Choosing the best way to reimburse employee travel expenses

If your employees incur work-related travel expenses, you can better attract and retain the best talent by reimbursing these expenses. But to secure tax-advantaged treatment for your business and your employees, it's critical to comply with IRS rules.

Reasons to reimburse

While unreimbursed work-related travel expenses generally are deductible on a taxpayer's individual tax return (subject to a 50% limit for meals and entertainment) as a miscellaneous itemized deduction, many employees won't be able to benefit from the deduction. Why?

It's likely that some of your employees don't itemize. Even those who do may not have enough miscellaneous itemized expenses to exceed the 2% of adjusted gross income floor. And only expenses in excess of the floor can actually be deducted.

On the other hand, reimbursements can provide tax benefits to both your business and the employee. Your business can deduct the reimbursements (also subject to a 50% limit for meals and entertainment), and they're excluded from the employee's taxable income — provided that the expenses are legitimate business expenses and the reimbursements comply with IRS rules. Compliance can be accomplished by using either the per diem method or an accountable plan.

Per diem method

The per diem method is simple: Instead of tracking each individual's actual expenses, you use IRS tables to determine reimbursements for lodging, meals and incidental expenses, or just for meals and incidental expenses. (If you don't go with the per diem method for lodging, you'll need receipts to substantiate those expenses.)

The IRS per diem tables list localities here and abroad. They reflect seasonal cost variations as well as the varying costs of the locales themselves — so London's rates will be higher than Little Rock's. An even simpler option is to apply the "high-low" per diem method within the continental United States to reimburse employees up to $282 a day for high-cost localities and $189 for other localities.

You must be extremely careful to pay employees no more than the appropriate per diem amount. The IRS imposes heavy penalties on businesses that routinely fail to do so.

Accountable plan

An accountable plan is a formal arrangement to advance, reimburse or provide allowances for business expenses. To qualify as "accountable," your plan must meet the following criteria:

- It must pay expenses that would otherwise be deductible by the employee.
- Payments must be for "ordinary and necessary" business expenses.
- Employees must substantiate these expenses — including amounts, times and places — ideally at least monthly.
- Employees must return any advances or allowances they can't substantiate within a reasonable time, typically 120 days.

If you fail to meet these conditions, the IRS will treat your plan as nonaccountable, transforming all reimbursements into wages taxable to the employee, subject to income taxes (employee) and employment taxes (employer and employee).

Please contact Ceschini, CPAs at (631) 474-9400 for more information about this topic and other tax and business developments – such as new IRS regulations and court decisions.