Tax Requirements Applicable to Travel Reimbursements, Advances and Bargaining Units Subsistence Allowance

INTRODUCTION

Employers must generally satisfy federal employment tax requirements with respect to all “wages” paid to employees. A key term which presents interpretational problems in applying this requirement is the word “wages.” Regulations, rulings and case law have served to provide guidance and examples of how broadly the term should be interpreted and how it should be applied to particular payment arrangements. The Internal Revenue Service (IRS) has set forth a specific set of rules for applying employment tax requirements in the context of travel reimbursements and advances made by employers. See IRS Publication 463.

A related set of Internal Revenue provisions address the question of whether employer-paid reimbursements and advances may be deducted by the employer for purposes of arriving at the employer’s taxable income. The requirements imposed for deductibility purposes relate to the type and degree of substantiation that must be maintained to prove the amount and purpose of particular travel expenses.

This bulletin will explain the rules with respect to employment taxes insofar as they apply to reimbursements and advances paid by employers with respect to travel and other subsistence payments. It will also address the related question of the employer’s right to deduct these payments as ordinary and necessary business expenses.

EMPLOYMENT TAX REQUIREMENT (WITHHOLDING)

If an amount paid by an employer to an employee falls within the definition of the term “wages,” the employer is generally required to withhold from the amount paid to the employee an amount equal to the employee’s share of Federal Insurance Contributions Act (FICA) tax and the amount required to be withheld and paid toward the employee’s income tax in accordance with the Form W-4 which the employee has submitted to the employer. The employer is required to promptly pay these withheld amounts to the IRS and to also pay the employer’s share of the FICA tax and the Federal Unemployment Tax Act (FUTA) tax.
If the employer fails to pay these employment taxes, an audit by the IRS could impose an enormous tax liability on the employer. The employer will be required upon audit to pay not only the FUTA tax and employer’s share of FICA tax, which it should have paid when the wages were paid to the employee, but it will also be required to pay from its own funds the employee’s share of FICA tax and the income tax which should have been withheld. The IRS will also assess penalties and interest on any additional FICA, FUTA and income withholding which an employer is required to pay as the result of an audit. Furthermore, if an employer corporation is unwilling or unable to pay the tax, the IRS will hold principal officers of the corporation personally liable for making these payments.

Because of the potentially large tax exposure which could result from an IRS audit determination that employment tax requirements were not satisfied, it is extremely important that employers not inadvertently omit from “wages” items which may not legitimately be excluded. Employers generally have no difficulty recognizing that salaries, bonuses and similar payments to employees constitute “wages” on which employment taxes must be paid. A determination whether reimbursements or advances to employees are properly characterized as “wages” may not be so simple, however.

The employment tax regulations specifically exclude from the definition of “wages” any “amounts paid specifically, either as advances or reimbursements, for traveling or other bona fide ordinary and necessary expenses incurred or reasonably expected to be incurred in the business of the employer.” Although this language would appear, on its face, to be quite broad in scope, the IRS has narrowed it in application.

The regulations specifically require that a reimbursement or advance will be excluded from wages only if it is paid by separate check or is otherwise specifically identified. Therefore, if the employer is delivering to an employee a single check for both salary and a travel advance, the employer should maintain particular records of this break-down. If the payment is not broken down in this fashion, the IRS could treat the entire payment as wages subject it to employment taxes.

Travel expenses paid or incurred in connection with a temporary work assignment away from home are typically qualified travel expenses. However, travel expenses paid in connection with an indefinite work assignment do not qualify as deductible travel expenses and therefore are classified as wages. Any work assignment in excess of one year is considered indefinite. Also, if it is realistically expected that the employee will work at an assignment for more than one year, whether or not the employee actually works there that long, the assignment is considered indefinite. Likewise, an assignment that starts as a temporary assignment will become an indefinite assignment as soon as it is known that the assignment is expected to last more than one year and then becomes wages from that point forward, according to Rev. Rul. 93-86. Any allowance paid for travel expenses incurred on an indefinite assignment is supplemental wages to the employee and fully taxable.

In published rulings, the IRS has stated that it is not proper to exclude advances from wages unless the employee is required to account to the employer to verify that the reimbursements or advances are actually expended for business purposes. For example, if an employer provides an automobile allowance for an employee to cover his
daily travel expenses, but does not require any verification whether the employee uses his own automobile or travels for free with others, the employer will not be entitled to treat the payments to the employee as reimbursements or advances, and employment taxes will have to be paid on the amount of the automobile allowance.

INCOME TAX DEDUCTIBILITY

SUBSTANTIATION REQUIREMENTS

The requirements imposed by Notice 894 for employment tax purposes overlap with the requirements imposed by Section 274 of the Code with respect to an employer’s taxable income.

Unless the employer satisfies the substantiation requirements imposed by Section 274, the employer will not be permitted to deduct the amount of the travel advances or reimbursements, regardless of whether the employer has excluded these payments from wages for employment tax purposes. Furthermore, although Code Section 162 generally permits the deduction of all ordinary and necessary business expenses, this general provision is limited by Section 274(n) which permits only 50% of the cost of meals to be deducted. This restriction applies regardless of whether the meal expense is incurred while on travel away from home.

The regulations under Section 274 explicitly state that taxpayers bear the burden of proof to substantiate each element of expenditure for travel. There are two alternative methods for satisfying this substantiation requirement with respect to reimbursements or advances for travel and subsistence.

1. The first alternative is to satisfy the substantiation requirements generally imposed on all travel and entertainment expenses. To satisfy these requirements, the employer must obtain from each employee an accounting of how particular advances or reimbursement payments were actually expended. A simple written statement from the employee as to how he expended the funds will not be sufficient. Rather, the employer must require the employee to provide it with a detailed breakdown of particular expenses, together with copies of receipts, bills, invoices or other corroborative evidence establishing the specific amount, date, place and purpose of each travel expenditure. These records should be generally sufficient so that a person reviewing them would be able to verify that the funds advanced or paid as reimbursements were actually expended for travel away from the employees’ tax home, including the costs of airfare or other transportation, meals, lodging and incidental expenses of a non-personal nature. It is suggested that the employer audit or review its files maintained for substantiation purposes, with a critical eye to recognizing whether an IRS auditor would question the reliability and degree of substantiation maintained. If the employer maintains records sufficient to satisfy this general substantiation requirement, it will be entitled to deduct 50% of the amount of the employee’s meal expenses and the entire amount of airfare, lodging and other travel expenses.

2. The Internal Revenue regulations provide an alternative substantiation method which an employer who provides specific subsistence, transportation or meal allowances may use. These regulations allow the substantiation requirement to be
satisfied even though the detailed type of receipts, bills and other substantiation necessary to satisfy the general substantiation requirement discussed above is not satisfied. This alternative relates only to per diem or other reimbursement arrangements relating to subsistence expenses, such as meals, lodging, laundry and other incidental expenses, incurred during an employee’s travel away from home. It does not apply to the transportation cost to and from the away-from-home destination.

Because the deductibility of meal expenses is limited to 50% of the cost of the meals, an employer who uses a per diem method must allocate the per diem payment between the allowance for meal expenses and the allowance for other expenses. The employer will be entitled to deduct only 50% of the meal expenses allowance but will be entitled to deduct the entire amount of the other element of the per diem payment. The IRS has stated that it will permit any employer that pays a single per diem amount to cover both meals and lodging to allocate the amount between meals and lodging “on a reasonable basis.” To establish such a reasonable basis of allocation reflecting the average meal expenses ordinarily incurred by employees while traveling in the same geographical area would be sufficient.

INCOME TAX CONSEQUENCES TO THE EMPLOYEE

If an employer does not report a reimbursement or advance on the Form W-2 provided to the employee, the employee can exclude the amount of the reimbursement or advance from his income. If a reimbursement or advance is listed on the Form W-2 as wages, the employee must report the listed amount as income. The employee will be entitled, however, to claim deductions for the ordinary and necessary expenses incurred for his subsistence while traveling away from home. In this case, the burden of satisfying the Section 274 substantiation requirements will be solely upon the employee, rather than the employer.

The employee should be aware that he should deduct these business expenses “below the line,” i.e., he should deduct the expenses from adjusted gross income in order to arrive at taxable income, rather than deducting them from gross income to arrive at adjusted gross income. Because the deduction is below-the-line, the employee’s ability to deduct these expenses will be restricted by Section 67 of the Code. Section 67 restricts a taxpayer’s right to deduct certain types of below-the-line business expenses except to the extent that the aggregate amount of such expenses for the year exceeds two percent of the taxpayer’s adjusted gross income.

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