Business Expenses 101: The Expense Plan

Business 101:
Expense
Plans

Justworks

Table of Contents

This Is An Interactive Ebook!

Click a section title to skip to it, and click the icon in the header of any page to return to the Table of Contents.

INTRODUCTION

Why You Need An Accountable Expense Plan

Handling business expenses is a common—and necessary—financial aspect of running a company. The first step towards making the process efficient and beneficial is building an accountable plan.

Doing so prevents employee confusion and miscommunication around valid expenses, while also preventing you and your employees from paying unnecessary taxes. Reimbursed expenses from an accountable plan reduces your business' taxable income and avoids your employees paying income tax on the repayment.

Preparing an Accountable Expense Reimbursement Plan

The expense reimbursement process allows employers to pay back employees who have spent their own money for business-related expenses. When an employee receives an expense reimbursement, she won't be required to report such payments as wages or income.

These type of expenses tend to occur when employees travel for work, but can be associated with other activities related to their employment, including, for example, certain purchases of work-related supplies or tools.

Most businesses reimburse such expenses, but are business expense reimbursements taxable income to the employee?

* **NOTE:** Page 15 of IRS Publication 15, (Circular E), Employer's Tax Guide, states that expense reimbursements do not have to be included in an employee's wages if the business has an "accountable" plan.

In order to have an accountable plan, an expense reimbursement plan or advance payment program must meet the following three conditions:

→ **Business connection:**
The expense must occur in the performance of services as an employee of the employer.

→ **Substantiation:**
The employee must substantiate their business expenses by providing the employer with evidence of the amount, time, place, and business purpose of the expense. The employee also must submit business expenses within a reasonable period of time after they occurred.

→ **Returning excess amounts:**
If any amounts the employer pays to the employee exceed the amounts the employee spent, the employee must return excess amounts to the employer within a reasonable period of time.

So what should an accountable plan include? The following is a brief outline of what an accountable expense reimbursement plan may contain.

→ **Introduction**
Brief introduction to define an accountable plan and why employees must conform to its provisions.

→ **Review of Legal Requirements**
Explanation of IRS legal requirements and definitions.

→ **Employee Record Keeping Requirements**
- Employee business expense logs
- Mileage logs
- How to prove expenses

→ **How To Submit Business Expenses**
Information about who to contact with questions

→ **How To Submit Business Expenses**
Information about who to contact with questions

→ **Company Policies Regarding Travel Expenses**
- Business use of personal vehicle (using standard federal rate, FAVR, or cost)
- Travel expenses (at cost or per diem)
- Meals and entertainment

→ **Policies Regarding Employer Review and Timing of Reimbursements**

→ **Special Situations**
- Use of company-owned vehicles
- Use of company credit cards

Substantiating Employees' Business Expenses

IRS Publication 15, (Circular E), Employer's Tax Guide, states that the employee must substantiate their business expenses by providing the employer with evidence of the amount, time, place, and business purpose of the expense within a reasonable period of time after they are paid or incurred.

There are two methods of determining the reasonable period of time for substantiation and returning excess amounts:

→ FIXED-DATE METHOD

The expense must be substantiated by the employee within 60 days of being paid or incurred, and the excess amount of any advance must be returned to the employer within 120 days of when the expense was paid or incurred.

→ PERIODIC STATEMENT METHOD

The employer can issue a periodic statement to the employee detailing amounts that have been paid and not substantiated and require the employee to either substantiate the excess amount or return it to the employer within 120 days of receiving the statement. Periodic statements must occur at least quarterly.

An employer may have a hybrid plan that uses both methods described above. For instance, out-of-pocket expenses and mileage reimbursements may have to be substantiated under the fixed-date method. But the employer may use the periodic statement method for substantiating company credit card charges. In addition, an employer may issue a statement to an employee for business expenses that have been submitted for reimbursement, but will not be reimbursed until proper substantiation is provided.

What Kind of Employee Business Expenses Are Valid?

When an employer reimburses an employee pursuant to an accountable plan, the reimbursement won't count as wages or income to the employee. Typically, an employer may be able to deduct those reimbursements, but the deduction amount may be limited.

> To be deductible, a business expense must be both ordinary and necessary. An ordinary expense is one that is common and accepted in your industry. A necessary expense is one that is helpful and appropriate for your trade or business. An expense does not have to be indispensable to be considered necessary.
>
> IRS PUBLICATION 535, BUSINESS EXPENSES

What are some examples of ordinary and necessary expenses that would require employer reimbursement? The most common are work-related supplies, travel, meals, and entertainment. Supplies that an employee may purchase can be reimbursed at cost, but there are special rules and restrictions on the other categories mentioned. The rules for these categories are discussed in IRS Publication 463, Travel, Entertainment, Gift, and Car Expenses.

An important concept for reimbursements relating to traveling discussed in Publication 463 is the "tax home." The publication states:

> "Generally, your tax home is your regular place of business or post of duty, regardless of where you maintain your family home. It includes the entire city or general area in which your business or work is located.
>
> IRS PUBLICATION 463, TRAVEL, ENTERTAINMENT, GIFT AND CAR EXPENSES

The cost of work-related travel, including transportation, lodging, meals, and entertainment that meet the criteria outlined in IRS Publication 463, Travel, Entertainment, Gift, and Car Expenses are generally reimbursable expenses.

Under the new Tax Act, entertainment expenses cannot be deducted even if they are directly related to or associated with the active conduct of the trade or business. Meal expenses can only be deducted by the employer at 50% of the cost, the employee may be reimbursed 100% if they are reimbursed pursuant to an accountable plan.

Meal and entertainment costs incurred within the employee's tax home are reimbursable only if the meal or entertainment can be shown to have a bona fide business purpose.

Many employers will reimburse an employee who uses their personal vehicle for business at a standard mileage rate. Generally, this won't include commuting expenses between an employee's home and workplace. The standard mileage rate is set by the IRS each year. (The standard federal mileage rate for business in 2018 is 54.5 cents per mile.)

How Can an Employee Prove Their Business Expenses Are Valid?

IRS Publication 463, Travel, Entertainment, Gift, and Car Expenses, provides detailed information on how employees can prove expenses. Proof of an expense includes the following three items

- → Adequate records
- → Sufficient evidence
- → Written records

> "You should keep the proof you need in an account book, diary, log, statement of expense, trip sheets, or similar record. You should also keep documentary evidence that, together with your record, will support each element of an expense.
>
> IRS PUBLICATION 463, TRAVEL, ENTERTAINMENT, GIFT AND CAR EXPENSES P. 25

Records of expenses do not have to be in any particular format, but it must be in a form that allows the employee to keep a detailed record of the amount, time, place, and business purpose of the expense. The format used must also enable an employee the ability to document business meals that take place within the employee's tax home and meals provided for others when away from their tax home.

To substantiate these expenses, the employee must record the following information in their record:

- → The names of the individuals in attendance
- → The business purpose of the meeting
- → The date and place of the business meeting

The best sufficient evidence is documentary evidence that supports the employee's expenses. This may include receipts, canceled checks, or bills. Documentary evidence, however, is deemed adequate only if it shows the amount, date, place, and essential character of the expense.

In most cases, the IRS requires documentary evidence for travel expenses only if the expense is greater than $75. However, there are exceptions, especially lodging expenses. Since lodging bills may contain other expenses in addition to room charges (such as meals, telephone calls, laundry, Internet access, and video rentals), a hotel or motel must provide an itemized bill. Personal expenses (such as video rentals) should not be included or reimbursed.

Before submitting expenses for reimbursement, an employee should create a written record. This is a record that provides detailed proof of the employee's expenses.

Safe Harbor Employee Business Expense Allowances

Safe Harbor

Businesses often require their employees to incur expenses that will later be reimbursed by the business. Without proper substantiation, expense reimbursements may be treated as taxable income. In some cases, however, there are some expenses that require less substantiation. These can be referred to as Safe Harbor expense allowances.

The Internal Revenue Code (IRC) contains many instances of safe harbor business deductions. A safe harbor is basically defined as an alternative to the calculation, allocation, and substantiation of actual expenses for purposes of satisfying the requirements of the Internal Revenue Code. Many of the safe harbor provisions are specifically designated as safe harbor deductions, but the principle is applied in many other sections of the IRC as well.

The safe harbor principle can be applied to certain travel expenses.

Employees must still substantiate the time, place, and business purpose of the travel, but the amount of the expense can be treated as substantiated if it's based on one of the following methods:

- → The standard mileage rate
- → A fixed and variable rate (FAVR) allowance
- → A per diem amount

Standard Mileage Rate

The standard business mileage rate* is used to compute the cost of operating a personal automobile for business purposes. As long as the vehicle has not already been depreciated for business purposes, the cost of operating the vehicle is considered to be substantiated by multiplying the standard mileage rate by the number of miles driven for business purposes.

An employer may choose to provide an automobile allowance to an employee who uses their personal vehicle for business on a regular basis. Periodically, the employee is required to submit their mileage log in order to calculate the actual usage. The employer may reimburse the employee for excess mileage, and the employee may be required to return an excess payments. Excess payments that are not returned must be treated as supplemental wages subject to tax withholding.

* **NOTE:** The standard federal mileage rate for business in 2018 is 54.5 cents per mile. The 2018 maximum standard automobile cost for which an FAVR allowance may be used may not exceed $27,300 for automobiles or $31,000 for trucks and vans. IRS Notice 2014-79

Fixed and Variable Rate (FAVR) Allowance

An FAVR allowance is a mileage rate that has been calculated by the employer based on certain fixed costs (such as depreciation or lease payments, insurance, registration and license fees, and personal property taxes), as well as projected variable costs (such as gasoline and gasoline taxes, oil, tires, routine maintenance, and repairs). The projected costs are based on the locality, retail prices paid by consumers, and evidence of costs normally incurred by the owner of a vehicle.

Payments must be made at least quarterly. The base location is normally where the employee resides, or the employee's tax home. The cost of the automobile may not exceed the maximum standard automobile cost set by the IRS each year.

The advantage of using an FAVR allowance instead of the standard mileage rate is that in locations with higher automobile operating costs, the FAVR allowance may be more than the standard mileage rate. The disadvantage is that the employer must recalculate the FAVR allowance at least once every three months. The FAVR allowance is used by employees in the same way as the standard mileage rate to substantiate automobile costs.

* **NOTE:** Guidelines for calculating FAVR allowances is provided by the IRS in Revenue Procedure 2010-51.

Per Diem Amounts

Per diem rates are established for each fiscal year (beginning October 1) by the General Services Administration and are published on the GSA website. An employer may choose to pay for lodging expenses at cost, and use only the M&IE (meals and incidental expenses) per diem rate.

Employers may also choose to use per diem rates for the government's fiscal year or extend the rates through the end of the calendar year, as long as the choice is applied consistently to all employees.

> The regular federal per diem rate is the highest amount the federal government will pay its employees for lodging, meals, and incidental expenses (or meals and incidental expenses only) while they are traveling away from home in a particular area.
>
> IRS PUBLICATION 463, **TRAVEL, ENTERTAINMENT, GIFT AND CAR EXPENSES P.31**

Certain locations are designated as high-cost locations, so the per diem rates in those areas are higher.

Employees who use the rates for high-cost locations must also recognize that the rates change from month-to-date in some locations.

When these methods are used, no further calculations or proof of cost is required.

Build An Accountable Plan to Save A Lot of Headaches

Employees should only have to pay income taxes on the wages they earn and certain taxable fringe benefits. Expenses incurred by employees in the course of business should be costs incurred by the employer, not by its employees.

If the employer establishes a written accountable plan, and the employees submit properly documented expenses under that plan, then the reimbursements shouldn't count as taxable income.

However, a key to maintaining any accountable plan is to properly and timely substantiate expenses. Having a business accountant and referring to employment counsel are two ways for businesses to ensure they're deducting and reporting the right expenses.

Justworks Can Help

Justworks takes the busyness out of growing a business and alleviates the unknown. We've combined a simple platform and exceptional 24/7 customer service with the power of a PEO, so all teams have more time to focus on what matters.

Get access to corporate-level benefits, seamless payroll, HR tools, and compliance support — all in one place.

Want To Get Started?

Call: (844) 749-7785 . Email: hello@justworks.com . Visit: justworks.com