Tax Researcher

Volume XXIII Issue 8 August, 2006

BUSINESS EXPENSE REIMBURSEMENTS BY EMPLOYERS: How To Avoid Payroll Taxability

Employers normally do not expect their employees to bear the expense of outside meals or overnight lodging related to their business activities. Generally, the employer will make an "advance" or pay a reimbursement to the employee to cover such business expenses. The taxability of these employer payments will depend on what the employer requires and what the employee actually does, with respect to: 1.) return of any unused funds, and 2.) substantiation of how the funds actually were expended for business purposes.

Basically, there are three ways the employer can make the employee "whole." First, the employer's payments can be made under an "accountable" business expense reimbursement plan. Secondly, the employer may pay based on a per diem allowance that is within the per diem rates of the Federal government. Or, thirdly, the employer may pay the employee but not require the refund of unused amounts or substantiation of the expenses paid. Each of these methods has its own taxability rules.

Regardless of the method used to make the employee "whole," the employer's payment should be paid or identified separately from wages. If combined in a single payment along with wages, the amount reimbursed by the employer will be treated as TAXABLE WAGES to the employee.

"Accountable" Plans

Advances or business expense reimbursements made under an "accountable" plan generally are non-taxable and are not reported by the employer on the employee's Form W-2.

To be an “accountable” plan, the IRS requires that three conditions be satisfied:

a.) BUSINESS CONNECTION – The expenses paid by the employer must be for work-related expenses that would be deductible by the employee if claimed as a deductible business expense on the employee’s personal tax return (Form 1040).

b.) SUBSTANTIATION – The employee must provide evidence of the amount, time, use and business purpose of the advance or expense reimbursement. The substantiation must be provided within a “reasonable” time.

c.) RETURN OF EXCESS PAYMENTS - Employees must be required to return, within a reasonable period of time, any reimbursements or advances in excess of their substantiated expenses.

Importantly, even under an “accountable” plan, Federal income tax withholding and Social Security, Medicare and FUTA taxes apply to any advance or reimbursement for which the employee fails to substantiate the use or to return any excess amount, within a reasonable period of time. Federal income tax withholding may be computed as if the payment were supplemental wages, provided that the reimbursements were paid separately from regular wages, or were separately identified if combined with regular wages.

Per Diem Allowances

An alternative method for making the employee “whole,” which may be easier for both the employer and the employee, is to use a per diem allowance which does not exceed the per diem rates of the Federal government. Using this method, the IRS will ASSUME that the amounts for lodging, meals and incidental expenses are substantiated WITHOUT ANY FURTHER PROOF. Employees need only account for the time, place and business purpose of the travel.

Interestingly, employees whose ACTUAL expenses are less than their per diem are NOT required to return the excess. However, amounts advanced for days not actually traveled, must be returned to the employer or they will be taxable as wages.

The business travel must be away from home for the per diem allowance to apply to the lodging, meals and incidental expenses. “Incidental” expenses means laundry, dry cleaning fees, and tips for service. It does not include such expenses as transportation costs, telephone calls and taxi fares, which are too variable from person to person to be measured on a standardized basis. However, employees may be reimbursed for the latter expenses by the substantiation method, and thereby prevent the employer’s reimbursement from being taxable as wages.

Because the Federal per diem rate is the IRS standard for determining taxability, it is necessary to examine it more closely. The Federal government publishes its own per diem rates for Federal employees traveling on government business. The rates are revised annually, and follow the government’s fiscal year, which starts October 1, rather than the calendar year. The Federal per diem rate usually is shown by component: a.) lodging expense rate, and b.) the meal and incidental expense (M&IE) rate, for the locality of travel. To enable the respective rate to be specific to a locality, the Federal government uses three rate tables: a.) localities in the continental United States (CONUS); b.) non-foreign localities outside the U.S. (OCONUS), including Alaska, Hawaii, Puerto Rico, Northern Mariana Islands and U.S. possessions; and c.) foreign locations. “Locality of travel” is the place where the employee stops for sleep or rest.

Sometimes an employer will pay the per diem allowance only for meals and incidental expenses (M&IE). For example, an “M&IE only” per diem allowance would be paid if the employer:

— provides the lodging in-kind,

— pays the cost of the lodging directly to the lodging provider,

— does not expect lodging expenses to be incurred, or

— pays the employee for actual lodging expenses, separately substantiated.

Attempting to simplify the extensive Federal per diem rate tables, the IRS has authorized a “high-low” substantiation method for travel within the continental United States. Under this method, a short list of “high-cost” localities is identified. The applicable per diem rate for travel to any one of these “high-cost” localities is $226 per day ($168 for lodging and $58 for M&IE), effective October 1, 2005. Typically, the “high-cost” localities of travel are large cities like Boston or New York, or resort areas (for example: Aspen, CO; Martha’s Vineyard, MA; Park City, UT).

At the same time, the rate for ALL OTHER locations within the continental United States is $141 per day ($96 for lodging and $45 for M&IE).

The “high-low” substantiation method may not be used for travel outside the continental United States. Also, if the employer’s per diem covers only meals and incidental expenses (M&IE), the “high-low” substantiation method does not apply.

Furthermore, employers who begin using the “high-low” substantiation method for a particular employee’s travel within the continental United States, must continue to do so for the calendar year. However, the employer is permitted to switch to reimbursement for actual expenses, or to an M&IE per diem for the specific locality, BEFORE the end of that calendar year. Also, the employer may apply the per diem substantiation method for travel outside the continental United States during the same year.

Finally, the M&IE portion of the Federal per diem must be pro-rated for partial days. For example, perhaps only a portion of the first or last days of a business trip will be spent away from home. The employee is allowed one-fourth of the applicable M&IE per diem for each quarter of the day spent traveling or away from home. The IRS defines the daily quarters to be: midnight to 6 AM, 6 AM to noon, noon to 6 PM, and 6 PM to midnight.

“Non-Accountable” Plans

When the employer advances money to an employee in anticipation of business trip expenses, but does not require substantiation of the expenditure of those funds and the return of any unused amount, the employer is said to be using a “nonaccountable” plan. Indeed, whenever an employer’s plan does not meet one or more of the three requirements (see above) for an “accountable” plan, it is a “non-accountable” plan.

The consequence of a “non-accountable” plan is that any employer payments under the plan are considered taxable income to the employee, subject to all Federal employment taxes, and reportable as wages on the employee’s Form W-2.

Furthermore, an employee under an “accountable” plan who fails to substantiate any expenses or return an excess reimbursement within a reasonable time, must treat the unsubstantiated amount as though it was paid under a “nonaccountable” plan for purposes of taxability. Thus, if a single reimbursement or advance payment has both “accountable” and “non-accountable” elements, the payment is treated as made proportionately under two separate plans. However, the employer’s reporting and withholding requirements apply only to the “non-accountable” element.

"TIP CREDIT" IS NOT A TAX TERM — IT RELATES TO WAGE AND HOUR RULES

The notion of "tip credit" applies only to tipped employees. As defined by Federal law and in most states, any employee who "customarily and regularly" receives more than $30 per month in tips is a "tipped employee." And, what is a "tip"? It is a voluntary payment received by an employee from a customer, the amount of which is determined by the customer. The amount of the tip must not be dictated by employer policy, nor subject to negotiation with the employer. Therefore, for example, the 15% gratuity a hotel may require for service at a banquet is not a "tip."

If a worker qualifies as a "tipped employee," the employer may credit toward the required minimum wage rate some of the tips received by the worker and reported to the employer. By allowing a portion of tips received to qualify as wages for purposes of minimum wage requirements, the employer lawfully can pay at a lower cash wage rate. However, the tip credit per hour normally is limited to a certain maximum dollar amount (the "maximum tip credit"). This limit is $3.02 per hour under Federal law, but varies from state to state.

When Congress amended the Fair Labor Standards Act to increase the Federal minimum wage rate on October 1, 1996, a significant change was made in terminology. Reference to "tip credit" was dropped, and a more easily understood term was substituted — the "minimum cash wage for tipped employees." Instead of attending to the maximum wage amount an employer can hold back from the tipped employee, the focus became a limit on how small an hourly "cash" wage the employee can lawfully receive. At all times, the applicable minimum wage rate must equal the sum of the maximum tip credit and minimum cash wage.

It is important to recognize that six states do not have their own minimum wage laws, although many of their employers must follow the Federal rules on tip credit and "minimum cash wage for tipped employees." These states are Alabama, Arizona, Louisiana, Mississippi, South Carolina and Tennessee.

In addition, another seven states do not allow the use of tip credit under their respective minimum wage laws. For the latter group of states, the "minimum cash wage for tipped employees" will always be the same as the state's regular minimum wage rate. The jurisdictions with no tip credit option are: Alaska, California, Minnesota, Montana, Nevada, Oregon, and Washington; plus, the Commonwealth of Puerto Rico

Finally, Georgia and Virginia have no state laws regulating maximum tip credit, even though they each set $5.15 per hour as the minimum wage rate. New Jersey does not have a maximum tip credit rate, but "recommends" a cash wage rate of at least $3.09 per hour, for tipped employees.

UNCLAIMED WAGES — Who Keeps Them?

After working for you about six months, Tom quit and moved to another part of the country without leaving a forwarding address. Some time later, you notice that several of the last paychecks you gave him have never been cashed. What to do?

Alternatively, suppose Tom's last paycheck was mailed to him at his last-known address, but today the U.S. Postal Service returns the check in an envelope stamped "Addressee Unknown." What should you do?

Generally, Federal law does not address the question. But, one conclusion on which every state agrees is that the employer is not entitled to keep the unclaimed wages as though they are some kind of windfall.

The first step for the employer is to recognize that the method of payment was by bank check, and that under state negotiable instrument laws generally, a bank check becomes "stale" after six months. But this relates only to the METHOD of payment. The value represented by the check continues to be the property of Tom, your former employee. The only obstacle to Tom's possession of the wages is his apparent disappearance.

The second step is to understand that unclaimed wages are a form of abandoned property that may become the property of the state if not claimed by the owner within a certain period of time. All states and the District of Columbia have laws defining the approved ways to dispose of all forms of abandoned property. These statutory directives are called "escheat" laws.

Employers holding unclaimed wages must remit the funds to the state and report certain information, before a particular annual date designated by the particular state. Generally, the annual reports must provide the following information: employee's name, last known address, description of the abandoned property ("wages"), the date the wages became payable, the dollar amount involved, and the date of the last transaction with the employee. Employers also must make a reasonable effort to contact the employee to prevent unclaimed wages from becoming abandoned.

The states vary widely on the length of time that must elapse before unclaimed wages are presumed abandoned. Many states require only one year, but some require 5 or more years. When unclaimed wages are deemed “abandoned” by the particular state, the employer may cease reporting them annually.

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