

GUIDE TO EMPLOYEE TRAVEL EXPENSE REIMBURSEMENT

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Choosing the wrong travel expense reimbursement policy can increase overhead costs, damage work force morale and create legal disputes over the base wage used to calculate employee overtime rates. It is important for employers to understand the basic rules and options of travel expense reimbursement so they can choose the most efficient plan for employee travel.

The Internal Revenue Service (IRS) rules provide employers flexibility on employee reimbursement for most travel expenses. Employers should review each option and decide which would make the most sense financially and would be the best fit for their accounting program.

This paper outlines the current IRS rules that determine when employees are entitled to deduct travel expenses and the different reimbursement options available to employers.²

Qualification for Deductible Travel Expenses

Any travel-related reimbursement that does not qualify as a deductible travel expense is considered employee wages by the IRS.³ Employees' travel expenses may be deducted only if the employee is temporarily traveling away from his or her "tax home". Employers should first determine where an employee's tax home is and then determine whether the travel expenses are deductible.

Employee tax homes are generally determined by their regular place of business, regardless of where they maintain a family home. The tax home includes the entire city or general area in which the place of business is located. Employees with no regular place of business or regular residence are considered itinerant. Their tax homes are where they are currently working and their travel expenses are not deductible. Many construction field employees do not have a regular place of business due to the nature of the industry. Employers should analyze the following three factors to determine the tax home status of an employee who does not have a regular place of business or work:

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² This paper is current as of August 4, 2008.

³ IRS Publication 463, Chapter 1 contains detailed information on classifying whether an employee qualifies for deductible travel expenses.

- Whether the employee conducts part of his or her business in the same area where he or she spends the night;
- Whether the employee duplicates living expenses when away from that home for business; and
- Whether the employee often uses that home for lodging or has a family member living in that home.

The tax home is where the employee regularly lives if all three factors apply. An employee may have a tax home or may be itinerant if only two factors apply, depending on the facts and circumstances. An employee is considered itinerant if only one factor applies.

Not all expenses incurred by employees traveling outside their tax home are deductible. Generally, their duties must require them to be away from the general area of their tax home long enough to require sleep or rest. The rest requirement is not satisfied by napping in a car but does not require that employees travel outside their tax home overnight. Deductible expenses for partial days, such as departure and return days, must be prorated using one of two methods. The first method allows deduction of three-fourths of the applicable federal meal and incidental expense (M & IE)⁴ for each partial day. The second method allows deduction using any method that is consistently applied and in accordance with reasonable business practices.⁵

Assignment duration also determines whether employees qualify for deductible travel expenses. The location of the assignment becomes the new tax home and the employee does not qualify for deductible travel expenses if the travel is indefinite. Employee travel is indefinite when the location of the assignment is expected to last longer than one year. Employee travel is temporary when it is expected to last less than one year. The tax home does not change, and the employee can qualify for deductible travel expenses.

Temporary travel becomes indefinite if an assignment, or its schedule, is extended beyond one year due to changed circumstances. This would include employees who work on a series of assignments in the same location that together cover, or are expected to cover, a period of longer than one year. Only employee travel expenses incurred before the employer becomes aware of the changed circumstance are deductible.

⁴ Meals and incidental expenses include:

- Meals, room service, and fees and tips for food servers and luggage handlers;
- Laundry, dry cleaning, and pressing of clothing;
- Transportation between places of lodging or business and places where meals are taken, if suitable meals cannot be obtained at the temporary duty site; and
- Mailing cost associated with filing travel vouchers and payment of employer-sponsored charge card billings.

⁵ Employers can pay two full days of the applicable M & IE rate for travel away from home from 9 a.m. of one day to 5 p.m. of the next day, even though a federal employee would be limited to payment for one and one-half days. The IRS does not provide another example of what constitutes a reasonable business practice but other methods may be available.

Construction projects often run for extended periods of time in geographically diverse areas. It is important for contractors to note the IRS rules for travel expense deductibility when staffing projects outside their labor force's city or general area.

What Travel Expenses are Deductible?

Once it is determined that the employee is traveling away from his or her tax home, it must then be determined whether the travel expense itself is deductible. Employers can deduct "ordinary and necessary expenses" of employees traveling away from their tax home.

Transportation costs between cities such as airplane, bus, train or car are always deductible if the employee travels away from his or her tax home. Local transportation costs such as taxi, commuter bus, subway or airport limousine are deductible if the employee is away from the tax home and the travel is between the airport or other station and the employee's hotel, or between the hotel and work location. Baggage and shipping costs are deductible if necessary for the temporary work site.

Vehicle expenses are deductible if traveling away from the home or business. Actual expenses or the IRS standard mileage rates may be used. If a car is rented while away from the tax home, only the business-use portion of the rental fee is deductible. Lodging and meals are deductible where the employer is away from his or her tax home. Meals that are "lavish or extravagant" are not deductible. Other meals are deductible subject to the 50% limitation. Certain entertainment expenses are also deductible, but also subject to the 50% limitation. Entertainment expenses include meals. Examples of entertainment expenses include entertaining customers/clients and/or employees at restaurants, nightclubs, social, athletic or sporting events, or on hunting, fishing, vacation or similar trips. Cleaning, telephone, tips and other ordinary and necessary expenses are deductible as incidental expenses.⁶

Plans for Reimbursing an Employee for Deductible Travel Expenses

The IRS allows two basic options for reimbursing employees for deductible travel expenses: (1) employers can avoid paying employment tax by excluding reimbursement for travel expenses from employee wages under an accountable plan; or (2) employers can consider all payments to employees as wages under a non-accountable plan (and pay employment taxes) and employees can deduct travel expenses as miscellaneous itemized deductions. Both options allow flexibility in travel compensation and are subject to IRS accounting rules.⁷

Employers should analyze the financial and business-related impacts of each system below and decide which is best for their company. Companies may find the cost saved by not paying employment tax is outweighed by the costs of implementing and monitoring an accountable plan. Some employers may be able to pay lower workers' compensation premiums by setting up an

⁶ For detailed rules on deducting meals and entertainment, and the 50% rule, see IRS Publication 463, Chapter 2

⁷ Rules governing accounting practices for each option are posted in IRS Reg. 1.162-2. For examples of different compensation situations, review IRS Publication 463, Chapter 6.

accountable plan.⁸ Employers should recognize the time required for accounting, employee training and the possible effect on employee morale when deciding which system to use.

1. Accountable Plan

Amounts paid under an accountable plan are excluded from employee wages and are exempt from the withholding and payment of employment taxes. Reimbursement for employee travel expenses under the plan must meet the requirements for business connection, substantiation and returning amounts in excess of expenses to qualify.

The business connection requirement is met when employees are reimbursed for expenses paid or incurred in connection with the performance of services for their employer. Employers must either make a separate payment to reimburse employee travel expenses or specifically identify the travel reimbursement compensation when it is combined with employee wages. Reimbursements must qualify as a deductible travel expense to meet the business connection requirement for an accountable plan. Employee compensation for bona fide expenses that do not qualify as deductible travel expenses is considered paid under a non-accountable plan. All amounts are considered paid under a non-accountable plan when employers arrange to compensate employees regardless of whether they incur, or are reasonably expected to incur, eligible expenses.

The substantiation standard is met when employees properly report the required information for each type of business expense within a reasonable time period.⁹ Employees must generally submit information sufficient to substantiate the time, place, business purpose and amount of the expense to their employer. They are not required to substantiate amounts up to the federal rate allowed when compensated using a per diem or car allowance.

Accountable plans require that employees return any amount paid in excess of the substantiated amount to their employer within a reasonable time.¹⁰ Any excess amount not returned within a reasonable period of time is considered paid under a non-accountable plan as employee wages. The definition of a reasonable period of time depends on the surrounding facts and circumstances but the IRS gives two safe harbors. The safe harbors are not available where employers have shown a pattern of overcompensation to avoid reporting and withholding on excess expenses.

The fixed date method deals with advances made within 30 days of when the expense is paid or incurred by the employee. The safe harbor is met if the employee's expense is substantiated within 60 days and the excess amount is returned to the employer within 120 days after the expense is paid or incurred.

⁸ The rules governing the computation of workers' compensation insurance premiums vary from state to state. Employers should evaluate the rules that govern workers' compensation for each state in which their employees work or travel.

⁹ Rules detailing substantiation are posted in IRS Reg. 1.274-5T and 1.162-17. For examples of recordkeeping requirements, review IRS Publication 463, Chapter 5.

¹⁰ The rules for the reasonable period of time to substantiate expenses and return excess reimbursements are posted in IRS Reg. 1.62-2.

The periodic statement method requires employers to provide employees with statements, at least quarterly, stating any amount paid under the arrangement in excess of their substantiated expenses. The statement requests that employees substantiate any excess expenses that would qualify under an accountable plan and/or to return any amounts remaining unsubstantiated within 120 days of the statement.

The time period for withholding and payment of employment taxes, if required, depends on whether employees are reimbursed or paid an allowance in advance. Any portion of an allowance paid under a non-accountable plan is due no later than the first payroll period following the reasonable period for substantiation. Reimbursements paid under a non-accountable plan are due in the payroll period in which the expenses are reimbursed.

Rate and substantiation requirements are broken out below by compensation options for each eligible expense.

2. Non-accountable Plans

A non-accountable plan is a reimbursement or expense allowance arrangement that does not meet one or more of the three rules listed above under Accountable Plans. In addition, even if there is an accountable plan, some payments will be treated as being paid under a non-accountable plan, such as excess reimbursements if the employee fails to return same to the employer and reimbursement of nondeductible expenses related to the employer's business. Expenses under non-accountable are paid/reimbursed together with wages; they are not paid separately. The employer must report the total in box 1 of the W-2. The employee must complete IRS Form 2106 to itemize the deductions for travel, transportation, meals or entertainment. To be eligible, they must substantiate the time, place, business purpose and full or unreimbursed amount of the expense. The amount claimed annually by employees must exceed 2% of their adjusted gross income (AGI) to be eligible. Expenses for M & IE are subject to the 50% or other applicable deduction limitation as explained in "Accountable Plan" above.

Documentation and Reimbursement of Expenses Lodging, Meals and Incidental Expenses

Employers may exclude from employee wages lodging, and M & IE actual cost reimbursements that qualify under an accountable plan. Employers may generally deduct the actual submitted costs, or deduct based on per diem rates. Employers, however, may deduct only 50% of the amount paid to employees for M & IE under an accountable plan for tax purposes.¹¹

If paying actual costs, employees must provide their employer with a written record of the time, place, business purpose of the travel expense and receipts proving the M & IE amount to meet the substantiation requirement. They must also submit receipts for lodging if employee lodging expenses are incurred and not paid directly by the employer.

Per Diem Allowances

¹¹ Employers or employees subject to the Department of Transportation's "hours of service" limits, including interstate truckers, can deduct 75% for M & IE in 2008.

A per diem allowance is a fixed amount of daily reimbursement paid by employers to eligible employees for lodging and M & IE. A car allowance is the amount employers pay for the business use of an employee's car. An owner or relative of the owner may not use a per diem or car allowance as substantiation for an expense in an accountable plan. Individuals are related to the owner if:

- Their employer is their brother or sister, half-brother or -sister, spouse, ancestor or lineal descendant;
- Their employer is a corporation in which they own, directly or indirectly, more than 10% in value of the outstanding stock; or
- Certain relationships (such as grantor, fiduciary or beneficiary) exist between their employer, a trust and themselves.

IRS federal per diem rate limits for accountable plans depend on where employees are traveling and how they are being compensated. Travel rates within the continental United States (CONUS) are documented in IRS Publication 1542. The publication allows employers to use either the high-low or federal per diem substantiation methods and explains each in detail. It also contains the transition rules regarding switches between the two methods and between old and new rates. Rates are posted for both M & IE alone and lodging and M& IE combined. Rates for areas outside the continental United States (OCONUS), such as Alaska, Hawaii, Puerto Rico, and foreign localities, are published by the U.S. General Service Administration (GSA).¹²

Car allowance rules and methods are found in IRS Revenue Procedure 2005-78. It contains the federal standard mileage rate and sets limitations on the use of a fixed and variable rate (FAVR). The standard mileage rate for 2008 is set at 50.5 cents per mile and can be used with respect to an automobile that is either owned or leased by an employee. Employers may also pay a car allowance that includes a combination of payments covering fixed and variable costs under a FAVR rate.¹³ The FAVR rate must be based on data that is derived from the base locality, that reflect retail prices paid by consumers and that reasonably and statistically approximates the actual expenses employees receiving the allowance would incur as owners of the car.¹⁴

Car Expenses

Employees who provide their own car and employees who use an employer's car can both qualify for reimbursement of actual travel expenses under an accountable plan. Employers may exclude reimbursements for actual travel costs that qualify under an accountable plan from employee wages. Both the car's operating and fixed costs are reimbursable under an accountable plan if substantiated.

¹² GSA per diem rates are found at www.gsa.gov.

¹³ An example of FAVR rate compensation would be cents-per-mile for operating costs and a flat amount for fixed costs.

¹⁴ Employers using the FAVR rate should review IRS Revenue Procedure 2005-78 for additional rules and limitations outside the scope of this paper.

Employees must provide their employer with a written record of the time, place (or use), business purpose of the travel expense and receipts proving the amount to meet the substantiation requirement.

Meals and Incidental Expenses (M & IE)

Employers may only limit a per diem allowance to M & IE when they have provided for employee lodging or when employees have made other expense-free arrangements. They have the option of furnishing the lodging in kind, reimbursing employees for lodging expenses or directly paying for the lodging where there is a reasonable belief that employees will incur lodging expenses. Employers must figure the allowance on a basis similar to that used in computing employee compensation, such as hours worked or miles traveled.¹⁵

Employers may exclude M & IE allowances that qualify under an accountable plan, up to either the federal per diem rate or high-low substantiation rate, from employee wages. Any compensation above the applicable federal rate used is paid under a non-accountable plan as employee wages. Employers may generally deduct 50% of the amount paid to an employee for M & IE under an accountable plan for tax purposes.

Employees must provide their employer with a written record of the time, place and business purpose of the travel expense to meet the substantiation requirement.

Lodging and M & IE Combined

Employers may exclude from wages combined lodging and M & IE allowances that qualify under an accountable plan, up to either the federal per diem rate or high-low substantiation rate, from employee wages. Any compensation above the federal rate used is paid under a non-accountable plan as employee wages. Employers may generally deduct 50% of the amount paid to an employee for M & IE under an accountable plan for tax purposes.

Employers may use two methods to calculate the M & IE rate when the per diem allowance is less than the applicable federal per diem rate. Employers may use either the applicable federal M & IE rate or consider 40% of the allowance paid to the employee each day as the rate. The IRS mandates that employers pick one method and use it consistently throughout the year.

Employees must provide their employer with a written record of the time, place and business purpose of the travel expense to meet the substantiation requirement.

Car Expenses

Employers may use a car allowance only to compensate for travel costs associated with the use of a car owned or leased by their employee. They may compensate employees for eligible travel costs under an accountable plan up to either the federal standard mileage rate or acceptable FAVR rate.

¹⁵ Employees subject to the Department of Transportation's "hours of service" limits, such as interstate truckers, can be compensated for M & IE based on miles traveled.

Employers may exclude any amount-per-mile that qualifies under an accountable plan, up to the federal standard mileage rate, from employee wages. Any compensation above the standard mileage rate is paid under a non-accountable plan as employee wages. The choice to use either the standard mileage rate or actual expense reimbursement must be made in the first year that the car is available for business use. The compensation method may change from year to year for an employee-owned car. The method chosen in the first year must be used for the entire lease period, including renewals, if the employee is leasing the car.

Employers may exclude any amount that qualifies under an accountable plan, up to the FAVR rate, from employee wages.¹⁶ Any compensation above the FAVR rate is paid under a non-accountable plan as employee wages. The rules for selecting either the FAVR rate or actual expense reimbursement method mirror those under the standard mileage rate above. The rules regarding subsequent changes in the method used, depending on whether the car is leased or owned by the employee, are the same as those under the standard mileage rate as well.

The substantiation requirement is the same for both the standard mileage rate and FAVR allowance. Employees must provide their employer with a written record of the time, place (or use), and the business purpose of the travel expense to their employer.

Breakdown of Travel Compensation Options

IF the type of reimbursement (or other expense allowance) arrangement is under	THEN the employer reports on Form W-2
An accountable plan with:	
<i>Actual expense reimbursement:</i> Adequate accounting made and excess returned	No amount.
<i>Actual expense reimbursement:</i> Adequate accounting and return of excess both required but excess not returned	The excess amount as wages in box 1.
<i>Per diem or mileage allowance up to the federal rate:</i> Adequate accounting made and excess returned	No amount.

¹⁶ The amount allowed under the FAVR allowance is the allowance less:

- Any periodic variable rate payment that relates to miles in excess of the business miles substantiated by the employee and that the employee fails to return to the employer although required to do so;
- Any portion of a periodic fixed payment that relates to a period during which the employee is treated as not covered by the FAVR allowance and the employee fails to return to the employer although required to do so; and
- Any optional high mileage payments, above the standard mileage rate.

<i>Per diem or mileage allowance up to the federal rate:</i> Adequate accounting and return of excess both required but excess not returned	The excess amount as wages in box 1. The amount up to the federal rate is reported only in box 12—it is not reported in box 1.
<i>Per diem or mileage allowance exceeds the federal rate:</i> Adequate accounting made up to the federal rate only and excess not returned	The excess amount as wages in box 1. The amount up to the federal rate is reported only in box 12—it is not reported in box 1.
A non-accountable plan with:	
Either adequate accounting or return of excess, or both, not required by plan	The entire amount as wages in box 1.
No reimbursement plan	The entire amount as wages in box 1.

Conclusion

Employers should establish a program to educate employees about the travel expense reimbursement policy used. They should clearly state the employee responsibilities for the system used and should monitor employee reports for compliance with the applicable rules. Employers using accountable plans should communicate whether employees should return the amount in excess of substantiation or if it will be paid under a non-accountable plan as wages. They should explain the benefits of the accountable plan even though employee gross income for tax purposes will drop. Employers using a non-accountable plan, or paying compensation over the amount eligible for an accountable plan, should educate employees concerning miscellaneous itemized deductions. The IRS does not require employers to educate employees about their compensation plans, but doing so should streamline the process and improve worker morale.