

Part I

Section 62.—Adjusted Gross Income Defined

(Also: §§ 274(d), 3121(a), 3306(b), 3401(a))

26 CFR 1.62-2: Reimbursements and other expense allowance arrangements

(Also: §§ 1.274-5, 1.274-5T, 31.3121(a), 31.3306(b), 31.3401(a))

Rev. Rul. 2003-106

ISSUE

Whether an employer's expense reimbursement arrangement for deductible travel and entertainment expenses, which includes new procedures for the use of electronic receipts and expense reports, is an accountable plan under § 62(a)(2)(A) and (c) of the Internal Revenue Code and the regulations thereunder.

FACTS

An employer currently maintains a reimbursement arrangement, meeting the accountable plan requirements, under which it reimburses business-related travel and entertainment expenses incurred by its employees; paper receipts and expense reports are required. The employer reimburses employees for all properly substantiated business-related travel and entertainment charges submitted timely on an expense report along with any necessary receipts. The employer excludes from employees' wages reimbursements of all deductible business expenses provided under the arrangement. The employer also reimburses nondeductible business expenses (such as travel not away from home) and treats those reimbursements as wages. The employer does not reimburse employees for personal expenses.

To facilitate reimbursement of travel and entertainment expenses, the employer arranges to have a credit card company issue a business credit card to each employee the employer determines is likely to incur travel and entertainment expenses for necessary business reasons. Employees who use the business credit card receive monthly billing statements from the credit card company and are personally liable to the credit card company for all charges billed to the card, including late payment fees.

To reduce the burden associated with submitting receipts and expense reports, the employer implements an electronic reimbursement arrangement for travel and entertainment expenses that eliminates the need for paper receipts and paper expense reports in most instances. Under this new arrangement, the credit card company provides the employer with an electronic receipt for all expenses billed to an employee's business credit card on a daily basis. An electronic receipt contains the date of the charge, the amount of the charge, the merchant's name, the merchant's location, and, if

available, an itemization from the merchant of each expense included in the charge. The credit card company generally issues three types of electronic receipts to the employer: 1) a receipt with sufficient information on its face to indicate the nature of the charge (such as a charge from an airline carrier for a passenger ticket); 2) a receipt with an aggregate charge itemizing each expense (such as a final bill from a hotel listing separately the costs for meals, lodging and telephone calls); and 3) a receipt with an aggregate charge without itemizing each expense (such as a final bill from a hotel that does not list each charge separately).

Under the employer's new electronic expense reimbursement arrangement, the employer transfers the electronic receipts received from the credit card company to a database. This information cannot be altered once entered. Employees access the database to create an electronic expense report to accompany the electronic receipts associated with their travel and entertainment expenses. For all expenses, the employees must indicate whether the expenses are personal or business-related travel and entertainment. For all business-related travel and entertainment expenses, the employee must provide the following information in the electronic expense reports for each travel and entertainment expense: 1) a description of the expense and the business purpose it served; and 2) for each entertainment expense, the names and business relationship of the persons entertained in addition to the date of, place of, duration of, and participants in any business discussion that occurred directly before or after the entertainment.

The employer requires employees to submit paper expense reports and receipts for: 1) any expense over \$75 where the nature of the expense is not clear on the face of the electronic receipt; 2) all lodging invoices for which the credit card company does not provide the merchant's electronic itemization of each expense; and 3) any expenses paid for by the employee without using the business credit card. The employer requires that the paper receipts and expense reports contain information sufficient to substantiate the amount, date, time, place, and business purpose of each expense. For example, if the credit card company provides an electronic receipt for an amount billed from a hotel that does not itemize each expense on the bill, the employee must provide paper documentation detailing each expense. Also, if the employee incurs a travel or entertainment expense for necessary business reasons but pays for it without using the business credit card, the employee must submit paper receipts and a paper expense report.

To receive reimbursements under the reimbursement arrangement, employees must submit expense reports with any necessary receipts to the employer within 30 days after returning from a business trip or incurring a travel or entertainment expense, but no later than 60 days after incurring the expense. Once the employer approves an employee's travel and entertainment expense report, the employer sends payment directly to the credit card company for the business expenses listed in the report. The employer does not reimburse any charges made to the employee's business credit card that are not listed in the expense report approved by the employer. The employer treats

the reimbursement of any nondeductible business expenses as wages paid to the employee and does not reimburse personal expenses.

The employer's use and retention of electronic records meets the requirements of Rev. Proc. 98-25, 1998-1 C.B. 689.

LAW

Section 62 generally defines "adjusted gross income" as gross income minus certain ("above-the-line") deductions. Section 62(a)(2)(A) allows an employee an above-the-line deduction for expenses paid or incurred by the employee, in conjunction with services performed as an employee, under a reimbursement or other expense allowance agreement with the employer. Section 62(c) provides that an arrangement will not be treated as a reimbursement or other expense allowance arrangement for purposes of § 62(a)(2)(A) if: 1) the arrangement does not require the employee to substantiate the expenses covered by the arrangement to the person providing the reimbursement; or 2) the arrangement provides the employee with the right to retain any amount in excess of the substantiated expenses covered under the arrangement.

Under § 1.62-2(c)(1) of the Income Tax Regulations, a reimbursement or other expense allowance arrangement satisfies the requirements of § 62(c) if it meets the requirements set forth in paragraphs (d), (e), and (f) of § 1.62-2 (business connection, substantiation, and return of excess). If an arrangement meets these requirements, all amounts paid under the arrangement are treated as paid under an accountable plan. § 1.62-2(c)(2)(i). Amounts paid under an accountable plan are excluded from the employee's gross income, are not required to be reported on the employee's Form W-2, and are exempt from the withholding and payment of employment taxes. §§ 31.3121(a)-3, 31.3306(b)-2, 31.3401(a)-4 of the Employment Tax Regulations, and 1.6041-3(h)(1) of the Procedure and Administration Regulations.

If an arrangement does not satisfy one or more of these requirements, all amounts paid under the arrangement are paid under a "nonaccountable plan." § 1.62-2(c)(3). Amounts paid under a nonaccountable plan are included in the employee's gross income for the taxable year, must be reported to the employee on Form W-2, and are subject to withholding and payment of employment taxes. §§ 1.62-2(c)(5), 31.3121(a)-3(b)(2), 31.3306(b)-2(b)(2), 31.3401(a)-4(b)(2), and § 1.6041-3(h)(1). Additionally, § 1.62-2(k) provides that if a payor's reimbursement or other expense allowance arrangement evidences a pattern of abuse of the rules of § 62(c) and the regulations thereunder, all payments made under the arrangement will be treated as made under a nonaccountable plan.

An arrangement meets the business connection requirement of § 1.62-2(d)(1) if it provides advances, allowances, or reimbursements only for business expenses that are allowable as deductions under part VI (§ 161 and following), subchapter B, chapter 1 of the Code, and that are paid or incurred by the employee in connection with the performance of services as an employee. Under § 1.62-2(d)(2), if an arrangement, in addition to reimbursing deductible business expenses, also reimburses nondeductible

but otherwise bona fide expenses related to the employer's business (such as travel not away from home), the payor will be treated as maintaining two arrangements—the deductible business expenses will be treated as satisfying the business connection requirement, and the nondeductible business expenses will be treated as paid under a nonaccountable plan. The payment may be actually received from the employer, its agent, or a third party for whom the employee performs services as an employee of the employer. § 1.62-2(d)(1). Section 1.62-2(d)(3)(i) provides that the business connection requirement will not be satisfied if the payor arranges to pay an amount to an employee regardless of whether the employee incurs or is reasonably expected to incur bona fide business expenses related to the employer's business.

An arrangement for travel and entertainment expenses meets the substantiation requirement of § 1.62-2(e)(1) if the arrangement requires each business expense to be substantiated to the payor in accordance with paragraph (e)(2), within a reasonable period of time. An arrangement for those expenses meets the substantiation requirements if the employee makes an adequate accounting to the payor that satisfies the substantiation requirements of § 274(d) and the regulations thereunder. § 1.62-2(e)(2).

Section 274(d) disallows a deduction under § 162 for any expense for travel away from home, including meals and lodging, or entertainment unless the taxpayer substantiates by adequate records or by sufficient evidence the requisite elements of each expenditure. For travel expenses, the taxpayer must establish the amount, time, place, and business purpose of the expenditure. § 1.274-5T(b)(2). For business entertainment expenses, the taxpayer must establish the amount, date (and possibly duration of business discussion), place, business purpose, names and business relationship of the persons entertained, all as set forth in more detail in § 1.274-5T(b)(3) and (b)(4). Section 1.274-5T(c)(2)(i) provides that, to substantiate each element by adequate records, the taxpayer must maintain: 1) an account book, diary, log, statement of expense, trip sheets, or similar record; and 2) documentary evidence that, in combination, are sufficient to establish each element of an expenditure. The account book, diary, log, statement of expense, trip sheet, or similar record must be prepared or maintained in such manner that each recording of an element of an expenditure is "made at or near the time of the expenditure." § 1.274-5T(c)(2)(ii). The phrase "made at or near the time of the expenditure" means the elements of an expenditure are recorded at a time when, in relation to making the expenditure, the taxpayer has full present knowledge of each element of the expenditure, such as the amount, time, place, and business purpose. An expense account statement which is a transcription of an account book, diary, log, or similar record prepared or maintained at or near the time of the expenditure, is considered a record prepared or maintained at or near the time of the expenditure if the expense account statement is submitted by an employee to his employer in the regular course of good business practice. § 1.274-5T(c)(2)(ii)(A). An employee must use adequate records to make an adequate accounting to substantiate expenses to the payor. § 1.274-5(f)(4)(i).

Section 1.274-5(c)(2)(iii) requires documentary evidence for any expenditure for lodging while traveling away from home and for any other expenditure of \$75 or more, except for transportation charges if the documentary evidence is not readily available. Acceptable documentary evidence includes receipts, paid bills, or similar evidence sufficient to support an expenditure. Ordinarily, documentary evidence will be considered adequate to support an expenditure if it includes sufficient information to establish the amount, date, place, and the essential character of the expenditure. For example, a hotel receipt is sufficient to support expenditures for business travel if it contains the name, location, and date of the expenditures and separate amounts for each charge, such as lodging, meals, and telephone. § 1.274-5(c)(2)(iii)(B).

Reimbursement of any expenses not substantiated within a reasonable period of time must be treated as made under a nonaccountable plan, and treated as wages. Section 1.62-2(g)(2)(i) provides a fixed date method safe harbor for purposes of satisfying the "reasonable period of time" requirement. Under this safe harbor, an expense substantiated to the payor within 60 days after it is paid or incurred will be treated as substantiated within a reasonable period of time.

An arrangement meets the return of excess requirement of § 1.62-2(f)(1) if the arrangement requires the employee to return to the payor within a reasonable period of time any amount paid under the arrangement in excess of the substantiated expenses.

Revenue Procedure 98-25 specifies the basic requirements that the Internal Revenue Service considers to be essential for satisfying the recordkeeping requirements of § 6001 in cases where a taxpayer's records are maintained by electronic or other non-manual methods. Failure to comply with the revenue procedure may result in imposition of applicable penalties under Subtitle F of the Code.

ANALYSIS

The employer's reimbursement arrangement for the employee's deductible business expenses, which includes the use of electronic receipts and electronic expense reports, satisfies all three of the essential elements for an accountable plan under § 62(a)(2)(A) and (c).

First, the expenses that are reimbursed through the plan are exclusively business expenses. All expenses must be submitted on either electronic or paper reports and must include specific information. If the electronic information is insufficient to determine whether the expenses are business expenses, paper documentation is required. The employer's expense reporting procedures give the employer the information it needs to verify that it is reimbursing exclusively for business expenses, and furthermore to distinguish reimbursements for business expenses deductible under part VI (§ 161 and following), subchapter B, chapter 1 of the Code, from reimbursements of nondeductible but otherwise bona fide business expenses that must be treated as wages paid under a nonaccountable plan. Moreover, the electronic receipts are generated only for employees with business credit cards, and the business

credit cards are provided only to employees who are likely to incur travel and entertainment expenses for business reasons. Consequently, the employer's travel and entertainment reimbursement arrangement satisfies the business connection requirements of § 1.62-2(d).

Second, the arrangement meets the substantiation requirement of § 1.62-2(e)(1). The employees are required to submit expense reports, electronic or otherwise, within 30 days of traveling or incurring an entertainment expense (but no later than 60 days after an expense is paid or incurred), describing each element of the expenditure. This time period is within the fixed date method safe harbor of substantiating to the payor within 60 days after an expense is paid or incurred provided in § 1.62-2(g)(2)(i). Requiring employees to complete an expense report within 30 days after returning from a trip or incurring an entertainment expense, supported by the electronic or paper receipts, also satisfies the requirement under § 1.274-5T(c)(2)(ii) that an individual have full present knowledge of each element of the expenditure, such as the amount, time, place and business purpose of the expenditure.

The electronic receipts provided to the employer by the credit card company for certain expenses include information sufficient to establish the amount, date, place and essential character of the expenditure and, therefore, qualify as "receipts, paid bills, or similar evidence" for purposes of the documentary evidence requirements of § 1.274-5(c)(2)(iii). Additionally, the employer requires paper receipts and expense reports for any expense over \$75 where the nature of the expense is not clear on the face of the electronic receipt, all lodging expenses for which the credit card company does not provide an electronic listing of expenses itemized by the merchant, and any expenses paid for by the employee without using the business credit card. The electronic data and or paper documents submitted to the employer constitute adequate records under § 1.274-5(c)(2) and satisfy the requirement that the employee make an adequate accounting to the employer to substantiate the respective expenses for purposes of § 274(d) and the regulations thereunder. Thus, the employer's travel and entertainment expense reimbursement procedures satisfy the substantiation requirement of § 1.62-2(e)(2).

Third, the plan meets the requirement for return of any payments in excess of the employee's substantiated expenses under § 1.62-2(f) because the employer's travel and entertainment expense reimbursement procedures reimburse only substantiated expenses. Although the credit card company provides the employer with electronic receipts for all expenses charged to the employee's business credit card, the employer reimburses only those expenses identified to the employer as business expenses and included in the expense report with appropriate documentation. Therefore, there is no amount in excess of substantiated expenses provided that must be returned within a reasonable period of time.

HOLDING

An employer's expense reimbursement arrangement for deductible travel and entertainment expenses, which includes new procedures for the use of electronic receipts and expense reports, is an accountable plan under § 62(a)(2)(A) and (c) and the regulations thereunder.

DRAFTING INFORMATION

The principal author of this revenue ruling is Joe Spires of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this revenue ruling, contact Mr. Spires on (202) 622-6040 (not a toll-free call).