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Reimbursing Employees? Remember That Form Matters!

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As an inducement to recruit and retain employees, employers often agree to offer employees certain expense reimbursements. However, if these reimbursement arrangements fail to meet certain requirements, the employer and employee could face unexpected tax consequences. As discussed below, regardless of whether the reimbursement is intended to be a nontaxable or taxable benefit to the employee, the employer needs to structure the arrangement carefully or face undesirable results.

Accountable Plans

Employees who incur work-related expenses may be limited in their ability to deduct the business expenses on their income tax returns because of specific limitations placed on individual taxpayers. Therefore, employers routinely reimburse employees for their business related expenses. The goal is for the employer to receive a current deduction for the reimbursement while the employee excludes the reimbursement from income. In order to achieve this goal, the reimbursement should be made in accordance with the accountable plan rules established by the Internal Revenue Service ("IRS").

Under the accountable plan rules, reimbursements are excluded from the employee's income if the following requirements are met:

- The reimbursement must have a connection to the employer’s business;
- The employee must provide adequate substantiation of the business expense to the employer within a reasonable period of time; and,
- The employee must return excess reimbursement payments to the employer within a reasonable period of time.

Because reimbursements can be used to disguise compensation, they are often the subject of IRS scrutiny. Failure to comply with the substantiation requirement is a common problem. For example, an employer may reimburse an employee for mileage regardless of whether the employee provides proper documentation of the business use of the employee’s vehicle. Noncompliance could affect a specific reimbursement or could affect all payments under a reimbursement arrangement if there is a pattern of abuse.

Although the employee may be liable for income, Social Security, and Medicare taxes if the reimbursement is deemed compensation, the employer may also be liable for payroll taxes and may be penalized for failing to properly withhold the taxes payable by the employee.

Section 409A

Even if the employer and employee recognize that the reimbursement will be taxable to the employee, the reimbursement arrangement could trigger penalties under Section 409A of the Internal Revenue Code ("Section 409A"). Section 409A rules are extremely complicated and impose payment timing restrictions on certain deferrals of compensation. In general, a deferral of compensation occurs when an employee earns the right to compensation in one tax year but the compensation is payable in a later tax year. If a deferred compensation arrangement is not exempt from Section 409A and fails to comply with the rules, the employee is subject to a 20% penalty on the amount deferred.

Unless an exemption applies, taxable reimbursement arrangements are subject to the following rigid rules of Section 409A:

- The eligible expenses for reimbursement must be clearly and objectively defined and there must be a prescribed period of time during which the expenses must be incurred;
- The amount of expenses reimbursed in one year may not affect the amount of expenses eligible for reimbursement in a different year;
- The reimbursement must be made by the end of the year following the year in which the expenses were incurred; and,
- The right to reimbursement is not subject to liquidation or exchange for another benefit.

Designing a reimbursement arrangement can be a Section 409A trap for the unwary. For example, assume an employment agreement provides that an executive is entitled to the reimbursement of membership fees up to $15,000 over a three year period. The reimbursement violates Section 409A because, to the extent the executive incurs membership fees in the first year, the agreement would affect the amount available for reimbursement in the subsequent years.

Conclusion

Reimbursements can be an effective tool to provide benefits to recruit and retain employees. However, if the reimbursement is not structured properly, it can trigger harsh consequences for both the employer and employee. Therefore, reimbursement arrangements should be reviewed carefully by a knowledgeable professional to ensure compliance with the applicable tax rules.

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