

## Business Tax Planning

### Reimbursing and Proving Business Expenses

**Editor's Note:** The following material was adapted from the *Tax Planning for Businesses Quickfinder® Handbook*. The just-updated 2012 edition of this *Handbook* is now available, and it's filled with over 300 pages of indispensable business tax planning information. Order your own newly-updated *Handbook* at *Quickfinder.com*, or by calling 800-510-8997. Quickfinder—we're here year round to help you serve taxpayers' needs, whenever they need you.

**Employee reimbursements.** Employers often reimburse employees for the actual amount of business expenses they incur. Another option is to provide the employee an allowance or advance for paying expenses.

How a reimbursement or allowance arrangement is taxed depends on the employer's reimbursement plan.

- 1) **Accountable plan.** Employers deduct (as travel, meals, entertainment, etc.) the amount that they reimburse employees, to the extent allowable (taking into account limitations such as nondeductible club dues, nondeductible entertainment facilities and the 50% deduction limit on certain meal and entertainment expenses). These reimbursements are not taxable to the employees.
- 2) **Nonaccountable plan.** Employers deduct the reimbursement amounts as wages. The amounts paid to employees are reported on Form W-2 and are subject to payroll taxes. Thus, these amounts are taxable to the employees.

Accountable Plans	
Requirement	Description
Deductible expense.	The employee pays or incurs deductible expenses while performing services as an employee.
Adequate accounting within a reasonable time.	Employees must provide the employer with proof of their business expenses, including: <ul style="list-style-type: none"> <li>• Receipts and</li> <li>• Expense report, account book, day-planner or similar item where employee recorded each expense close to when it was incurred.</li> </ul>
Repayment of excess reimbursement or allowance within a reasonable time period.	Reasonableness depends on the facts and circumstances but any of the following generally qualify: <ul style="list-style-type: none"> <li>• Employees receive an advance within 30 days of the time they incur the expense.</li> <li>• Employees adequately account for their expenses within 60 days after the expenses were paid or incurred.</li> <li>• Employees return any excess reimbursement within 120 days after the expenses were paid or incurred.</li> <li>• Employers give their employees a periodic statement (at least quarterly) asking them to either return or adequately account for outstanding advances and the employees comply within 120 days of the date of the statement.</li> </ul>

If money is advanced to employees before the expenses are incurred, these requirements must also be met:

- 1) The advance is calculated to be no more than the anticipated expenses.
- 2) The advance is paid within a reasonable time before the expected expense.

Even if a reimbursement arrangement is set up to meet the requirements for an accountable plan, it won't be treated as such if the rules are not followed. In other words, any expenses reimbursed under the plan must be treated as wages if the employee doesn't actually substantiate the expenses or return any excess reimbursements within a reasonable time period. For a ruling illustrating the importance of proper substantiation see Revenue Ruling 2006-56.

**Nonaccountable plans.** A nonaccountable plan is any arrangement that does not meet the requirements for an accountable plan. All amounts paid under a nonaccountable plan are reported as wages on Form W-2 and are subject to income tax withholding, Social Security, Medicare and federal unemployment taxes.

Employers deduct the reimbursement as compensation or wages. Thus, the employer is not subject to the 50% limit on meals and entertainment for the reimbursements. However, the employee may deduct the expenses on his return, where the 50% limit is applied.

**Proving business expenses.** To deduct travel, entertainment, gift or transportation expenses, taxpayers must be able to prove (substantiate) certain elements of each expense.

**Caution:** In some cases, if taxpayers can establish that a deductible expense existed, they can estimate its amount [*Cohan*, 8 AFTR 10552 (2nd Cir. 1930)]. However, this so-called *Cohan* rule specifically does not apply to expenses for travel, meals or entertainment. Taxpayers must be able to substantiate the amount to deduct these expenses. [Temp. Reg. §1.274-5T(a)]

**Adequate records.** Written evidence is more reliable than oral evidence alone. However, a record prepared on a computer is considered an adequate record. Generally, entries in an account book, diary, expense report or similar record along with documentary evidence (for example, receipts, canceled checks or bills to support claimed expenses) are adequate to support a deduction.

**Business purpose.** A business purpose for an expense generally should be documented in writing. However, the degree of proof varies according to the circumstances. If the business purpose of an expense is clear from the surrounding circumstances, a written explanation is not required.

**Example:** John is a sales representative who calls on customers on an established sales route. He does not have to provide a written explanation of the business purpose for traveling that route. Instead, he can record the length of the delivery route once, the date of each trip at or near the time of the trips and the total miles he drove the car during the tax year. He could also establish the date of each trip with a receipt, record of delivery or other documentary evidence.

Requirements for Documentary Evidence	
Type of Document	Requirements
Hotel Receipt	<ul style="list-style-type: none"> <li>• Hotel's name and location.</li> <li>• Dates taxpayer stayed there.</li> <li>• Separate amounts for charges such as lodging, meals and telephone calls.</li> <li>• A credit card statement alone is not sufficient evidence for a lodging expense.</li> </ul>
Restaurant Receipt	<ul style="list-style-type: none"> <li>• Restaurant's name and location.</li> <li>• Number of people served.</li> <li>• The date and amount of the expense.</li> <li>• If a charge is made for items other than food and beverages, the receipt must show that this is the case.</li> </ul>
"Ticketless" Airfare	<ul style="list-style-type: none"> <li>• Copy of an email or fax of the airline itinerary/receipt. (Ltr. Rul. 9805007)</li> </ul>
Canceled Check	<ul style="list-style-type: none"> <li>• A canceled check along with a bill from the payee or other evidence that there was a business purpose.</li> <li>• A canceled check by itself does not prove a business expense.</li> </ul>
Receipt or other document is not needed for	<ul style="list-style-type: none"> <li>• Meals or lodging expenses for business travel that is reimbursed by the taxpayer's employer under an accountable plan, if the employer provides a per diem allowance for those expenses.</li> <li>• Expenses, other than lodging, that are less than \$75.</li> <li>• Transportation expense for which a receipt is not readily available.</li> </ul>