Expenses vs. Compensation: Know the rules and stay on the IRS' good side.

If you find your employees covering business-related expenses out of pocket, you need a plan to reimburse them. While this might seem simple initially, you must consider a slew of legalities and tax regulations when managing employee expense reimbursement.

When you have plans to reimburse your employees, you want to ensure it's done with an accountable plan in place so you can repay them 100% tax-free. Otherwise, the reimbursement will be taxable as wages.

Below, you will find more information on navigating this from an HR perspective.

What are employee expenses?

Employee expenses refer to costs associated with employees performing their job duty.

You can reimburse your employees for these expenses when they're necessary to perform the work-related task properly, and the employee can provide detailed receipts regarding the cost.

You must ensure the process is managed correctly, and if done correctly, you can reimburse them 100% tax-free instead of your employees being stuck with an unexpected tax bill, which is an unwelcome surprise.

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Employee expense guidelines

According to the accountable plan rules, there are guidelines to ensure this is done correctly, allowing for tax-free reimbursements.

Employees must have paid or incurred deductible expenses while working for you

This essentially means there must be a business connection. The business connection will be met if the plan provides payments for business expenses to be incurred by an employee in connection with the performance of services for the employer. Otherwise, if you pay your employee for something unrelated to a business task, it will be considered traditional compensation, which is taxable.

Employees adequately account for those expenses within a reasonable period

This is where most employees and employers struggle with expense reimbursement. Documentation is crucial for employee expenses to be managed appropriately and confirmed. Therefore, there must be guidelines in place to ensure this occurs.

- Employees should complete a detailed expense report showing the expenses they incurred, where it took place and the business conducted.
- Employees should submit receipts, canceled checks, or other detailed bills for verification.
- Employers can enact the de minimis rule in which employees may be reimbursed tax-free for their business expenses, up to $75, without the need to submit receipts. Hotel bills are , however, excluded from this rule.
- Most employers will set the de minimis amount at $25, which is the old rule.

A stranger (aka IRS auditor) should be able to review your documentation and quickly determine that it was a business expense.

Employees return excess reimbursements or allowances within a reasonable period

Reimbursements are considered excess reimbursements when the employee failed to adequately account for the expense within a reasonable time.

This can be tricky because if you paid reimbursement or an advance to an employee that wasn’t accounted for, the excess amount would be taxable for both you and the employee.

However, there are safe harbors in place by the IRS to make this part easier.

The reasonable time safe harbor will consider it appropriate for an employee to receive an advance within 30 days of incurring an expense, account for the cost within 60 days of it being incurred, and return excess reimbursement within 120 days after the employee incurred the expense.

Alternatively, the periodic statement safe harbor gives employees a periodic statement to account for outstanding amounts complying within 120 days.

Accountable plan policy pointers

If you want a secure, accountable plan policy in place, be sure to incorporate these rules.

- Employees should submit original receipts; if originals aren’t available, allow the service recipient or vendor to prepare the receipt and include their name, date, and the amount of the expense.
- Employees can’t alter receipts.

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- Receipts completed by employees won't be reimbursed and will be subject to investigation for possible falsification of company records because receipts are company property.
- Employees must explain why copies of receipts are submitted instead of originals.
- A responsible corporate officer must submit exceptions with supporting documentation.

Types of business expenses

Employees can incur a wide range of expenses, but here are some of the most common you'll likely have to reimburse over time.

Petty cash expense

There's no rule from the IRS concerning a petty cash expense, but these are typically small expenses that cost less than $75 and don't require a receipt under the de minimis rule.

Meal and entertainment expenses

When your employee incurs meals and entertainment-related expenses, here are some guidelines to consider.

According to the IRS, meals can only be deductible if they're considered ordinary and necessary for the business. Meals are ordinary when it's a normal, usual, or customary way of operating in your line of business. While necessary expenses mean they're appropriate or helpful for your business.

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Times when the meals can't be reimbursed include:

- The dining experience is lavish or extravagant
- The employee or employer isn't present during the meal
- An employee's spouse is included in the meal, and there's no business reason for the spouse to attend

As of today, employees can deduct 50% of meal expenses on Form 1120.

However, entertainment is different.

You can no longer deduct entertainment expenses. That means it's up to you to determine whether you still want your employees to partake in entertainment-related activities and reimburse them for it.

Suppose your employees are partaking in an entertainment event, such as taking clients to a baseball game. In that case, you want to ensure the food and drink receipts are separate from the entertainment receipts, like buying tickets or souvenirs from the game, or they're differentiated when receipts are submitted.

Traveling expenses

Travel is another typical reimbursable expense for employees.

Overnight travel

You can reimburse every expense an employee incurs while traveling overnight purely for business. Other situations might occur when an employee is traveling for personal reasons but pays for business-related expenses, these can be reimbursed 100% tax-free. Also, if an employee only needs to be gone for a night, but it's cheaper to stay for the weekend, they can reimburse all expenses since the additional time out of town isn't considered a personal trip.

When traveling with a spouse, their fees are only reimbursable if they're there for something specifically related to business.

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When reimbursing employees, you can use a mix of per diem allowances and direct reimbursements. A per diem is a fixed sum paid each day employees must travel away from home on business. In addition, there are hotel, meal, and incidental per diem rates, which vary by location. When using per diems, employees don't have to account for everything they paid.

High low rates are another way to use per diems and are a simplified and shorter method of computing the federal per diem rate. However, you can't use this version for lodging, meals, and incidentals and to pay for meals and incidental expenses only.

Regular per diems might be more advantageous for the employee.

Meals

Employees who are away from home overnight may be reimbursed for their substantiated meal expenses. However, if an employee is attending an all-day seminar, they can only be reimbursed tax-free for their meal unless there's a business reason for picking up the tab on someone else's meal.

Vehicle expenses

When reimbursing for vehicle expenses, there are numerous considerations to keep in mind.

Car allowances can be reimbursed at the IRS' standard mileage rate of 56¢ a mile (for 2021), though you may use a lower per-mile rate.

Also, when employees are telecommuting as a requirement, you may reimburse the expenses incurred by employees to travel from their home office to the primary office. Similarly, if they drive from home to their first job of the day, like when working with clients, a seminar, or a contracting site, the expenses may be reimbursed tax-free.

Additional travel-related circumstances that will allow for reimbursement include:

- **Travel that's all in a day's work:** Expenses incurred by employees may be reimbursed tax-free.
- **Special one-day assignment:** Expenses incurred by employees may be reimbursed tax-free.
- **Travel to a temporary location:** Tax-free reimbursements can be made for up to one year. When it becomes apparent employees will be at the work site for longer than one year, these expenses are taxable when it becomes obvious employees will be at the work site for longer than one year.

Cell phone expenses

Employees' business use of their phone or employer-provided equipment may be reimbursed tax-free if you have a substantial noncompensatory reason for requiring them to use cell phones. That means employers must contact employees in an emergency, or employees must contact clients after hours. The IRS gives you a little break here before they don't require you to keep records of business and personal use for this reimbursement.

You can only reimburse employees for their basic monthly calling/data charges as long as their plan is reasonably related to the employer's needs.

However, if phones are given as a perk, they don't qualify for substantial noncompensatory reasons, requiring more record keeping.

Employees' work from home expenses

When employees work from home for your convenience, you can reimburse them for the business use of their

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home internet tax-free. However, employees must track their business use of the internet.

You can also reimburse them for home office expenses such as paper and ink, but employees must submit receipts.

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