substantiate by adequate records or sufficient evidence corroborating the taxpayer's own statement the following elements:

- (1) Amount;
- (2) Date;
- (3) Place (name and address or location) and type of entertainment or meal.
- (4) Reason for entertainment or the business purpose and the nature of the business benefit expected to be gained;
- (5) Business relationship to the taxpayer of the persons at the entertainment or meal (name, occupation, title); and
- (6) Presence of the taxpayer or an employee at the business meal.

Proof of Travel Away from Home Expenses

Generally, in order to deduct away from home travel expenses, the taxpayer must substantiate, by adequate records or sufficient evidence corroborating the taxpayer's own statement, the following elements:

- (1) Amount of each separate expenditure for travel away from home, such as the cost of transportation or lodging;
- (2) Dates of departure and return for each trip away from home, and the number of days away from home spent on business;
- (3) Destination or locality of travel, described by the name of the city or town or other similar designation; and
- (4) Business purpose for the travel or nature of the business benefit derived or expected to be derived as a result of the travel.

Local Travel

Local travel expenses include ordinary and necessary expenses of getting from one workplace to another in the course of business when the taxpayer is not traveling away from home. The substantiation rules apply to these expenses and the taxpayer must prove the following elements:

- (1) Cost of transportation;
- (2) Date of the transportation;
- (3) Business destination;
- (4) Reason for the expense.

Standard Mileage Allowance (IRS code pp. 3598)

By using the standard mileage allowance, taxpayers have the advantage of bypassing some of the record keeping requirements that are normally associated with the substantiation of car expenses. For 1997, the general standard mileage rate for all business miles driven during the year by an employee is 31.5 cents per mile.

Generally, when an employer provides a standard mileage rate to its employees, the amount of expense that is deemed substantiated by the employee is the standard mileage rate multiplied by the number of substantiated business miles. In addition, an employee will be deemed to have satisfied the adequate accounting requirements if the employee substantiates to the employer the elements of time, place (or use), and business purpose of the car expense.

Transportation Costs (IRS Code Sec. 162 pp. 2380)

An employee may deduct local business transportation expenses except the cost of commuting to and from work. Local transportation includes travel from one job to another, from one customer or client to another customer or client, and from the individual's office or business location in order to perform business tasks, such as delivery and pickup of supplies and inventory.

Commuting expenses

Commuting expenses between a person's residence and a business location within the area of the person's tax home are not deductible even if work is done during the commute.

Per Diem Method of Substantiating Away from Home Expenses (IRS code pp. 3597)

The ordinary and necessary expense for meals, and or incidental travel expense incurred while traveling away from home will be deemed to be substantiated when an employer provides a per diem allowance under a reimbursement or other expense allowance arrangement to pay for such expenses.

Advantages and disadvantages

The advantage in using the per diem method to substantiate expenses is that it helps eliminate much of the record keeping that is usually associated with away from home travel expenses. The possible disadvantage of the per diem method is that the allowable deduction computed under this method may be significantly less than the allowable deduction computed under the actual expense method.

Per Diem allowance

A per diem allowance is a payment under a reimbursement or other expense allowance that is 1) paid with respect to expenses incurred or which the payer reasonably expects will be incurred by an employee for meal and or incidental expenses for travel away from home in connection with the performance of services as an employee; 2) reasonably calculated not to exceed the amount of the expense or the anticipated expense; and 3) paid at the applicable federal per diem rate, a flat rate or stated IRS scheduled rate.

Per Diem substantiation methods

Under a per diem allowance method, a payer pays a per diem allowance in lieu of reimbursing actual expenses for lodging, meal and incidental expense incurred or to be incurred by an employee for travel away from home. The amount of the expenses that is deemed substantiated for each calendar day is equal to the lessor of the per diem allowance for such day or the amount computed at the federal per diem rate for the locality of travel.

Meals only per Diem allowance

A per diem allowance is treated as paid only for meals and incidental expenses if the payer 1) pays the employee for actual expenses for lodging, 2) provides the lodging in kind, 3) pays the actual expenses for

lodging directly to the provider of the lodging, or 4) does not have a reasonable belief that lodging expenses were or will be incurred by the employee.

Tax treatment of per diem amount received

The portion of a per diem allowance received from a payer that is less than or equal to the amount computed at the applicable federal rate under any of the substantiation methods is not includable in an employee's income if the elements of time, place, and business purpose are substantiated.

Federal Meals and incidental expense (M&IE) rate

The range of M&IE rates is designated by regions in the IRS code. In general the range spans:

- High = \$50 per day
- Low = \$30 per day

Entertainment Activities (IRS code 274 pp. 3581)

Generally, deductions are not allowed for any expense associated with an activity considered to be entertainment, amusement, or recreation, except to the extent that it is established the expense was *directly related* or *associated* with the active conduct of a trade or business. A few exceptions of these strict rules exist.

Directly related entertainment

An expense is considered directly related to the active conduct of a trade or business if all the following requirements are met:

The taxpayer had more than a general expectation of deriving income or some other specific business benefit at some indefinite future time:

- during the period of entertainment, the taxpayer was actively engaged in the conduct of business with the person being entertained;
- the active conduct of business was the principle aspect of the taxpayer's combined business-entertainment activity; and
- The expenses were allocable to the taxpayer and the person with whom business was conducted during the entertainment or with whom business would have been conducted had unexpected circumstances not intervened.

Entertainment expenses will not be considered to be directly related when the entertainment occurs where there is little, if any, possibility for the active conduct of business. This situation generally arises when:

- the taxpayer is not present;
- there are substantial distractions; or
- A group of people is entertained and the group includes persons other than business associates.

Associated entertainment

Taxpayers may deduct the cost of meals and entertainment associated with the active conduct of a trade or business and occurring directly before or after a bona fide and substantial business discussion.

Spouses

Taxpayers may not deduct the cost of entertaining their spouses, or the spouses of their business associates, unless they can show that there was a clear business purpose rather than a personal or social purpose for paying the expense.

Special exceptions (IRS code pp. 3585)

Generally, an entertainment or meal expense is only deductible if it is either “directly related to” or “associated with” the active conduct of a trade or business. However, special exceptions to these general requirements exist. If an expense fits within one of these exceptions it will be deductible if it satisfies the standard “ordinary and necessary” test established for deductible business expenses. These exceptions apply to expenses for the following items:

- Food and beverages for employees furnished on the business premises
- Recreational, social or similar expenses primarily for employees who are not highly compensated.
- Directly related expenses of employee, shareholder, director, etc., business meetings.
- Expenses directly related and necessary to attendance at a business meeting or convention of any tax-exempt Organization described in Code Sec. 501(c)(6).
- Cost of food, services and facilities made available to the general public as a means of advertising or promoting goodwill in the community.

Ordinary and Necessary Expenses (IRS Code Sec. 162 pp. 2103)

An expense incurred in the operation of a trade or business must be an ordinary and necessary expense of the trade or business to be deductible.

Ordinary

The term “ordinary” is a variable affected by time, place and circumstances. In this contest, “ordinary” does not mean that the payments must be habitual or normal in the sense that the same taxpayer will make them often. An expense that is incurred only once by a taxpayer can be “ordinary” if it is considered normal for a taxpayer in a similar trade or business to incur such an expense.

Necessary expenses

“Necessary” distinguishes a business expense from a personal expense incurred by a taxpayer. In order to qualify as a “necessary expense”, the expense need not be vital to the business’s continuation and need only be appropriate or helpful to the business.