Chapter 4: Special Taxpayers

It is fundamental to U.S. tax law that taxpayers are entitled to deduct business expenses, generally defined by the Code as the “ordinary” and “necessary” expenses incurred in carrying on a trade or business. Eligible nonemployee business expenses are deductible as part of the calculation of the taxpayer’s adjusted gross income (AGI). Unreimbursed employee business expenses, however, are deductible from income only to the extent that, when combined with other miscellaneous itemized deductions, they total more than 2% of the taxpayer's AGI. The amount of the total miscellaneous itemized deductions that exceeds the 2% floor is entered on line 27 of Schedule A, Itemized Deductions.

In recognition of the impact that unreimbursed expenses have on employees, employers often reimburse employees or provide them with an allowance to cover business expenses. As long as this reimbursement or allowance is made under an accountable plan, the reimbursement is not includable in the employee's wages, and the employee does not pay tax on this amount. If the reimbursement paid to the employee by the employer does not meet the requirements of an accountable plan, it is deemed to have been paid under a nonaccountable plan. A reimbursement provided by an employer to an employee under a nonaccountable plan is includable as wages on the employee’s Form W-2, Wage and Tax Statement. Employees can then deduct eligible expenses as unreimbursed business expenses.

Depending on the facts and circumstances of the employer-employee payment arrangement, some reimbursements or allowances from an employer to an employee may be made under an accountable plan, while other payments between the same parties may be made under a nonaccountable plan.

ACCOUNTABLE PLAN

An arrangement under which an employer reimburses an employee for expenses or provides an advance or an allowance to the employee to cover the expenses is an accountable plan if all the following requirements are met:

1. The expenses have a business connection, meaning that the employee incurred the expenses in connection with the performance of services as an employee of the employer and the expenses are allowable as deductions.
2. The employee adequately substantiates the expenses by accounting to the employer for these expenses within a reasonable period of time.
3. The employee returns to the employer any excess reimbursement, advance, or allowance within a reasonable period of time.

The determination of whether expenses are paid under an accountable plan is determined on an employee-by-employee basis.

1. IRC §162(a).
2. IRC §62(a)(1).
3. IRC §67(a).
6. Treas. Reg. §§1.62-2(d), (e), (f).
Adequate Substantiation

Requirement 2 states that employees must adequately substantiate the expenses paid by their employers through an accountable plan. The following expense categories must be substantiated.7

- Travel expenses while away from home, including meals and lodging

Note. The tax rules for deducting travel expenses, including the 50% limitation on meals and entertainment are explained in the 2013 University of Illinois Federal Tax Workbook, Volume C, Chapter 5: Special Taxpayers.

- Expenses associated with business entertainment, amusement, or recreation, or incurred for a facility used in connection with these types of activity
- Business gifts (The amount deductible by the employer may be limited.)
- Certain “listed property,” including passenger automobiles8

Substantiation for travel, entertainment, and gift expenses must include an adequate accounting and other evidence to prove the following.9

- The amount of the expense or gift
- The time and place of the travel or entertainment, the use of the facility, or the date and description of the gift
- The business purpose of the expense or gift
- The business relationship to the employee of the persons entertained or receiving the gift

The regulations specify that an “adequate accounting” means that an employee must submit to the employer an account book, diary, log, statement of expense, trip sheet, or similar record maintained by the employee in which the information as to each element of an expenditure is recorded at or near the time of the expenditure.10 In addition, for all lodging expenses incurred while traveling away from home and for any other expenditure of $75 or more (with the exception of a transportation charge when documentation may not be readily available), the employee must also submit to the employer documentary evidence such as receipts, paid bills, or similar evidence sufficient to support the expenditure.11

The table on the following page provides a template for an adequate accounting by an employee.12

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7. IRC §274(d).
9. IRC §274(d).
### Deemed Substantiation

An employer can pay a per diem allowance to an employee instead of reimbursing actual travel expenses to an employee. The amount of the expenses paid for each calendar day is **deemed substantiated** if it does not exceed the lesser of the per diem allowance for that day or the amount computed at the federal per diem rate. If the employee provides an adequate accounting to the employer (as described earlier), they are not required to include the amount deemed substantiated in their gross income. The amount deemed substantiated is not reported as wages on the employee’s Form W-2 and is exempt from withholding and payment of employment taxes.\(^\text{13}\)

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**Note.** The federal per diem rates are effective October 1 of each fiscal year. These rates can be found at [www.gsa.gov/perdiem](http://www.gsa.gov/perdiem).

**Note.** For a detailed explanation of how to calculate appropriate deductions for meals and lodging using the federal per diem rates, including a discussion of the high-low method, see the 2013 *University of Illinois Federal Tax Workbook, Volume C, Chapter 5: Special Taxpayers.*

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