

**LTR-RUL, UIL No. 125.04-00 Cafeteria plans, Nontaxable benefit; UIL No. 3121.01-06 Definitions, Wages, Payment for expenses; UIL No. 3306.02-00 Definitions, Wages; UIL No. 3401.01-00 Definitions, Wages subject to withholding, Letter Ruling 9052002, (Sep. 05, 1990)**

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**Uniform Issue List Information:**

UIL No. 0125.04-00

Cafeteria plans

- Nontaxable benefit

UIL No. 3121.01-06

Definitions

- Wages

-- Payment for expenses

UIL No. 3306.02-00

Definitions

- Wages

UIL No. 3401.01-00

Definitions

- Wages subject to withholding

NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

[Code Secs. 125, 3121, 3306 and 3401]

ISSUE

Are the salary reduction amounts under the travel reimbursement provisions of the Taxpayer's flexible benefit program reportable as wages on the participant's Form W-2 and subject to employment taxes and income tax withholding?

FACTS

On \*\*\*\*\* the Taxpayer adopted a Travel Reimbursement Plan as part of its Flexible Benefit Program. The Flexible Benefit Program offers employees a choice among group medical insurance, group disability income insurance, dependent/child care expenses, medical expenses and out of town travel expenses. To participate in the Flexible Benefit Program, employees complete a "Salary Reduction Agreement." Section I of that Agreement states, "WHEREAS, Employee wishes to obtain the benefits of IRC Section 79, 105, 106, 125, 129, 162 and any other Sections, as amended, that provide benefits; and WHEREAS, Employer is willing to assist Employee in

obtaining said benefits. NOW, THEREFORE, it is mutually agreed as follows: Employee's cash compensation per pay period shall be reduced \$\*\*\*\*\* plus (if selected) \$44.00 per day for Out of Town Travel expense effective with a pay period beginning on or after January 1, \*\*\*\*\*."

Under the Taxpayer's Travel Reimbursement Plan, a participating employee receives a \$44 per diem allowance for meals and lodging expenses for each day the employee certifies to the Taxpayer that the employee was away from home overnight on business. Article IV, section 4.02 of the Travel Reimbursement Plan states that, "A Participant shall submit a reimbursement request weekly setting forth the number of days away from home during the previous week while traveling on business for the Company." In exchange for the \$44 allowance, the participating employee's salary is reduced by \$44 pursuant to the Salary Reduction Agreement. Article V of the Travel Reimbursement Plan states that,

The Company will fund this Plan by making employer contributions, in whole or in part, pursuant to salary reduction agreements under which a Participant elects to reduce his compensation and to have such amounts contributed to the Plan, as employer contributions, by the Company on his behalf.

A participating employee, who is paid on a weekly basis, benefits financially in that taxable wages, for purposes of federal income tax withholding and the Federal Insurance Contribution Act (FICA), are reduced by the \$44 for each day the employee is away from home overnight on business. The reduced federal income tax withholding and reduced FICA result in an increase in the take-home pay of the employee (i.e., the salary reduction amount is taken out of gross weekly income on a pre-tax basis and the identical amount is immediately "reimbursed" to the employee in the same paycheck). Wages shown on the employee's Form W-2 exclude the per diem amounts. Employees who do not participate in the Travel Reimbursement Plan have their entire gross income subject to withholding and FICA taxes and their Forms W-2s reflect the total gross income earned.

The Taxpayer also realizes financial benefits under the Travel Reimbursement Plan in that the salary reduction amounts reduce the Taxpayer's liability for FICA taxes and Federal Unemployment Tax Act (FUTA) taxes.

The Taxpayer maintains that the \$44 paid for each day a participating employee certifies absence from home overnight on business is excludable from the employee's gross income under section 1.16217(b)(1) of the Income Tax Regulations because it constitutes reimbursement for travel expenses for which the employee is required to account to his employer. Additionally, the Taxpayer maintains that because the salary reduction is for travel, it is excluded from "wages" as defined in sections 3121, 3301 and 3401 of the Internal Revenue Code.

#### APPLICABLE LAW AND RATIONALE

An employee who has a choice between a nontaxable benefit and a taxable benefit (such as wages) generally must, under the doctrine of constructive receipt, include in gross income the taxable benefit he or she could have chosen, even if the employee actually chooses the nontaxable benefit. Section 1.451-2 of the Income Tax Regulations provides that income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, section 125 of the Code provides an exception to the constructive receipt rule and states that, "Except as provided in subsection (b) [relating to discriminatory plans], no amount shall be included in the gross income of a participant in a cafeteria plan solely because, under the plan, the participant may choose among the benefits of the plan." In addition, section 3121(a)(5)(G) for purposes of FICA and section 3306(b)(5)(G) for purposes of FUTA provide that the term "wages" does not include any payment made to, or on behalf of, an employee or his beneficiary under a cafeteria plan (within the meaning of section 125) if such payment would not be treated as wages without regard to such plan and it is reasonable to believe that (if section 125 applied) section 125 would not treat any wages as constructively received.

Accordingly, if the cafeteria plan rules under section 125 are not satisfied, the protection against constructive

receipt afforded by that provision is lost and the employee must include the taxable amounts in gross income (i.e., salary reduction amounts equal to the cost of the benefits selected). Therefore, the taxation of particular benefits and the inclusion of those benefits in gross income ultimately depends on whether there is a valid cafeteria plan.

On February 10, 1984, the Service issued News Release IR-84-22 which states:

So-called 'reimbursement,' 'flexible spending' and similar arrangements which purport to allow employees to pay their out-of-pocket ... personal expenses with 'pre-tax dollars' are without substance and do not reduce employees' taxable income.

Under these arrangements, employees submit proof of expenses to their employer, who recharacterizes a portion of the employees' otherwise agreed-upon salary as 'reimbursement' for such expenses. On that basis the employer treats, and advises employees to treat, the recharacterized amount as a tax-free payment and removes it from 'wages' for employment tax purposes. There may be variations of this type of arrangement which are equally invalid.

The IRS said that any 'reimbursement' under any such arrangements is part of the employee's income under Internal Revenue Code section 61 and is subject to federal income tax withholding and federal employment taxes.

...

Code section 125 does not change these results. ... [V]alid cafeteria plans [are those] in which the employee can make a one-time election before the beginning of the year between cash and eligibility for reimbursement of certain expenses for the year up to a stated amount. Under these plans, if the employee elects reimbursement, but incurs such expenses during the year in an amount less than the limitation, the employee receives no further benefits or payments of any kind.

Subsequently, on May 7, 1984, the Service published proposed cafeteria plan regulations (Prop. Treas. Reg. §1.125-1) (49 C.F.R. 19321). Question and Answer 15 of the proposed regulations provides that, "Generally, in order for participants to avoid constructive receipt with respect to taxable benefits offered under a cafeteria plan, the taxable benefits must at no time become currently available to the participants." Question and Answer 14 of the proposed regulations further provides that, "A benefit is treated as currently available to a participant if the participant is free to receive the benefit currently at his discretion or the participant could receive the benefit currently if an election or notice of an intent to receive the benefit were given. A benefit will not be treated as not currently available merely because of a requirement that the participant must elect or give notice of intent to receive the benefit in advance of receipt of the benefit." An arrangement, such as the one discussed in News Release IR-84-22, under which the benefit is received and the salary reduction is made only when and if the expense has been incurred and the employee elects to give notice of intent to receive the benefit, results in the taxable benefit (i.e., the salary reduction amounts) being "currently available" and includible in a participant's taxable income as if the participant had received the salary and paid it over to purchase the benefit. The salary reduction amounts under these types of arrangements will not avoid constructive receipt pursuant to Q&A 14 and Q&A 15 of Prop. Treas. Reg. §1.125-1.

In the legislative history of the Deficit Reduction Act of 1984 (Pub. L. 98-369) (DEFRA), Congress considered Prop. Treas. Reg. §1.125-1 and provided general and special transition relief from the effects of those rules for a limited period of time. The general transition relief was directed toward those rules in the proposed regulations concerning whether a plan is a cafeteria plan and the special transition relief was directed toward those rules relating to the applicable statutory exclusion provisions. With respect to the transition relief provisions, the Conference Report states:

... The general relief rule provides that a plan will not fail to be a cafeteria plan merely because of a failure to satisfy the rules relating to cafeteria plans under the proposed Treasury regulations and that a flexible spending arrangement will not fail the requirements of the applicable statutory exclusions merely because of a failure to satisfy the rules relating to such exclusions under these regulations. This general relief is provided until the earlier of January 1, 1985, or the effective date of any modification of the plan or arrangement to provide additional benefits if such modification becomes effective after February 10, 1984. The conference agreement does not prevent the application of the proposed Treasury regulations after the earlier of such dates ... The general transition rule is applicable to both benefit bank flexible spending arrangements and zero balance reimbursement account (ZEBRA) type flexible spending arrangements ... Under the ZEBRA-type arrangement, amounts generally are not specifically allocated to an account before the beginning of the year, but instead amounts are allocated only after an expense is incurred. H.R. Rep. No. 98-861, 98th Cong., 2d Sess, 1175-1176 (1984).

The special transition relief applied to benefits provided before the earlier of July 1, 1985, or the effective date of any modification of the arrangement to provide additional benefits if such modification became effective after February 10, 1984. The Conference agreement did not prevent the application of the proposed Treasury regulations after the earlier of the applicable dates.

Thus, in DEFRA, Congress specifically reviewed Prop. Treas. Reg. §1.125-1 and acquiesced, after a transition period, in the application of the Service's proposed rules to "ZEBRA" type arrangements which are denied the protection of section 125 from the doctrine of constructive receipt.

In the instant case, employees who elect to participate in the Travel Reimbursement Plan have their salary reduced by \$44 per day for each day they certify that they are away from home overnight on business. However, amounts are not specifically allocated to the Travel Reimbursement Plan account before the beginning of the plan year but rather are allocated only after the employee certifies that the travel expenses have been incurred. Thus, under the Travel Reimbursement Plan, like, the ZEBRA-type flexible spending arrangements, the employee is free to receive the taxable benefit (the salary reduction amount) currently at his or her discretion by simply not certifying that any travel expenses have been incurred. The taxable benefit, therefore, is "currently available" to the participant in contravention of the cafeteria plan regulations and the express intent of Congress as set forth in DEFRA.

Accordingly, because the salary reduction amounts used to pay Travel Reimbursement Plan expenses are "currently available," participants cannot avoid constructive receipt with respect to such amounts under the cafeteria plan rules. The entire salary reduction amounts allocable to the Travel Reimbursement Plan are includible in a participant's gross income. Because the salary reduction amounts would have been wages for withholding purposes if the participant had elected to receive the amounts as salary, the reimbursements retain their character as wages for withholding purposes. Moreover, based on the Service's published position and the legislative history of section 125, it would not have been reasonable under sections 3121(a)(5)(G) and 3306(b)(5)(G) of the Code to believe that section 125 would protect the wages from constructive receipt. Thus, the salary reduction amounts allocable to the Travel Reimbursement Plan are wages for FICA, and FUTA purposes as if the participants had received the salary and paid it over to fund this benefit.

Rev. Rul. 55-196, 1955-1 C.B. 492, considered a situation in which a traveling salesman entered into an arrangement with his employer whereby it was agreed that a portion of the salesman's gross commissions would be considered either an allowance toward expenses incurred in the business of the employer or a reimbursement of expenses previously incurred by the salesman in the business of the employer. The Service ruled that only the difference between the gross commissions and the allowance or reimbursements for expenses constituted wages for federal employment and income tax withholding purposes, provided proper identification was made of the portion representing the allowance or reimbursements.

The facts considered in Rev. Rul. 55-196 are distinguishable from the facts of the instant case. The benefits in the instant case are provided under the cafeteria plan provisions of the Code which did not exist at the time the

revenue ruling was published. The cafeteria plan provisions specifically create a statutory system under which nontaxable benefits may be funded through salary reduction agreements. The income tax treatment of those benefits will depend on compliance with the cafeteria plan rules and employment tax treatment will be determined under sections 3121(a)(5)(G) and 3306(b)(5)(G) of the Code.

## CONCLUSION

Salary reduction amounts under the travel reimbursement provisions of the Taxpayer's flexible benefit program are reportable as wages on the participant's Form W-2 and subject to employment taxes and income tax withholding.

No opinion is expressed as to the tax consequences of this transaction under any other section of the Code.

**FINAL-REG, ESN-REGS, §1.62-2. Reimbursements and other expense allowance arrangements**

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Reg. §1.62-2(c)(5) does not reflect P.L. 103-66.

**§1.62-2. Reimbursements and other expense allowance arrangements**

(a) *Table of contents.* --The contents of this section are as follows:

(a) *Table of contents.*

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(b) *Scope.* --For purposes of determining "adjusted gross income," section 62(a)(2)(A) allows an employee a deduction for expenses allowed by Part VI (section 161 and following), subchapter B, chapter 1 of the Code, paid by the employee, in connection with the performance of services as an employee of the employer, under a reimbursement or other expense allowance arrangement with a payor (the employer, its agent, or a third party). Section 62(c) provides that an arrangement will not be treated as a reimbursement or other expense allowance

arrangement for purposes of section 62(a)(2)(A) if (1) such arrangement does not require the employee to substantiate the expenses covered by the arrangement to the payor, or (2) such arrangement provides the employee the right to retain any amount in excess of the substantiated expenses covered under the arrangement. This section prescribes rules relating to the requirements of section 62(c).

*(c) Reimbursement or other expense allowance arrangement*

(1) *Defined.* --For purposes of §§1.62-1, 1.62-1T and 1.62-2, the phrase "reimbursement or other expense allowance arrangement" means an arrangement that meets the requirements of paragraphs (d) (business connection), (e) (substantiation), and (f) (returning amounts in excess of expenses) of this section. A payor may have more than one arrangement with respect to a particular employee, depending on the facts and circumstances. See paragraph (d)(2) of this section (payor treated as having two arrangements under certain circumstances).

*(2) Accountable plans*

(i) *In general.* --Except as provided in paragraph (c)(2)(ii) of this section, if an arrangement meets the requirements of paragraphs (d), (e), and (f) of this section, all amounts paid under the arrangement are treated as paid under an "accountable plan."

(ii) *Special rule for failure to return excess.* --If an arrangement meets the requirements of paragraphs (d), (e), and (f) of this section, but the employee fails to return, within a reasonable period of time, any amount in excess of the amount of the expenses substantiated in accordance with paragraph (e) of this section, only the amounts paid under the arrangement that are not in excess of the substantiated expenses are treated as paid under an accountable plan.

*(3) Nonaccountable plans*

(i) *In general.* --If an arrangement does not satisfy one or more of the requirements of paragraphs (d), (e), or (f) of this section, all amounts paid under the arrangement are treated as paid under a "nonaccountable plan." If a payor provides a nonaccountable plan, an employee who receives payments under the plan cannot compel the payor to treat the payments as paid under an accountable plan by voluntarily substantiating the expenses and returning any excess to the payor.

(ii) *Special rule for failure to return excess.* --If an arrangement meets the requirements of paragraphs (d), (e), and (f) of this section, but the employee fails to return, within a reasonable period of time, any amount in excess of the amount of the expenses substantiated in accordance with paragraph (e) of this section, the amounts paid under the arrangement that are in excess of the substantiated expenses are treated as paid under a nonaccountable plan.

(4) *Treatment of payments under accountable plans.* --Amounts treated as paid under an accountable plan are excluded from the employee's gross income, are not reported as wages or other compensation on the employee's Form W-2, and are exempt from the withholding and payment of employment taxes (Federal Insurance Contributions Act (FICA), Federal Unemployment Tax Act (FUTA), Railroad Retirement Tax Act (RRTA), Railroad Unemployment Repayment Tax (RURT), and income tax). See paragraph (l) of this section for cross references.

(5) *Treatment of payments under nonaccountable plans.* --Amounts treated as paid under a nonaccountable plan are included in the employee's gross income, must be reported as wages or other compensation on the employee's Form W-2, and are subject to withholding and payment of employment taxes (FICA, FUTA, RRRTA, RURT, and income tax). See paragraph (h) of this section. Expenses attributable to amounts included in the employee's gross income may be deducted, provided the employee can substantiate the full amount of his or her expenses (i.e., the amount of the expenses, if any, the reimbursement for which is treated as paid under an accountable plan as well as those for which the employee is claiming the deduction) in accordance with §1.274-5T and 1.274(d)-1 or §1.162-17, but only as a miscellaneous itemized deduction subject to the limitations applicable to such expenses (e.g., the 80-percent limitation on meal and entertainment expenses provided in section 274(n) and the 2-percent floor provided in section 67).

(d) *Business connection*

(1) *In general.* --Except as provided in paragraphs (d)(2) and (d)(3) of this section, an arrangement meets the requirements of this paragraph (d) if it provides advances, allowances (including per diem allowances, allowances only for meals and incidental expenses, and mileage allowances), or reimbursements only for business expenses that are allowable as deductions by Part VI (section 161 and the 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 of the employer. The payment may be actually received from the employer, its agent, or a third party for whom the employee performs a service as an employee of the employer, and may include amounts charged directly or indirectly to the payor through credit card systems or otherwise. In addition, if both wages and the reimbursement or other expense allowance are combined in a single payment, the reimbursement or other expense allowance must be identified either by making a separate payment or by specifically identifying the amount of the reimbursement or other expense allowance.

(2) *Other bona fide expenses.* --If an arrangement provides advances, allowances, or reimbursements for business expenses described in paragraph (d)(1) of this section (i.e., deductible employee business expenses) and for other bona fide expenses related to the employer's business (e.g., travel that is not away from home) that are not deductible under Part VI (section 161 and the following), subchapter B, chapter 1 of the Code, the payor is treated as maintaining two arrangements. The portion of the arrangement that provides payments for the deductible employee business expenses is treated as one arrangement that satisfies this paragraph (d). The portion of the arrangement that provides payments for the nondeductible employee expenses is treated as a second arrangement that does not satisfy this paragraph (d) and all amounts paid under this second arrangement will be treated as paid under a nonaccountable plan. See paragraphs (c)(5) and (h) of this section.

(3) *Reimbursement requirement*

(i) *In general.* --If a payor arranges to pay an amount to an employee regardless of whether the employee incurs (or is reasonably expected to incur) business expenses of a type described in paragraph (d)(1) or (d)(2) of this section, the arrangement does not satisfy this paragraph (d) and all amounts paid under the arrangement are treated as paid under a nonaccountable plan. See paragraphs (c)(5) and (h) of this section.

(ii) *Per diem allowances.* --An arrangement providing a per diem allowance for travel expenses of a type described in paragraph (d)(1) or (d)(2) of this section that is computed on a basis similar to that used in computing the employee's wages or other compensation (e.g., the number of hours worked, miles traveled, or pieces produced) meets the requirements of this paragraph (d) only if, on December 12, 1989, the per diem allowance was identified by the payor either by making a separate payment or by specifically identifying the amount of the per diem allowance, or a per diem allowance computed on that basis was commonly used in the industry in which the employee is employed. See section 274(d) and §1.274(d)-1. A per diem allowance described in this paragraph (d)(3)(ii) may be adjusted in a manner that reasonably reflects actual increases in employee business expenses occurring after December 12, 1989.

(e) *Substantiation*

(1) *In general.* --An arrangement meets the requirements of this paragraph (e) if it requires each business expense to be substantiated to the payor in accordance with paragraph (e)(2) or (e)(3) of this section, whichever is applicable, within a reasonable period of time. See §1.274-5T or §1.162-17.

(2) *Expenses governed by section 274(d).* --An arrangement that reimburses travel, entertainment, use of a passenger automobile or other listed property, or other business expenses governed by section 274(d) meets the requirements of this paragraph (e)(2) if information sufficient to satisfy the substantiation requirements of section 274(d) and the regulations thereunder is submitted to the payor. See §1.274-5. Under section 274(d), information sufficient to substantiate the requisite elements of each expenditure or use must be submitted to the payor. For example, with respect to travel away from home, §1.274-5(b)(2) requires that information sufficient to substantiate the amount, time, place, and business purpose of the expense must be submitted to the payor. Similarly, with respect to use of a passenger automobile or other

listed property, §1.274-5(b)(6) requires that information sufficient to substantiate the amount, time, use, and business purpose of the expense must be submitted to the payor. See §1.274-5(g) and (j), which grant the Commissioner the authority to establish optional methods of substantiating certain expenses. Substantiation of the amount of a business expense in accordance with rules prescribed pursuant to the authority granted by §1.274-5(g) or (j) will be treated as substantiation of the amount of such expense for purposes of this section.

(3) *Expenses not governed by section 274(d)*. --An arrangement that reimburses business expenses not governed by section 274(d) meets the requirements of this paragraph (e)(3) if information is submitted to the payor sufficient to enable the payor to identify the specific nature of each expense and to conclude that the expense is attributable to the payor's business activities. Therefore, each of the elements of an expenditure or use must be substantiated to the payor. It is not sufficient if an employee merely aggregates expenses into broad categories (such as "travel") or reports individual expenses through the use of vague, nondescriptive terms (such as "miscellaneous business expenses"). See §1.162-17(b).

(f) *Returning amounts in excess of expenses*

(1) *In general*. --Except as provided in paragraph (f)(2) of this section, an arrangement meets the requirements of this paragraph (f) if it requires the employee to return to the payor within a reasonable period of time any amount paid under the arrangement in excess of the expenses substantiated in accordance with paragraph (e) of this section. The determination of whether an arrangement requires an employee to return amounts in excess of substantiated expenses will depend on the facts and circumstances. An arrangement whereby money is advanced to an employee to defray expenses will be treated as satisfying the requirements of this paragraph (f) only if the amount of money advanced is reasonably calculated not to exceed the amount of anticipated expenditures, the advance of money is made on a day within a reasonable period of the day that the anticipated expenditures are paid or incurred, and any amounts in excess of the expenses substantiated in accordance with paragraph (e) of this section are required to be returned to the payor within a reasonable period of time after the advance is received.

(2) *Per diem or mileage allowances*. --The Commissioner may, in his discretion, prescribe rules in pronouncements of general applicability under which a reimbursement or other expense allowance arrangement that provides per diem allowances providing for ordinary and necessary expenses of traveling away from home (exclusive of transportation costs to and from destination) or mileage allowances providing for ordinary and necessary expenses of local travel and transportation while traveling away from home will be treated as satisfying the requirements of this paragraph (f), even though the arrangement does not require the employee to return the portion of such an allowance that relates to the days or miles of travel substantiated and that exceeds the amount of the employee's expenses deemed substantiated pursuant to rules prescribed under section 274(d), provided the allowance is paid at a rate for each day or mile of travel that is reasonably calculated not to exceed the amount of the employee's expenses or anticipated expenses and the employee is required to return to the payor within a reasonable period of time any portion of such allowance which relates to days or miles of travel not substantiated in accordance with paragraph (e) of this section.

(g) *Reasonable period*

(1) *In general*. --The determination of a reasonable period of time will depend on the facts and circumstances.

(2) *Safe harbors*

(i) *Fixed date method*. --An advance made within 30 days of when an expense is paid or incurred, an expense substantiated to the payor within 60 days after it is paid or incurred, or an amount returned to the payor within 120 days after an expense is paid or incurred will be treated as having occurred within a reasonable period of time.

(ii) *Periodic statement method*. --If a payor provides employees with periodic statements (no less frequently than quarterly) stating the amount, if any, paid under the arrangement in excess of the expenses the employee has substantiated in accordance with paragraph (e) of this section, and

requesting the employee to substantiate any additional business expenses that have not yet been substantiated (whether or not such expenses relate to the expenses with respect to which the original advance was paid) and/or to return any amounts remaining unsubstantiated within 120 days of the statement, an expense substantiated or an amount returned within that period will be treated as being substantiated or returned within a reasonable period of time.

(3) *Pattern of overreimbursements.* --If, under a reimbursement or other expense allowance arrangement, a payor has a plan or practice to provide amounts to employees in excess of expenses substantiated in accordance with paragraph (e) of this section and to avoid reporting and withholding on such amounts, the payor may not use either of the safe harbors provided in paragraph (g)(2) of this section for any years during which such plan or practice exists.

(h) *Withholding and payment of employment taxes*

(1) *When excluded from wages.* --If an arrangement meets the requirements of paragraphs (d), (e), and (f) of this section, the amounts paid under the arrangement that are not in excess of the expenses substantiated in accordance with paragraph (e) of this section (i.e., the amounts treated as paid under an accountable plan) are not wages and are not subject to withholding and payment of employment taxes. If an arrangement provides advances, allowances, or reimbursements for meal and entertainment expenses and a portion of the payment is treated as paid under a nonaccountable plan under paragraph (d)(2) of this section due solely to section 274(n), then notwithstanding paragraph (h)(2)(ii) of this section, these nondeductible amounts are neither treated as gross income nor subject to withholding and payment of employment taxes.

(2) *When included in wages*

(i) *Accountable plans*

(A) *General rule.* --Except as provided in paragraph (h)(2)(i)(B) of this section, if the expenses covered under an arrangement that meets the requirements of paragraphs (d), (e), and (f) of this section are not substantiated to the payor in accordance with paragraph (e) of this section within a reasonable period of time or if any amounts in excess of the substantiated expenses are not returned to the payor in accordance with paragraph (f) of this section within a reasonable period of time, the amount which is treated as paid under a nonaccountable plan under paragraph (c)(3)(ii) of this section is subject to withholding and payment of employment taxes no later than the first payroll period following the end of the reasonable period. A payor may treat any amount not substantiated or returned within the periods specified in paragraph (g)(2) of this section as not substantiated or returned within a reasonable period of time.

(B) *Per diem or mileage allowances*

(1) *In general.* --If a payor pays a per diem or mileage allowance under an arrangement that meets the requirements of paragraphs (d), (e), and (f) of this section, the portion, if any, of the allowance paid that relates to days or miles of travel substantiated in accordance with paragraph (e) of this section and that exceeds the amount of the employee's expenses deemed substantiated for such travel pursuant to rules prescribed under section 274(d) and §1.274(d)-1 or §1.274-5T(j) is treated as paid under a nonaccountable plan. See paragraph (c)(3)(ii) of this section. Because the employee is not required to return this excess portion, the reasonable period of time provisions of paragraph (g) of this section (relating to the return of excess amounts) do not apply to this excess portion.

(2) *Reimbursements.* --Except as provided in paragraph (h)(2)(i)(B)(4) of this section, in the case of a per diem or mileage allowance paid as a reimbursement at a rate for each day or mile of travel that exceeds the amount of the employee's expenses deemed substantiated for a day or mile of travel, the excess portion described in paragraph (h)(2)(i) of this section is subject to withholding and payment of employment taxes in the payroll period in which the payor reimburses the expenses for the days or miles of travel substantiated in accordance with paragraph (e) of this section.

(3) *Advances.* --Except as provided in paragraph (h)(2)(i)(B)(4) of this section, in the case of a per diem or mileage allowance paid as an advance at a rate for each day or mile of travel that exceeds the amount of the employee's expenses deemed substantiated for a day or mile of travel, the excess portion described in paragraph (h)(2)(i) of this section is subject to withholding and payment of employment taxes no later than the first payroll period following the payroll period in which the expenses with respect to which the advance was paid (i.e., the days or miles of travel) are substantiated in accordance with paragraph (e) of this section. The expenses with respect to which the advance was paid must be substantiated within a reasonable period of time. See paragraph (g) of this section.

(4) *Special rules.* --The Commissioner may, in his discretion, prescribe special rules in pronouncements of general applicability regarding the timing of withholding and payment of employment taxes on per diem and mileage allowances.

(ii) *Nonaccountable plans.* --If an arrangement does not satisfy one or more of the requirements of paragraphs (d), (e), or (f) of this section, all amounts paid under the arrangement are wages and are subject to withholding and payment of employment taxes when paid.

(i) *Application.* --The requirements of paragraphs (d)(business connection), (e)(substantiation), and (f) (returning amounts in excess of expenses) of this section will be applied on an employee-by-employee basis. Thus, for example, the failure by one employee to substantiate expenses under an arrangement in accordance with paragraph (e) of this section will not cause amounts paid to other employees to be treated as paid under a nonaccountable plan.

(j) *Examples.* --The rules contained in this section may be illustrated by the following examples.

*Example (1). Reimbursement requirement.* Employer S pays its engineers \$200 a day. On those days that an engineer travels away from home on business for Employer S, Employer S designates \$50 of the \$200 as paid to reimburse the engineer's travel expenses. Because Employer S would pay an engineer \$200 a day regardless of whether the engineer was traveling away from home, the arrangement does not satisfy the reimbursement requirement of paragraph (d)(3)(i) of this section. Thus, no part of the \$50 Employer S designated as a reimbursement is treated as paid under an accountable plan. Rather, all payments under the arrangement are treated as paid under a nonaccountable plan. Employer S must report the entire \$200 as wages or other compensation on the employees' Forms W-2 and must withhold and pay employment taxes on the entire \$200 when paid.

*Example (2). Reimbursement requirement, multiple arrangements.* Airline T pays all its employees a salary. Airline T also pays an allowance under an arrangement that otherwise meets the requirements of paragraphs (d), (e), and (f) of this section to its pilots and flight attendants who travel away from their home base airports, whether or not they are "away from home." Because the allowance is paid only to those employees who incur (or are reasonably expected to incur) expenses of a type described in paragraph (d)(1) or (d)(2) of this section, the arrangement satisfies the reimbursement requirement of paragraph (d)(3)(i) of this section. Under paragraph (d)(2) of this section, Airline T is treated as maintaining two arrangements. The portion of the arrangement providing the allowances for away from home travel is treated as an accountable plan. The portion of the arrangement providing the allowances for non-away from home travel is treated as a nonaccountable plan. Airline T must report the non-away from home allowances as wages or other compensation on the employees' Forms W-2 and must withhold and pay employment taxes on these payments when paid.

*Example (3). Reimbursement requirement.* Corporation R pays all its salespersons a salary. Corporation R also pays a travel allowance under an arrangement that otherwise meets the requirements of paragraphs (d), (e), and (f) of this section. This allowance is paid to all salespersons, including salespersons that Corporation R knows, or has reason to know, do not travel away from their offices on Corporation R business and would not be reasonably expected to incur travel expenses. Because the allowance is not paid only to those employees who incur (or are reasonably expected to incur) expenses of a type described in paragraph (d)(1) or (d)(2) of this section, the arrangement does not satisfy the reimbursement requirement of paragraph (d)(3)(i) of this section. Thus, no part of the allowance Corporation R designated as a reimbursement is treated as paid under an accountable plan. Rather, all payments under the arrangement are treated as paid under a nonaccountable plan. Corporation R must report all payments under the arrangement as wages or other compensation on the

employees' Forms W-2 and must withhold and pay employment taxes on the payments when paid.

*Example (4). Separate arrangement, miscellaneous expenses.* Under an arrangement that meets the requirements of paragraphs (d), (e), and (f) of this section, County U reimburses its employees for lodging and meal expenses incurred when they travel away from home on County U business. For its own convenience, County U also separately pays certain of its employees a \$25 monthly allowance to cover the cost of small miscellaneous office expenses. County U does not require its employees to substantiate these miscellaneous expenses and does not require them to return the amounts by which the monthly allowance exceeds the miscellaneous expenses. The monthly allowance arrangement is a nonaccountable plan. County U must report the monthly allowances as wages or other compensation on the employees' Forms W-2 and must withhold and pay employment taxes on the monthly allowances when paid. The nonaccountable plan providing the monthly allowances is treated as separate from the accountable plan providing reimbursements for lodging and meal expenses incurred for travel away from home on County U business.

*Example (5). Excessive advances.* In anticipation of employee business expenses that Corporation V does not reasonably expect to exceed \$400 in any quarter, Corporation V nonetheless advances \$1,000 to Employee A for such expenses. Whenever Employee A substantiates an expense in accordance with paragraph (e) of this section, Corporation V provides an additional advance in an amount equal to the amount substantiated, thereby providing a continuing advance of \$1,000. Because the amounts advanced under this arrangement are not reasonably calculated so as not to exceed the amount of anticipated expenditures and because the advance of money is not made on a day within a reasonable period of the day that the anticipated expenditures are paid or incurred, the arrangement is a nonaccountable plan. The arrangement fails to satisfy the requirements of paragraphs (d)(business connection) and (f) (reasonable calculation of advances) of this section. Thus, Corporation V must report the entire amount of each advance as wages or other compensation and must withhold and pay employment taxes on the entire amount of each advance when paid.

*Example (6). Excess mileage advance.* Under an arrangement that meets the requirements of paragraphs (d), (e), and (f) of this section, Employer W pays its employees a mileage allowance at a rate of 30 cents per mile (when the amount deemed substantiated for each mile of travel substantiated is 26 cents per mile) to cover automobile business expenses. The allowance is paid at a rate for each mile of travel that is reasonably calculated not to exceed the amount of the employee's expenses or anticipated expenses. Employer W does not require the return of the portion of the mileage allowance (4 cents) that exceeds the amount deemed substantiated for each mile of travel substantiated in accordance with paragraph (e) of this section. In June, Employer W advances Employee B \$150 for 500 miles to be traveled by Employee B during the month. In July, Employee B substantiates 500 miles of business travel. The amount deemed substantiated by Employee B is \$130. However, Employer W does not require Employee B to return the remaining \$20 of the advance. No later than the first payroll period following the payroll period in which the business miles of travel are substantiated, Employer W must withhold and pay employment taxes on \$20 (500 miles × 4 cents per mile).

*Example (7). Excess per diem reimbursement.* Under an arrangement that meets the requirements of paragraphs (d), (e), and (f) of this section, Employer X pays its employees a per diem allowance to cover lodging, meal, and incidental expenses incurred for travel away from home on Employer X business at a rate equal to 120 percent of the amount deemed substantiated for each day of travel to the localities to which the employees travel. Employer X does not require the employees to return the 20 percent by which the reimbursement for those expenses exceeds the amount deemed substantiated for each day of travel substantiated in accordance with paragraph (e) of this section. Employee C substantiates six days of business travel away from home: two days in a locality for which the amount deemed substantiated is \$100 a day and four days in a locality for which the amount deemed substantiated is \$125 a day. Employer X reimburses Employee C \$840 for the six days of travel away from home ( $2 \times (120\% \times \$100) + 4 \times (120\% \times \$125)$ ), and does not require Employee C to return the excess portion ( $\$140$  excess portion =  $(2 \text{ days} \times \$20 (\$120 - \$100) + 4 \text{ days} \times \$25 (\$150 - \$125))$ ). For the payroll period in which Employer X reimburses the expenses, Employer X must withhold and pay employment taxes on \$140.

*Example (8). Return requirement.* Employer Y provides expense allowances to certain of its employees to cover business expenses of a type described in paragraph (d)(1) of this section under an arrangement that requires the employees to substantiate their expenses within a reasonable period of time and to return any excess amounts within a reasonable period of time. Each time an employee returns an excess amount to Employer Y, however, Employer Y pays the employee a "bonus" equal to the amount returned by the employee. The arrangement fails to satisfy the requirements of paragraph (f)(returning amounts in excess of

expenses) of this section. Thus, Employer Y must report the entire amount of the expense allowance payments as wages or other compensation and must withhold and pay employment taxes on the payments when paid. Compare example (6)(where the employee is not required to return the portion of the mileage allowance that exceeds the amount deemed substantiated for each mile of travel substantiated).

*Example (9). Timely substantiation.* Employer Z provides a \$500 advance to Employee D for a trip away from home on Employer Z business. Employee D incurs \$500 in business expenses on the trip. Employer Z uses the periodic statement method safe harbor. At the end of the quarter during which the trip occurred, Employer Z sends a quarterly statement to Employee D stating that \$500 was advanced to Employee D during the quarter and that no expenses were substantiated and no excess amounts returned. The statement advises Employee D that Employee D must substantiate any additional business expenses within 120 days of the date of the statement, and must return any unsubstantiated excess within the 120-day period. Employee D fails to substantiate any expenses or to return the excess within the 120-day period. Employer Z treats the \$500 as wages and withholds and pays employment taxes on the \$500. After the 120-day period has expired, Employee D substantiates the \$500 in travel expenses in accordance with paragraph (e) of this section. Employer Z properly reported and withheld and paid employment taxes on the \$500 and no adjustments may be made. Employee D must include the \$500 in gross income and may deduct the \$500 of expenses as a miscellaneous itemized deduction subject to the 2-percent floor provided in section 67.

(k) *Anti-abuse provision.* --If a payor's reimbursement or other expense allowance arrangement evidences a pattern of abuse of the rules of section 62(c) and this section, all payments made under the arrangement will be treated as made under a nonaccountable plan.

(l) *Cross references.* --For employment tax regulations relating to reimbursement and expense allowance arrangements, see §§31.3121(a)-3, 31.3231(e)-3, 31.3306(b)-2, and 31.3401(a)-4, which generally apply to payments made under reimbursement or other expense allowance arrangements received by an employee on or after July 1, 1990 with respect to expenses paid or incurred on or after July 1, 1990. For reporting requirements, see §1.6041-3(i), which generally applies to payments made under reimbursement or other expense allowance arrangements received by an employee on or after January 1, 1989 with respect to expenses paid or incurred on or after January 1, 1989.

(m) *Effective dates.* --This section generally applies to payments made under reimbursement or other expense allowance arrangements received by an employee in taxable years of the employee beginning on or after January 1, 1989, with respect to expenses paid or incurred in taxable years beginning on or after January 1, 1989. Paragraph (h) of this section generally applies to payments made under reimbursement or other expense allowance arrangements received by an employee on or after July 1, 1990 with respect to expenses paid or incurred on or after July 1, 1990. Paragraphs (d)(3)(ii) and (h)(2)(i)(B) of this section apply to payments made under reimbursement or other expense allowance arrangements received by an employee on or after January 1, 1991 with respect to expenses paid or incurred on or after January 1, 1991. Paragraph (e)(2) of this section applies to payments made under reimbursement or other expense allowance arrangements received by an employee with respect to expenses paid or incurred after December 31, 1997. [Reg. §1.62-2.]

¶ [T.D. 8324, 12-14-90. Amended by T.D. 8451, 12-4-92; T.D. 8666, 5-29-96; T.D. 8784, 9-30-98; T.D. 8864, 1-21-2000 and T.D. 9064, 6-30-2003.]

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*Essentials Explanations:*

**1.62-2**

ESN ¶25,465

**1.62-2(c)**

ESN ¶11,120; ESN ¶11,220; ESN ¶9301

**1.62-2(c)(1)**

ESN ¶25,465; ESN ¶25,466; ESN ¶9301

**1.62-2(c)(2)**

ESN ¶13,025; ESN ¶28,033

**1.62-2(c)(3)**

ESN ¶25,466; ESN ¶9301

**1.62-2(c)(4)**

ESN ¶25,468; ESN ¶9298; ESN ¶9301

**1.62-2(c)(5)**

ESN ¶25,467; ESN ¶25,469; ESN ¶9301

**1.62-2(d)**

ESN ¶9301

**1.62-2(e)**

ESN ¶9301

**1.62-2(f)**

ESN ¶9301

**1.62-2(g)**

ESN ¶9301

**1.62-2(g)(2)**

ESN ¶13,025

**1.62-2(h)**

ESN ¶13,025

**1.62-2(h)(1)**

ESN ¶13,025

**1.62-2(i)**

ESN ¶25,466

## IRS-PUB, 2006, IRS Publication No. 15, 5. Wages and Other Compensation

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Publication No. 15:

### 5. Wages and Other Compensation

Wages subject to federal employment taxes generally include all pay that you give to an employee for services performed. The pay may be in cash or in other forms. It includes salaries, nonqualified deferred compensation recognized under section 409A, vacation allowances, bonuses, commissions, and fringe benefits. It does not matter how you measure or make the payments. Amounts an employer pays as a bonus for signing or ratifying a contract in connection with the establishment of an employer-employee relationship and an amount paid to an employee for cancellation of an employment contract and relinquishment of contract rights are wages subject to social security, Medicare, and federal unemployment taxes and income tax withholding. Also, compensation paid to a former employee for services performed while still employed is wages subject to employment taxes. See section 6 for a discussion of tips and section 7 for a discussion of supplemental wages. Also, see section 15 for exceptions to the general rules for wages. Publication 15-A, Employer's Supplemental Tax Guide, provides additional information on wages and other compensation. Publication 15-B, Employer's Tax Guide to Fringe Benefits, provides information on other forms of compensation, including:

- Accident and health benefits,
  
- Achievement awards,
  
- Adoption assistance,
  
- Athletic facilities,
  
- De minimis (minimal) benefits,
  
- Dependent care assistance,
  
- Educational assistance,
  
- Employee discounts,
  
- Employee stock options,
  
- Group-term life insurance coverage,
  
- Lodging on your business premises,
  
- Meals,

- Moving expense reimbursements,
- No-additional-cost services,
- Retirement planning services,
- Transportation (commuting) benefits,
- Tuition reduction, and
- Working condition benefits.

**Employee business expense reimbursements.** A reimbursement or allowance arrangement is a system by which you pay the advances, reimbursements, and charges for your employees' substantiated business expenses. How you report a reimbursement or allowance amount depends on whether you have an accountable or a nonaccountable plan. If a single payment includes both wages and an expense reimbursement, you must specify the amount of the reimbursement.

These rules apply to all ordinary and necessary employee business expenses that would otherwise qualify for a deduction by the employee.

**Accountable plan.** To be an accountable plan, your reimbursement or allowance arrangement must require your employees to meet all three of the following rules.

- 1) They must have paid or incurred deductible expenses while performing services as your employees.
- 2) They must adequately account to you for these expenses within a reasonable period of time.
- 3) They must return any amounts in excess of expenses within a reasonable period of time.

Amounts paid under an accountable plan are not wages and are not subject to income tax withholding and payment of social security, Medicare, and federal unemployment (FUTA) taxes.

If the expenses covered by this arrangement are not substantiated (or amounts in excess of expenses are not returned within a reasonable period of time), the amount paid under the arrangement in excess of the substantiated expenses is treated as paid under a nonaccountable plan. This amount is subject to income tax withholding and payment of social security, Medicare, and FUTA taxes for the first payroll period following the end of the reasonable period.

A reasonable period of time depends on the facts and circumstances. Generally, it is considered reasonable if your employees receive their advance within 30 days of the time that they incur the expenses, adequately account for the expenses within 60 days after the expenses were paid or incurred, and return any amounts in excess of expenses within 120 days after the expenses were paid or incurred. Also, it is considered reasonable if you give your employees a periodic statement (at least quarterly) that asks them to either return or adequately account for outstanding amounts and they do so within 120 days.

**Nonaccountable plan.** Payments to your employee for travel and other necessary expenses of your business under a nonaccountable plan are wages and are treated as supplemental wages and subject to income tax withholding and payment of social security, Medicare, and FUTA taxes. Your payments are treated as paid under a nonaccountable plan if:

- Your employee is not required to or does not substantiate timely those expenses to you with receipts or other documentation,
- You advance an amount to your employee for business expenses and your employee is not required to or does not return timely any amount he or she does not use for business expenses, or
- You advance or pay an amount to your employee without regard for anticipated or incurred business expenses.

See section 7 for more information on supplemental wages.

**Per diem or other fixed allowance.** You may reimburse your employees by travel days, miles, or some other fixed allowance. In these cases, your employee is considered to have accounted to you if your reimbursement does not exceed rates established by the Federal Government. The 2005 standard mileage rate for auto expenses was 40.5 cents per mile through August 31, 2005, and 48.5 cents per mile from September 1, 2005, through December 31, 2005. The rate for 2006 is 44.5 cents per mile. The government per diem rates for meals and lodging in the continental United States are listed in Publication 1542, Per Diem Rates. Other than the amount of these expenses, your employees' business expenses must be substantiated (for example, the business purpose of the travel or the number of business miles driven).

If the per diem or allowance paid exceeds the amounts specified, you must report the excess amount as wages. This excess amount is subject to income tax withholding and payment of social security, Medicare, and FUTA taxes. Show the amount equal to the specified amount (for example, the nontaxable portion) in box 12 of Form W-2 using code L.

**Wages not paid in money.** If in the course of your trade or business you pay your employees in a medium that is neither cash nor a readily negotiable instrument, such as a check, you are said to pay them "in kind." Payments in kind may be in the form of goods, lodging, food, clothing, or services. Generally, the fair market value of such payments at the time that they are provided is subject to federal income tax withholding and social security, Medicare, and FUTA taxes.

However, noncash payments for household work, agricultural labor, and service not in the employer's trade or business are exempt from social security, Medicare, and FUTA taxes. Withhold income tax on these payments only if you and the employee agree to do so. Nonetheless, noncash payments for agricultural labor, such as

commodity wages, are treated as cash payments subject to employment taxes if the substance of the transaction is a cash payment.

**Moving expenses.** Reimbursed and employer-paid qualified moving expenses (those that would otherwise be deductible by the employee) paid under an accountable plan are not includible in an employee's income unless you have knowledge that the employee deducted the expenses in a prior year. Reimbursed and employer-paid nonqualified moving expenses are includible in income and are subject to employment taxes and income tax withholding. For more information on moving expenses, see Publication 521, Moving Expenses.

**Meals and lodging.** The value of meals is not taxable income and is not subject to income tax withholding and social security, Medicare, and FUTA taxes if the meals are furnished for the employer's convenience and on the employer's premises. The value of lodging is not subject to income tax withholding and social security, Medicare, and FUTA taxes if the lodging is furnished for the employer's convenience, on the employer's premises, and as a condition of employment.

"For the convenience of the employer " means that you have a substantial business reason for providing the meals and lodging other than to provide additional compensation to the employee. For example, meals that you provide at the place of work so that an employee is available for emergencies during his or her lunch period are generally considered to be for your convenience.

However, whether meals or lodging are provided for the convenience of the employer depends on all of the facts and circumstances. A written statement that the meals or lodging are for your convenience is not sufficient.

**50% test.** If over 50% of the employees who are provided meals on an employer's business premises receive these meals for the convenience of the employer, all meals provided on the premises are treated as furnished for the convenience of the employer. If this 50% test is met, the value of the meals is excludable from income for all employees and is not subject to federal income tax withholding or employment taxes.

For more information, see Publication 15-B, Employer's Tax Guide to Fringe Benefits.

**Health insurance plans.** If you pay the cost of an accident or health insurance plan for your employees, that may include an employee's spouse and dependents, your payments are not wages and are not subject to social security, Medicare, and FUTA taxes, or federal income tax withholding. Generally, this exclusion also applies to qualified long-term care insurance contracts. However, the cost of health insurance benefits must be included in the wages of S corporation employees who own more than 2% of the S corporation (2% shareholders).

**Health Savings Accounts and medical savings accounts.** Your contributions to an employee's Health Savings Account (HSA) or medical savings account (Archer MSA) are not subject to social security, Medicare, or FUTA taxes, or federal income tax withholding if it is reasonable to believe at the time of payment of the contributions that they will be excludable from the income of the employee. To the extent that it is not reasonable to believe that they will be excludable, your contributions are subject to these taxes. Employee contributions to their HSAs or MSAs through a payroll deduction plan must be included in wages and are subject to social security, Medicare, and FUTA taxes, and income tax withholding. However, contributions made under a salary reduction arrangement in a section 125 cafeteria plan are not wages and are not subject to employment taxes or withholding. For more information, see the Instructions for Form 8889.

**Medical care reimbursements.** Generally, medical care reimbursements paid for an employee under an employer's self-insured medical reimbursement plan are not wages and are not subject to social security, Medicare, and FUTA taxes, or income tax withholding. See Publication 15-B for an exception for highly

compensated employees.

**Fringe benefits.** You generally must include fringe benefits in an employee's gross income (but see *Nontaxable fringe benefits* next). The benefits are subject to income tax withholding and employment taxes. Fringe benefits include cars that you provide, flights on aircraft that you provide, free or discounted commercial flights, vacations, discounts on property or services, memberships in country clubs or other social clubs, and tickets to entertainment or sporting events. In general, the amount that you must include is the amount by which the fair market value of the benefits is more than the sum of what the employee paid for it plus any amount that the law excludes. There are other special rules that you and your employees may use to value certain fringe benefits. See Publication 15-B for more information.

**Nontaxable fringe benefits.** Some fringe benefits are not taxable (or are minimally taxable) if certain conditions are met. See Publication 15-B for details. Examples include:

- 1) Services provided to your employees at no additional cost to you,
- 2) Qualified employee discounts,
- 3) Working condition fringes that are property or services that the employee could deduct as a business expense if he or she had paid for it. Examples include a company car for business use and subscriptions to business magazines,
- 4) Minimal value fringes (including an occasional cab ride when an employee must work overtime, local transportation benefits provided because of unsafe conditions and unusual circumstances, and meals that you provide at eating places that you run for your employees if the meals are not furnished at below cost),
- 5) Qualified transportation fringes subject to specified conditions and dollar limitations (including transportation in a commuter highway vehicle, any transit pass, and qualified parking),
- 6) Qualified moving expense reimbursement. See *Moving expenses* , above for details,
- 7) The use of on-premises athletic facilities, if substantially all of the use is by employees, their spouses, and their dependent children, and
- 8) Qualified tuition reduction that an educational organization provides to its employees for education. For more information, see Publication 970, Tax Benefits for Education.

However, do not exclude the following fringe benefits from the income of highly compensated employees unless the benefit is available to other employees on a nondiscriminatory basis.

- No-additional-cost services (item 1 above).

- Qualified employee discounts (item 2 above).
- Meals provided at an employer operated eating facility (included in item 4 above).
- Reduced tuition for education (item 8 above).

For more information, including the definition of a highly compensated employee, see Publication 15-B.

**When fringe benefits are treated as paid.** You may choose to treat certain noncash fringe benefits as paid by the pay period, by the quarter, or on any other basis that you choose as long as you treat the benefits as paid at least once a year. You do not have to make a formal choice of payment dates or notify the IRS of the dates that you choose. You do not have to make this choice for all employees. You may change methods as often as you like, as long as you treat all benefits provided in a calendar year as paid by December 31 of the calendar year. See Publication 15-B for more information, including a discussion of the special accounting rule for fringe benefits provided during November and December.

**Valuation of fringe benefits.** Generally, you must determine the value of fringe benefits no later than January 31 of the next year. Before January 31, you may reasonably estimate the value of the fringe benefits for purposes of withholding and depositing on time.

**Withholding on fringe benefits.** You may add the value of fringe benefits to regular wages for a payroll period and figure withholding taxes on the total, or you may withhold federal income tax on the value of the fringe benefits at the flat 25% supplemental wage rate. However, see *Withholding on supplemental wages when an employee receives more than \$1,000,000 of supplemental wages during the calendar year* in section 7.

You may choose not to withhold income tax on the value of an employee's personal use of a vehicle that you provide. You must, however, withhold social security and Medicare taxes on the use of the vehicle. See Publication 15-B for more information on this election.

**Depositing taxes on fringe benefits.** Once you choose payment dates for fringe benefits (discussed above), you must deposit taxes in the same deposit period that you treat the fringe benefits as paid. To avoid a penalty, deposit the taxes following the general deposit rules for that deposit period.

If you determine by January 31 that you overestimated the value of a fringe benefit at the time you withheld and deposited for it, you may claim a refund for the overpayment or have it applied to your next employment tax return. See *Valuation of fringe benefits* above. If you underestimated the value and deposited too little, you may be subject to a failure-to-deposit penalty. See section 11 for information on deposit penalties.

If you deposited the required amount of taxes but withheld a lesser amount from the employee, you can recover from the employee the social security, Medicare, or income taxes that you deposited on his or her behalf, and included in the employee's Form W-2. However, you must recover the income taxes before April 1 of the following year.

**Sick pay.** In general, sick pay is any amount that you pay under a plan to an employee who is unable to work

because of sickness or injury. These amounts are sometimes paid by a third party, such as an insurance company or an employees' trust. In either case, these payments are subject to social security, Medicare, and FUTA taxes. Sick pay becomes exempt from these taxes after the end of 6 calendar months after the calendar month that the employee last worked for the employer. The payments are always subject to federal income tax. See Publication 15-A for more information.

**IRS-PUB, 2004, IRS Publication No. 535, Reimbursements**

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Publication No. 535:

**Reimbursements**

A "reimbursement or allowance arrangement " provides for payment of advances, reimbursements, and charges for travel, meals, and entertainment expenses incurred by your employees during the ordinary course of business. Upon satisfying your established substantiation requirements, you can deduct the allowable amount on your tax return. Because of differences between accounting methods and tax law, these amounts may not be the same. For example, you may deduct 100% of the cost of meals on your business books and records. However, for tax purposes, only 50% of these costs are allowed by law as a tax deduction.

A reimbursement or allowance arrangement (including per diem allowances, discussed later) depends on whether you have: (1) an accountable plan or (2) a nonaccountable plan. If you reimburse these expenses under an accountable plan, then you can deduct the amount allowable to the extent of the tax law as travel, meal, and entertainment expenses on your tax return.

If you reimburse these expenses under a nonaccountable plan, then you must report the reimbursements as wages on Form W-2, *Wage and Tax Statement* , and deduct them as wages on the appropriate line of your tax return. If you make a single payment to your employees and it includes both wages and an expense reimbursement, you must specify the amount attributable to reimbursement and report it accordingly. See *Table 13-1* , Reporting Reimbursements.

Table 13-1. **Reporting Reimbursements**

<b>IF the type of reimbursement (or other expense allowance) arrangement is under</b>	<b>THEN the employer reports on For</b>
-2	

**An accountable plan with:**

<i>Actual expense reimbursement:</i>	No amount.
--------------------------------------	------------

Adequate accounting made and excess returned

<i>Actual expense reimbursement:</i>	The excess amount as wages in bo
--------------------------------------	----------------------------------

Adequate accounting and return of excess both required but excess not returned

*Per diem or mileage allowance up to the federal rate:*

No amount.

Adequate accounting made and excess returned

*Per diem or mileage allowance up to the federal rate:*

The excess amount as wages in box amount up to the federal rate is in box 12=it is not reported in

Adequate accounting and return of excess both required but excess not returned

*Per diem or mileage allowance exceeds the federal rate:*

The excess amount as wages in box amount up to the federal rate is in box 12=it is not reported in

Adequate accounting made up to the federal rate only and excess not returned

**A nonaccountable plan with:**

Either adequate accounting or return of excess, or both, not required by plan

The entire amount as wages in bo

**No reimbursement plan**

The entire amount as wages in bo

**Accountable Plans** An accountable plan, requires your employees to meet all of the following requirements. They must:

- 1) have paid or incurred deductible expenses while performing services as your employees,
- 2) adequately account to you for these expenses within a reasonable period of time, and
- 3) return any excess reimbursement or allowance within a reasonable period of time.

An arrangement under which you advance money to employees is treated as meeting (3) above only if the following requirements are also met.

- The advance is reasonably calculated not to exceed the amount of anticipated expenses.
- You make the advance within a reasonable period of time.

If any expenses reimbursed under this arrangement are not substantiated, or an excess reimbursement is not returned within a reasonable period of time by an employee, you are not allowed to deduct these expenses as reimbursed under an accountable plan. Instead, treat the reimbursed expenses as paid under a nonaccountable plan, discussed later.

**Adequate accounting.** Your employees must adequately account to you for their travel, meals, and entertainment expenses. They must give you documentary evidence of their travel, mileage, and other employee business expenses. This evidence should include items such as receipts, along with either a statement of expenses, an account book, a day-planner, or similar record in which the employee entered each expense at or near the time the expense was incurred.

**Excess reimbursement or allowance.** An excess reimbursement or allowance is any amount you pay to an employee that is more than the business-related expenses for which the employee adequately accounted. The employee must return any excess reimbursement or other expense allowance to you within a reasonable period of time.

**Reasonable period of time.** A reasonable period of time depends on the facts and circumstances. Generally, actions that take place within the times specified in the following list will be treated as taking place within a reasonable period of time.

- 1) You give an advance within 30 days of the time the employee incurred the expense.
- 2) Your employees adequately account for their expenses within 60 days after the expenses were paid or incurred.
- 3) Your employees return any excess reimbursement within 120 days after the expenses were paid or incurred.
- 4) You give a periodic statement (at least quarterly) to your employees that asks them to either return or adequately account for outstanding advances and they comply within 120 days of the date of the statement.

**How to deduct.** You can claim a deduction for travel, meals, and entertainment expenses if you reimburse your employees for these expenses under an accountable plan. Generally, the amount you can deduct for meals and entertainment, is subject to a 50% limit, discussed later. If you are a sole proprietor, or are filing as a single member Limited Liability Company, deduct the reimbursement on line 24b, Schedule C (Form 1040) or line 2, Schedule C-EZ (Form 1040).

If you are filing an income tax return for a corporation, the reimbursement should be included with the amount claimed on the *Other deductions* line of Form 1120, *U.S. Corporation Income Tax Return*, or Form 1120-A, *U.S. Corporation Short-Form Income Tax Return*. If you are filing any other business income tax return, such as a partnership or S corporation return, deduct the reimbursement on the appropriate line of the return as provided in the instructions for that return.

**Per Diem and Car Allowances** You may reimburse your employees under an accountable plan based on travel days, miles, or some other fixed allowance. In these cases, your employee is considered to have accounted to you for the amount of the expense that does not exceed the rates established by the federal government. Your employee must actually substantiate to you the other elements of the expense, such as time, place, and business purpose.

**Federal rate.** The federal rate can be figured using any one of the following methods.

1) For per diem amounts:

- a) The regular federal per diem rate.
- b) The standard meal allowance.
- c) The high-low rate.

2) For car expenses:

- a) The standard mileage rate.
- b) A fixed and variable rate (FAVR).

**Car allowance.** Your employee is considered to have accounted to you for car expenses that do not exceed the standard mileage rate. For 2004, the standard mileage rate is 37.5 cents per mile for each business mile.

You can choose to reimburse your employees using a fixed and variable rate (FAVR) allowance. This is an allowance that includes a combination of payments covering fixed and variable costs, such as a cents-per-mile rate to cover your employees' variable operating costs (such as gas, oil, etc.) plus a flat amount to cover your employees' fixed costs (such as depreciation, insurance, etc.). For information on using a FAVR allowance, see Revenue Procedure 2002-61 in Internal Revenue Bulletin 2002-39. You can read Revenue Procedure 2002-61 at many public libraries or online at [www.irs.gov](http://www.irs.gov).

**Per diem allowance.** If your employee actually substantiates to you the other elements (discussed earlier) of

the expenses reimbursed using the per diem allowance, how you report and deduct the allowance depends on whether the allowance is for lodging and meal expenses or for meal expenses only and whether the allowance is more than the federal rate.

**Regular federal per diem rate.** The regular federal per diem rate is the highest amount the federal government will pay to its employees while away from home on travel. It has two components:

- 1) lodging expense, and
- 2) meal and incidental expense (M & IE).

The rates are different for different locations. Publication 1542 lists the rates in the continental United States.

**Standard meal allowance.** The federal rate for meal and incidental expenses (M & IE) is the standard meal allowance. You may pay only an M & IE allowance to employees who travel away from home if:

- you pay the employee for actual expenses for lodging based on receipts submitted to you,
- you provide for the lodging,
- you pay for the actual expense of the lodging directly to the provider,
- you do not have reasonable belief that lodging expenses were incurred by the employee, or
- the allowance is computed on a basis similar to that used in computing the employee's wages (that is, number of hours worked or miles traveled).

**Internet access.** Per diem rates are available on the Internet. You can access per diem rates at [www.policyworks.gov/perdiem](http://www.policyworks.gov/perdiem).

**High-low method.** This is a simplified method of computing the federal per diem rate for lodging and meal expenses for traveling within the continental United States. It eliminates the need to keep a current list of the per diem rate in effect for each city in the continental United States.

Under the high-low method, the per diem amount for travel during 2004 is \$207 (\$46 for M & IE) for certain high-cost locations. All other areas have a per diem amount of \$126 (\$36 for M & IE). The high-cost locations eligible for the \$207 per diem amount under the high-low method are listed in Publication 1542.

**Reporting per diem and car allowances.** The following discussion explains how to report per diem and car allowances. The manner in which you report them depends on how the allowance compares to the federal rate. See *Table 13-1*.

**Allowance less than or equal to the federal rate.** If your allowance for the employee is less than or equal to the appropriate federal rate, that allowance is not included as part of the employee's pay in box 1 of the employee's Form W-2. Deduct the allowance as travel expenses (including meals that may be subject to the 50% limit, discussed later). See *How to deduct* under *Accountable Plans*, earlier.

**Allowance more than the federal rate.** If your employee's allowance is more than the appropriate federal rate, you must report the allowance as two separate items.

Include the allowance amount up to the federal rate in box 12 (code L) of the employee's Form W-2. Deduct it as travel expenses (as explained above). This part of the allowance is treated as reimbursed under an accountable plan.

Include the amount that is more than the federal rate in box 1 (and in boxes 3 and 5 if they apply) of the employee's Form W-2. Deduct it as wages subject to income tax withholding, social security, Medicare, and federal unemployment taxes. This part of the allowance is treated as reimbursed under a nonaccountable plan as explained later under *Nonaccountable Plans*.

**Meals and Entertainment** Under an accountable plan, you can generally deduct only 50% of any otherwise deductible business-related meal and entertainment expenses you reimburse your employees. The deduction limit applies even if you reimburse them for 100% of the expenses.

**Application of the 50% limit.** The 50% deduction limit applies to reimbursements you make to your employees for expenses they incur for meals while traveling away from home on business and for entertaining business customers at your place of business, a restaurant, or another location. It applies to expenses incurred at a business convention or reception, business meeting, or business luncheon at a club. The deduction limit may also apply to meals you furnish on your premises to your employees.

**Related expenses.** Taxes and tips relating to a meal or entertainment activity you reimburse to your employee under an accountable plan are included in the amount subject to the 50% limit. Reimbursements you make for expenses, such as cover charges for admission to a nightclub, rent paid for a room to hold a dinner or cocktail party, or the amount you pay for parking at a sports arena, are all subject to the 50% limit. However, the cost of transportation to and from an otherwise allowable business meal or a business-related entertainment activity is not subject to the 50% limit.

**Amount subject to 50% limit.** If you provide your employees with a per diem allowance only for meal and incidental expenses, the amount treated as an expense for food and beverages is the lesser of the following.

- The per diem allowance.
  
- The federal rate for M & IE.

If you provide your employees with a per diem allowance that covers lodging, meals, and incidental expenses, you must treat an amount equal to the federal M & IE rate for the area of travel as an expense for food and beverages. If the per diem allowance you provide is less than the federal per diem rate for the area of travel, you can treat 40% of the per diem allowance as the amount for food and beverages.

**Meal expenses when subject to "hours of service " limits.** For tax years beginning in 2004, 70% of the reimbursed meals your employees consume while away from their tax home on business during, or incident to, any period subject to the Department of Transportation's hours of service limits are deductible.

See Publication 463 for a detailed discussion of individuals subject to the Department of Transportation's hours of service limits.

**De minimis (minimal) fringe benefit.** The 50% limit does not apply to an expense for food or beverage that is excluded from the gross income of an employee because it is a de minimis fringe benefit. See Publication 15-B for additional information on de minimis fringe benefits.

**Company cafeteria or executive dining room.** The cost of food and beverages you provide primarily to your employees on your business premises is deductible. This includes the cost of maintaining the facilities for providing the food and beverages. These expenses are subject to the 50% limit unless they qualify as a de minimis fringe benefit, discussed in Publication 15-B, or unless they are compensation to your employees and you treat them as provided under a nonaccountable plan.

**Employee activities.** The expense of providing recreational, social, or similar activities (including the use of a facility) for your employees is deductible. The benefit must be primarily for your employees who are not highly compensated.

For this purpose, a highly compensated employee is an employee who meets either of the following requirements.

- 1) Owned a 10% or more interest in the business during the year or the preceding year. An employee is treated as owning any interest owned by his or her brother, sister, spouse, ancestors, and lineal descendants.
- 2) Received more than \$90,000 in pay for the preceding year. You may choose to include only employees who were also in the top 20% of employees when ranked by pay for the preceding year.

For example, the expenses for food, beverages, and entertainment for a company-wide picnic are not subject to the 50% limit.

**Nonaccountable Plans** A nonaccountable plan is an arrangement that does not meet the requirements for an accountable plan. All amounts paid, or treated as paid, under a nonaccountable plan are reported as wages on Form W-2. The payments are subject to income tax withholding, social security, Medicare, and federal unemployment taxes. You can deduct the reimbursement as compensation or wages only to the extent it meets the deductibility tests for employees' pay in chapter 2. Deduct the allowable amount as compensation or wages on the appropriate line of your income tax return, as provided in its instructions.

Generally, amounts paid for meals, entertainment, and amusement provided to individuals who are not your employees are not subject to the 50% limit. Such activities must be directly related to the active conduct of your trade or business. Examples include:

- Amounts paid for meals, goods, services, or the use of a facility. You are allowed a deduction only to the extent it is included in the gross income of the recipient as compensation for services or as a prize or award.
- Expenses that exceed \$600 and are required to be reported on an information return, for example, Form 1099-MISC. See the *General Instructions for Forms 1099, 1098, 5498, and W-2G* for more information about reporting requirements.
- The cost of providing meals, entertainment, goods and services, or use of facilities you sell to the public. For example, if you operate a nightclub, your expense for the entertainment you furnish to your customers, such as a floor show, is a business expense that is fully deductible.
- The cost of providing meals, entertainment, or recreational facilities to the general public as a means of advertising or promoting goodwill in the community is fully deductible.

**TD, Treasury Decision 8324, Employee business expenses: Reporting: Withholding: Reimbursements and allowances, (Dec. 14, 1990)**

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**Treasury Decision 8324**

Federal Register Filing Date: December 14, 1990.

**Employee business expenses: Reporting: Withholding: Reimbursements and allowances.**--Reg. §§1.62-2 and 31.3401(a)-4 and amendments to Reg. §§1.62-1T, 1.162-17, 31.3401(a)-1 and 1.6041-3, relating to the taxation of and reporting and withholding on payments with respect to employee business expenses under a reimbursement or other expense allowance arrangement, have been adopted. BACK REFERENCES: 90FED ¶715, 90FED ¶715A, 90FED ¶1396, 90FED ¶4933, 90FED ¶4935 and 90 FED ¶5074.

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary regulations concerning the taxation of and reporting and withholding on payments with respect to employee business expenses under a reimbursement or other expense allowance arrangement. These final and temporary regulations reflect changes to the law made by the Family Support Act of 1988. These final and temporary regulations will affect employees who receive payments and payors who make payments under reimbursement or other expense allowance arrangements.

EFFECTIVE DATES: The provisions of these temporary regulations under §1.62-1T are effective for expenses paid or incurred in taxable years beginning before January 1, 1989. The income tax provisions of these final regulations under §1.62-2 are effective for payments made under reimbursement or other expense allowance arrangements received by an employee in taxable years of the employee beginning on or after January 1, 1989, with respect to expenses paid or incurred in taxable years beginning on or after January 1, 1989. However, the provisions of §1.62-2(h) of these regulations are effective for payments made under reimbursement or other expense allowance arrangements received by an employee on or after July 1, 1990, with respect to expenses paid or incurred on or after July 1, 1990, and the provisions of §§1.62-2(d)(3) and 1.62-2(h)(2)(i)(B) of these regulations are effective for payments made under reimbursement or other expense allowance arrangements received by an employee on or after January 1, 1991, with respect to expenses paid or incurred on or after January 1, 1991. The provisions of §1.162-17(e)(3) of these regulations are effective for taxable years beginning on or after January 1, 1989. The reporting provisions of these final regulations under §1.6041-3 (i) are effective for payments made under reimbursement or other expense allowance arrangements that are received by an employee on or after January 1, 1989, with respect to expenses paid or incurred on or after January 1, 1989; however, a transition rule is provided under §1.6041-3(i) effective for payments made prior to July 1, 1990. The provisions of these final regulations under §§31.3121(a)-1(h), 31.3121(a)-3, 31.3231(e)-1, 31.3231(e)-3, 31.3306(b)-1, 31.3306(b)-2, 31.3401(a)-(1)(b)(2) and 31.3401(a)-4 are effective for amounts that are received by an employee on or after July 1, 1990, with respect to expenses paid or incurred on or after July 1, 1990. The amendment to Part 602 is effective upon publication.

FOR FURTHER INFORMATION CONTACT: Richard Pavel at 202-377-9372 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

*Paperwork Reduction Act*

The collection of information requirements contained in this final regulation have been reviewed and approved by the Office of Management and Budget in accordance with the requirements of the Paperwork Reduction Act (44 U.S.C. 3504(h)) under control number 1545-1148. The estimated average annual burden per recordkeeper is one-half hour.

This estimate is an approximation of the average time expected to be necessary for a collection of information. It is based on such information as is available to the Internal Revenue Service. Individual recordkeepers may require greater or less time, depending on their particular circumstances.

Comments concerning the accuracy of these burden estimates and suggestions for reducing the burden should be directed to the Internal Revenue Service, Attn: IRS Reports Clearance Officer T:FP, Washington, D.C. 20224, and to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, D.C. 20503.

### *Background*

On December 12, 1989, the Federal Register published temporary regulations (54 FR 51021) [T.D. 8276, 1990-1 C.B. 14] on employee business expense reimbursements and allowances. Those regulations provided guidance concerning the taxation of and reporting and withholding on payments with respect to employee business expenses under a reimbursement or other expense allowance arrangement. The text of those temporary regulations also served as the comment document for a notice of proposed rulemaking ("the proposed regulations") published in the Federal Register for the same day (54 FR 51038) [EE-8-89, 1990-1 C.B. 616].

Written comments were received from the public on the proposed regulations. In addition, on June 11, 1990, the Internal Revenue Service held a public hearing concerning the regulations. After consideration of the comments received and the statements made at the public hearing, the proposed regulations are adopted as revised by this Treasury decision. This Treasury decision also supersedes and obsoletes Announcement 90-127, 1990-48 I.R.B. 8.

### SUMMARY OF COMMENTS AND EXPLANATION OF PROVISIONS:

#### *More than one expense allowance arrangement.*

Commentators requested that the regulations provide guidance on what factors are considered in determining whether an employer has one arrangement or more than one arrangement with an employee. Commentators were especially concerned that small amounts of nonaccountable payments might be treated as part of an otherwise accountable plan, thereby "tainting" the accountable payments if clearly separate plans were not adopted. The final regulations clarify that if an arrangement provides advances, allowances, or reimbursements for deductible employee business expenses and for other bona fide expenses related to the employer's business that are not deductible, the payor will be treated as maintaining two arrangements. The portion of the arrangement that provides payments for the deductible employee business expenses will be treated as one arrangement that satisfies the business connection test and the portion of the arrangement that provides payments for the nondeductible employee business expenses will be treated as a second arrangement that does not satisfy the business connection test.

#### *Reimbursement requirement.*

Some practitioners have asked whether a portion of an employee's salary may be recharacterized as being paid under a reimbursement arrangement. The final regulations clarify that if a payor arranges to pay an amount to an employee regardless of whether the employee incurs (or is reasonably expected to incur) deductible business expenses or other bona fide expenses related to the employer's business that are not deductible, the arrangement does not meet the business connection requirement of §1.62-2(d) of the regulations and all amounts paid under the arrangement are treated as paid under a nonaccountable plan. These amounts are subject to withholding and payment of employment taxes when paid. Thus, no part of an employee's salary may be recharacterized as being paid under a reimbursement arrangement or other expense allowance arrangement.

The final regulations also provide that an arrangement providing a per diem allowance for travel expenses (whether or not deductible) that is computed on a basis similar to that used in computing the employee's wages or other compensation (e.g., the number of hours worked, miles traveled, or pieces produced) satisfies the business

connection requirement of §1.62-2(d) only if, as of December 12, 1989, (1) the per diem allowance was identified by the payor either by making a separate payment or by specifically identifying the amount of the per diem allowance, or (2) a per diem allowance computed on that basis was commonly used in the industry in which the employee is employed. A per diem allowance that satisfies this requirement may be adjusted in a manner that reasonably reflects actual increases in employee business expenses occurring after December 12, 1989.

*Special withholding rules for per diem or mileage allowances.*

Some practitioners have suggested that the safe harbors provided for satisfying the reasonable period of time requirements can be used to avoid reporting and withholding on per diem or mileage allowances where the amount paid exceeds the amount of expenses deemed substantiated. The safe harbors were not intended to be used in that manner.

Accordingly, the final regulations provide that, if (under an arrangement that meets the business connection, substantiation, and return of excess requirements of the regulation) a payor pays a per diem or mileage allowance, the portion, if any, of the allowance paid that relates to days or miles of travel substantiated and that exceeds the amount of the employee's expenses deemed substantiated for those days or miles of travel is treated as paid under a nonaccountable plan. Because the employee is not required to return this excess portion, the reasonable period of time provisions (relating to the return of excess amounts) do not apply to this excess portion.

The final regulations also provide that in the case of a per diem or mileage allowance paid as a reimbursement at a rate for each day or mile of travel that exceeds the amount of the employee's expenses deemed substantiated for a day or mile of travel (e.g., the employer reimburses at a rate of 30 cents per mile when the amount deemed substantiated is 26 cents per mile), the excess portion is subject to withholding and payment of employment taxes in the payroll period in which the payor reimburses the expenses for the days or miles of travel substantiated. The final regulations further provide that in the case of a per diem or mileage allowance paid as an advance at a rate for each day or mile of travel that exceeds the amount of the employee's expenses deemed substantiated for a day or mile of travel, the excess portion is subject to withholding and payment of employment taxes no later than the first payroll period following the payroll period in which the expenses with respect to which the advance was paid (i.e., the days or miles of travel) are substantiated. Of course, the expenses with respect to which the advance was paid must be substantiated within a reasonable period of time.

The final regulations also provide that the Commissioner may, in his discretion, prescribe special rules in pronouncements of general applicability regarding the timing of withholding and payment of employment taxes on per diem and mileage allowances.

*The employer's obligation to report.*

Commentators requested clarification as to whether amounts treated as paid under an accountable plan may, in certain circumstances, be reported by the employer on the employee's Form W-2. The proposed regulations provided that such amounts "are not required to be reported" on the employee's Form W-2. The final regulations clarify that amounts treated as paid under an accountable plan are not reported as wages or other compensation on the employee's Form W-2. Thus, if an employer operates an accountable plan and the employee meets all the requirements of the regulations in terms of timely substantiation and return of excess, the employer may not report such amounts as wages or other compensation on the employee's Form W-2. However, the regulations do not require the employer to provide an accountable plan. Thus, if the employer chooses to provide an expense allowance arrangement that does not meet the accountable plan requirements, the employer must report all amounts paid under the plan as wages or other compensation on the employee's Form W-2 even though an employee might voluntarily substantiate expenses to the employer and return any excess amounts to the employer.

### *Pattern of overreimbursements.*

The safe harbors provided for satisfying the reasonable period of time requirements are designed to meet reasonable administrative needs of employers, not to permit avoidance of the rules regarding accountable plans. Accordingly, the final regulations clarify that if, under a reimbursement or other expense allowance arrangement, a payor has a plan or practice to provide amounts in excess of substantiated expenses to employees and to avoid reporting and withholding on such amounts, the payor may not use either of the safe harbors provided under the reasonable period of time requirement for any years during which such plan or practice exists.

### *Anti-abuse rule.*

The final regulations provide that if a payor's reimbursement or other expense allowance arrangement evidences a pattern of abuse of the rules under section 62(c) of the Code and the regulations thereunder, regarding reimbursement and other expense allowance arrangements, all payments made under the arrangement will be treated as made under a nonaccountable plan and the appropriate penalties will be imposed.

### *Examples.*

As a result of questions raised by commentators, examples have been added to the final regulations to illustrate the application of the regulations.

### *Exempting state, county, and local governments.*

Commentators from state, county, and local governments requested that they be exempted from the requirements of the regulations. There is no indication in the statute or the legislative history that Congress intended that there be an exemption for government employers. The final regulations therefore treat government employers and private sector employers in the same manner and do not exempt federal, state, county, and local governments.

### *Country club dues.*

Practitioners have requested that the final regulations provide special rules for country club dues because of special deduction limitations applicable to such dues. These rules would create a special reasonable period safe harbor for country club dues and would provide an exception to the return of excess requirement for country club dues that are reported as wages and subjected to withholding and payment of employment taxes. These suggestions have not been adopted because they would create needless complexity in the regulations and they are not supported by the statute or the legislative history.

### *Deemed substantiation issues.*

Commentators submitted several comments regarding issues raised by Revenue Procedures 89-66 and 89-67, 1989-2 C.B. 792, 795, and their progeny. Those issues are generally not addressed by these final regulations, but will instead be addressed in revenue procedures or other pronouncements of general applicability.

### *Moving expenses.*

Some practitioners have asked whether the regulations are intended to apply to reimbursements for moving expenses. Section 62(a)(2)(A) of the Code and the regulations refer to advances, allowances, or reimbursements for business expenses that are allowable as deductions by Part VI (section 161 and the following), subchapter B, chapter 1 of the Code. Therefore, neither the proposed regulations nor the final regulations deal with deductions, such as moving expense deductions under section 217, that are not found in Part VI.

#### *Reporting rules.*

The final regulations generally retain the same reporting rules that were provided in the temporary regulations. However, in order to simplify reporting in 1990 and because of the July 1, 1990 effective date for withholding, the transitional reporting rule that was provided in the temporary regulations for payments received by an employee on or after January 1, 1989, and prior to January 1, 1990, has been extended to payments received by an employee prior to July 1, 1990 (rather than January 1, 1990, as provided in the proposed regulations).

#### *Special Analyses*

It has been determined that these rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. Chapter 5) and the Regulatory Flexibility Act (5 U.S.C. Chapter 6) do not apply to these regulations, and, therefore, a final Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking for the regulations was submitted to the Administrator of the Small Business Administration for comment on their impact on small business.

#### *Drafting Information*

The principal author of these regulations is Richard Pavel, Office of the Assistant Chief Counsel (Employee Benefits and Exempt Organizations), Internal Revenue Service. However, personnel from other offices of the Service and Treasury Department participated in their development.

\* \* \* \* \*

#### *Adoption of Amendments to the Regulations*

Accordingly, 26 CFR Parts 1, 31, and 602 are amended as follows:

#### **PART 1--[AMENDED]**

Paragraph 1. The authority for Part 1 is amended in part by removing the citation " §§1.62-1T and 1.62-2T also issued under 26 U.S.C. 62" and by adding the following citations:

Authority: 26 U.S.C. 7805 \* \* \* Secs. 1.62-1T and 1.62-2 also issued under 26 U.S.C. 62 \* \* \* Sec. 1.6041-3 also issued under 26 U.S.C. 62.

Par. 2. In §1.62-1T, paragraph (c)(2) is revised to read as follows:

*§1.62-1T Adjusted gross income (temporary).*

\* \* \* \* \*

(c) *Deductions allowable in computing adjusted gross income.*

\* \* \*

(2) Deductions allowable under part VI, subchapter B, chapter 1 of the Code, (section 161 and following) that consist of expenses paid or incurred by the taxpayer in connection with the performance of services as an employee under an express reimbursement or other expense allowance arrangement (as defined in paragraph (f) of this section or §1.62-2, whichever is applicable) with his or her employer;

\* \* \* \* \*

Par. 3. Section 1.62-2T is removed and section 1.62-2 is added in the appropriate place to read as follows:

§1.62-2 *Reimbursements and other expense allowance arrangements.*

(a) *Table of contents.* The contents of this section are as follows:

(a) *Table of contents.*

(b) *Scope.*

(c) *Reimbursement or other expense allowance arrangement.*

(1) *Defined.*

(2) *Accountable plans.*

(i) *In general.*

(ii) *Special rule for failure to return excess.*

(3) *Nonaccountable plans.*

(i) *In general.*

(ii) *Special rule for failure to return excess.*

(4) *Treatment of payments under accountable plans.*

(5) *Treatment of payments under nonaccountable plans.*

(d) *Business connection.*

(1) *In general.*

(2) *Other bona fide expenses.*

(3) *Reimbursement requirement.*

(i) *In general.*

(ii) *Per diem allowances.*

(e) *Substantiation.*

(1) *In general.*

(2) *Expenses governed by section 274(d).*

(3) *Expenses not governed by section 274(d).*

(f) *Returning amounts in excess of expenses.*

(1) *In general.*

(2) *Per diem or mileage allowances.*

(g) *Reasonable period.*

(1) *In general.*

(2) *Safe harbors.*

(i) *Fixed date method.*

(ii) *Periodic payment method.*

(3) *Pattern of overreimbursements.*

(h) *Withholding and payment of employment taxes.*

(1) *When excluded from wages.*

(2) *When included in wages.*

(i) *Accountable plans.*

(A) *General rule.*

(B) *Per diem or mileage allowances.*

(1) *In general.*

(2) *Reimbursements.*

(3) *Advances.*

(4) *Special rules.*

(ii) *Nonaccountable plans.*

(i) *Application.*

(j) *Examples.*

(k) *Anti-abuse provision.*

(l) *Cross references.*

(m) *Effective dates.*

(b) *Scope.* For purposes of determining "adjusted gross income," section 62(a)(2)(A) allows an employee a deduction for expenses allowed by Part VI (section 161 and following), subchapter B, chapter 1 of the Code, paid

by the employee, in connection with the performance of services as an employee of the employer, under a reimbursement or other expense allowance arrangement with a payor (the employer, its agent, or a third party). Section 62(c) provides that an arrangement will not be treated as a reimbursement or other expense allowance arrangement for purposes of section 62(a)(2)(A) if (1) such arrangement does not require the employee to substantiate the expenses covered by the arrangement to the payor, or (2) such arrangement provides the employee the right to retain any amount in excess of the substantiated expenses covered under the arrangement. This section prescribes rules relating to the requirements of section 62(c).

(c) *Reimbursement or other expense allowance arrangement--(1) Defined.* For purposes of §§1.62-1T and 1.62-2, the phrase "reimbursement or other expense allowance arrangement" means an arrangement that meets the requirements of paragraphs (d) (business connection), (e) (substantiation), and (f) (returning amounts in excess of expenses) of this section. A payor may have more than one arrangement with respect to a particular employee, depending on the facts and circumstances. See paragraph (d)(2) of this section (payor treated as having two arrangements under certain circumstances).

(2) *Accountable plans--(i) In general.* Except as provided in paragraph (c)(2)(ii) of this section, if an arrangement meets the requirements of paragraphs (d), (e), and (f) of this section, all amounts paid under the arrangement are treated as paid under an "accountable plan."

(ii) *Special rule for failure to return excess.* If an arrangement meets the requirements of paragraphs (d), (e), and (f) of this section, but the employee fails to return, within a reasonable period of time, any amount in excess of the amount of the expenses substantiated in accordance with paragraph (e) of this section, only the amounts paid under the arrangement that are not in excess of the substantiated expenses are treated as paid under an accountable plan.

(3) *Nonaccountable plans--(i) In general.* If an arrangement does not satisfy one or more of the requirements of paragraphs (d), (e), or (f) of this section, all amounts paid under the arrangement are treated as paid under a "nonaccountable plan." If a payor provides a nonaccountable plan, an employee who receives payments under the plan cannot compel the payor to treat the payments as paid under an accountable plan by voluntarily substantiating the expenses and returning any excess to the payor.

(ii) *Special rule for failure to return excess.* If an arrangement meets the requirements of paragraphs (d), (e), and (f) of this section, but the employee fails to return, within a reasonable period of time, any amount in excess of the amount of the expenses substantiated in accordance with paragraph (e) of this section, the amounts paid under the arrangement that are in excess of the substantiated expenses are treated as paid under a nonaccountable plan.

(4) *Treatment of payments under accountable plans.* Amounts treated as paid under an accountable plan are excluded from the employee's gross income, are not reported as wages or other compensation on the employee's Form W-2, and are exempt from the withholding and payment of employment taxes (Federal Insurance Contributions Act (FICA), Federal Unemployment Tax Act (FUTA), Railroad Retirement Tax Act (RRTA), Railroad Unemployment Repayment Tax (RURT), and income tax). See paragraph (l) of this section for cross references.

(5) *Treatment of payments under nonaccountable plans.* Amounts treated as paid under a nonaccountable plan are included in the employee's gross income, must be reported as wages or other compensation on the employee's Form W-2, and are subject to withholding and payment of employment taxes (FICA, FUTA, RRTA, RURT, and income tax). See paragraph (h) of this section. Expenses attributable to amounts included in the employee's gross income may be deducted, provided the employee can substantiate the full amount of his or her expenses (i.e., the amount of the expenses, if any, the reimbursement for which is treated as paid under an accountable plan as well as those for which the employee is claiming the deduction) in accordance with §1.274-5T or §1.162-17, but only as a miscellaneous itemized deduction subject to the limitations applicable to such expenses (e.g., the 80-percent limitation on meal and entertainment expenses provided in section 274(n) and the

2-percent floor provided in section 67).

(d) *Business connection*--(1) *In general.* Except as provided in paragraphs (d)(2) and (d)(3) of this section, an arrangement meets the requirements of this paragraph (d) if it provides advances, allowances (including per diem allowances, allowances only for meals and incidental expenses, and mileage allowances), or reimbursements only for business expenses that are allowable as deductions by Part VI (section 161 and the 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 of the employer. The payment may be actually received from the employer, its agent, or a third party for whom the employee performs a service as an employee of the employer, and may include amounts charged directly or indirectly to the payor through credit card systems or otherwise. In addition, if both wages and the reimbursement or other expense allowance are combined in a single payment, the reimbursement or other expense allowance must be identified either by making a separate payment or by specifically identifying the amount of the reimbursement or other expense allowance.

(2) *Other bona fide expenses.* If an arrangement provides advances, allowances, or reimbursements for business expenses described in paragraph (d)(1) of this section (i.e., deductible employee business expenses) and for other bona fide expenses related to the employer's business (e.g., travel that is not away from home) that are not deductible under Part VI (section 161 and the following), subchapter B, chapter 1 of the Code, the payor is treated as maintaining two arrangements. The portion of the arrangement that provides payments for the deductible employee business expenses is treated as one arrangement that satisfies this paragraph (d). The portion of the arrangement that provides payments for the nondeductible employee expenses is treated as a second arrangement that does not satisfy this paragraph (d) and all amounts paid under this second arrangement will be treated as paid under a nonaccountable plan. See paragraphs (c)(5) and (h) of this section.

(3) *Reimbursement requirement*--(i) *In general.* If a payor arranges to pay an amount to an employee regardless of whether the employee incurs (or is reasonably expected to incur) business expenses of a type described in paragraph (d)(1) or (d)(2) of this section, the arrangement does not satisfy this paragraph (d) and all amounts paid under the arrangement are treated as paid under a nonaccountable plan. See paragraphs (c)(5) and (h) of this section.

(ii) *Per diem allowances.* An arrangement providing a per diem allowance for travel expenses of a type described in paragraph (d)(1) or (d)(2) of this section that is computed on a basis similar to that used in computing the employee's wages or other compensation (e.g., the number of hours worked, miles traveled, or pieces produced) meets the requirements of this paragraph (d) only if, on December 12, 1989, the per diem allowance was identified by the payor either by making a separate payment or by specifically identifying the amount of the per diem allowance, or a per diem allowance computed on that basis was commonly used in the industry in which the employee is employed. See section 274(d) and §1.274-5T(g). A per diem allowance described in this paragraph (d)(3)(ii) may be adjusted in a manner that reasonably reflects actual increases in employee business expenses occurring after December 12, 1989.

(e) *Substantiation*--(1) *In general.* An arrangement meets the requirements of this paragraph (e) if it requires each business expense to be substantiated to the payor in accordance with paragraph (e)(2) or (e)(3) of this section, whichever is applicable, within a reasonable period of time. See §1.274-1T or §1.162-17.

(2) *Expenses governed by section 274(d).* An arrangement that reimburses travel, entertainment, use of a passenger automobile or other listed property, or other business expenses governed by section 274(d) meets the requirements of this paragraph (e)(2) if information sufficient to satisfy the substantiation requirements of section 274(d) and the regulations thereunder is submitted to the payor. See §1.274-5T. Under section 274(d), information sufficient to substantiate the requisite elements of each expenditure or use must be submitted to the payor. For example, with respect to travel away from home, §1.274-5T(b)(2) requires that information sufficient to substantiate the amount, time, place, and business purpose of the expense must be submitted to the payor. Similarly, with respect to use of a passenger automobile or other listed property, §1.274-5T(b)(6) requires that information sufficient to substantiate the amount, time, use, and business purpose of the expense must be

submitted to the payor. See §1.274-5T(g), however, which grants the Commissioner authority to prescribe rules permitting the amount of certain expenses to be deemed substantiated to the payor (in lieu of substantiating the actual amount of such expenses) where an arrangement provides for a reimbursement, a per diem allowance, or a mileage allowance for travel away from home or transportation expenses. See also §1.274-5T(j), which grants the Commissioner the authority to establish a method under which a taxpayer may elect to use a specified amount for meals while traveling away from home in lieu of substantiating the actual cost of meals. Substantiation of the amount of a business expense in accordance with rules prescribed pursuant to the authority granted by §1.274-5T(g) or §1.274-5T(j) will be treated as substantiation of the amount of such expense for purposes of this section.

(3) *Expenses not governed by section 274(d)*. An arrangement that reimburses business expenses not governed by section 274(d) meets the requirements of this paragraph (e)(3) if information is submitted to the payor sufficient to enable the payor to identify the specific nature of each expense and to conclude that the expense is attributable to the payor's business activities. Therefore, each of the elements of an expenditure or use must be substantiated to the payor. It is not sufficient if an employee merely aggregates expenses into broad categories (such as "travel") or reports individual expenses through the use of vague, nondescriptive terms (such as "miscellaneous business expenses"). See §1.162-17(b).

(f) *Returning amounts in excess of expenses--(1) In general*. Except as provided in paragraph (f)(2) of this section, an arrangement meets the requirements of this paragraph (f) if it requires the employee to return to the payor within a reasonable period of time any amount paid under the arrangement in excess of the expenses substantiated in accordance with paragraph (e) of this section. The determination of whether an arrangement requires an employee to return amounts in excess of substantiated expenses will depend on the facts and circumstances. An arrangement whereby money is advanced to an employee to defray expenses will be treated as satisfying the requirements of this paragraph (f) only if the amount of money advanced is reasonably calculated not to exceed the amount of anticipated expenditures, the advance of money is made on a day within a reasonable period of the day that the anticipated expenditures are paid or incurred, and any amounts in excess of the expenses substantiated in accordance with paragraph (e) of this section are required to be returned to the payor within a reasonable period of time after the advance is received.

(2) *Per diem or mileage allowances*. The Commissioner may, in his discretion, prescribe rules in pronouncements of general applicability under which a reimbursement or other expense allowance arrangement that provides per diem allowances providing for ordinary and necessary expenses of traveling away from home (exclusive of transportation costs to and from destination) or mileage allowances providing for ordinary and necessary expenses of local travel and transportation while traveling away from home will be treated as satisfying the requirements of this paragraph (f), even though the arrangement does not require the employee to return the portion of such an allowance that relates to the days or miles of travel substantiated and that exceeds the amount of the employee's expenses deemed substantiated pursuant to rules prescribed under section 274(d), provided the allowance is paid at a rate for each day or mile of travel that is reasonably calculated not to exceed the amount of the employee's expenses or anticipated expenses and the employee is required to return to the payor within a reasonable period of time any portion of such allowance which relates to days or miles of travel not substantiated in accordance with paragraph (e) of this section.

(g) *Reasonable period--(1) In general*. The determination of a reasonable period of time will depend on the facts and circumstances.

(2) *Safe harbors--(i) Fixed date method*. An advance made within 30 days of when an expense is paid or incurred, an expense substantiated to the payor within 60 days after it is paid or incurred, or an amount returned to the payor within 120 days after an expense is paid or incurred will be treated as having occurred within a reasonable period of time.

(ii) *Periodic statement method*. If a payor provides employees with periodic statements (no less frequently than quarterly) stating the amount, if any, paid under the arrangement in excess of the expenses the employee has

substantiated in accordance with paragraph (e) of this section, and requesting the employee to substantiate any additional business expenses that have not yet been substantiated (whether or not such expenses relate to the expenses with respect to which the original advance was paid) and/or to return any amounts remaining unsubstantiated within 120 days of the statement, an expense substantiated or an amount returned within that period will be treated as being substantiated or returned within a reasonable period of time.

(3) *Pattern of overreimbursements.* If, under a reimbursement or other expense allowance arrangement, a payor has a plan or practice to provide amounts to employees in excess of expenses substantiated in accordance with paragraph (e) of this section and to avoid reporting and withholding on such amounts, the payor may not use either of the safe harbors provided in paragraph (g)(2) of this section for any years during which such plan or practice exists.

(h) *Withholding and payment of employment taxes--(1) When excluded from wages.* If an arrangement meets the requirements of paragraphs (d), (e), and (f) of this section, the amounts paid under the arrangement that are not in excess of the expenses substantiated in accordance with paragraph (e) of this section (i.e., the amounts treated as paid under an accountable plan) are not wages and are not subject to withholding and payment of employment taxes.

(2) *When included in wages--(i) Accountable plans--(A) General rule.* Except as provided in paragraph (h)(2)(i)(B) of this section, if the expenses covered under an arrangement that meets the requirements of paragraphs (d), (e), and (f) of this section are not substantiated to the payor in accordance with paragraph (e) of this section within a reasonable period of time or if any amounts in excess of the substantiated expenses are not returned to the payor in accordance with paragraph (f) of this section within a reasonable period of time, the amount which is treated as paid under a nonaccountable plan under paragraph (c)(3)(ii) of this section is subject to withholding and payment of employment taxes no later than the first payroll period following the end of the reasonable period. A payor may treat any amount not substantiated or returned within the periods specified in paragraph (g)(2) of this section as not substantiated or returned within a reasonable period of time.

(B) *Per diem or mileage allowances--(1) In general.* If a payor pays a per diem or mileage allowance under an arrangement that meets the requirements of paragraphs (d), (e), and (f) of this section, the portion, if any, of the allowance paid that relates to days or miles of travel substantiated in accordance with paragraph (e) of this section and that exceeds the amount of the employee's expenses deemed substantiated for such travel pursuant to rules prescribed under section 274(d) and §1.274-5T(g) or (j) is treated as paid under a nonaccountable plan. See paragraph (c)(3)(ii) of this section. Because the employee is not required to return this excess portion, the reasonable period of time provisions of paragraph (g) of this section (relating to the return of excess amounts) do not apply to this excess portion.

(2) *Reimbursements.* Except as provided in paragraph (h)(2)(i)(B)(4) of this section, in the case of a per diem or mileage allowance paid as a reimbursement at a rate for each day or mile of travel that exceeds the amount of the employee's expenses deemed substantiated for a day or mile of travel, the excess portion described in paragraph (h)(2)(i) of this section is subject to withholding and payment of employment taxes in the payroll period in which the payor reimburses the expenses for the days or miles of travel substantiated in accordance with paragraph (e) of this section.

(3) *Advances.* Except as provided in paragraph (h)(2)(i)(B)(4) of this section, in the case of a per diem or mileage allowance paid as an advance at a rate for each day or mile of travel that exceeds the amount of the employee's expenses deemed substantiated for a day or mile of travel, the excess portion described in paragraph (h)(2)(i) of this section is subject to withholding and payment of employment taxes no later than the first payroll period following the payroll period in which the expenses with respect to which the advance was paid (i.e., the days or miles of travel) are substantiated in accordance with paragraph (e) of this section. The expenses with respect to which the advance was paid must be substantiated within a reasonable period of time. See paragraph (g) of this section.

(4) *Special rules.* The Commissioner may, in his discretion, prescribe special rules in pronouncements of general applicability regarding the timing of withholding and payment of employment taxes on per diem and mileage allowances.

(ii) *Nonaccountable plans.* If an arrangement does not satisfy one or more of the requirements of paragraphs (d), (e), or (f) of this section, all amounts paid under the arrangement are wages and are subject to withholding and payment of employment taxes when paid.

(i) *Application.* The requirements of paragraphs (d)(business connection), (e)(substantiation), and (f)(returning amounts in excess of expenses) of this section will be applied on an employee-by-employee basis. Thus, for example, the failure by one employee to substantiate expenses under an arrangement in accordance with paragraph (e) of this section will not cause amounts paid to other employees to be treated as paid under a nonaccountable plan.

(j) *Examples.* The rules contained in this section may be illustrated by the following examples.

*Example (1). Reimbursement requirement.* Employer S pays its engineers \$200 a day. On those days that an engineer travels away from home on business for Employer S, Employer S designates \$50 of the \$200 as paid to reimburse the engineer's travel expenses. Because Employer S would pay an engineer \$200 a day regardless of whether the engineer was traveling away from home, the arrangement does not satisfy the reimbursement requirement of paragraph (d)(3)(i) of this section. Thus, no part of the \$50 Employer S designated as a reimbursement is treated as paid under an accountable plan. Rather, all payments under the arrangement are treated as paid under a nonaccountable plan. Employer S must report the entire \$200 as wages or other compensation on the employees' Forms W-2 and must withhold and pay employment taxes on the entire \$200 when paid.

*Example (2). Reimbursement requirement, multiple arrangements.* Airline T pays all its employees a salary. Airline T also pays an allowance under an arrangement that otherwise meets the requirements of paragraphs (d), (e), and (f) of this section to its pilots and flight attendants who travel away from their home base airports, whether or not they are "away from home." Because the allowance is paid only to those employees who incur (or are reasonably expected to incur) expenses of a type described in paragraph (d)(1) or (d)(2) of this section, the arrangement satisfies the reimbursement requirement of paragraph (d)(3)(i) of this section. Under paragraph (d)(2) of this section, Airline T is treated as maintaining two arrangements. The portion of the arrangement providing the allowances for away from home travel is treated as an accountable plan. The portion of the arrangement providing the allowances for non-away from home travel is treated as a nonaccountable plan. Airline T must report the non-away from home allowances as wages or other compensation on the employees' Forms W-2 and must withhold and pay employment taxes on these payments when paid.

*Example (3). Reimbursement requirement.* Corporation R pays all its salespersons a salary. Corporation R also pays a travel allowance under an arrangement that otherwise meets the requirements of paragraphs (d), (e), and (f) of this section. This allowance is paid to all salespersons, including salespersons that Corporation R knows, or has reason to know, do not travel away from their offices on Corporation R business and would not be reasonably expected to incur travel expenses. Because the allowance is not paid only to those employees who incur (or are reasonably expected to incur) expenses of a type described in paragraph (d)(1) or (d)(2) of this section, the arrangement does not satisfy the reimbursement requirement of paragraph (d)(3)(i) of this section. Thus, no part of the allowance Corporation R designated as a reimbursement is treated as paid under an accountable plan. Rather, all payments under the arrangement are treated as paid under a nonaccountable plan. Corporation R must report all payments under the arrangement as wages or other compensation on the employees' Forms W-2 and must withhold and pay employment taxes on the payments when paid.

*Example (4). Separate arrangement, miscellaneous expenses.* Under an arrangement that meets the

requirements of paragraphs (d), (e), and (f) of this section, County U reimburses its employees for lodging and meal expenses incurred when they travel away from home on County U business. For its own convenience, County U also separately pays certain of its employees a \$25 monthly allowance to cover the cost of small miscellaneous office expenses. County U does not require its employees to substantiate these miscellaneous expenses and does not require them to return the amounts by which the monthly allowance exceeds the miscellaneous expenses. The monthly allowance arrangement is a nonaccountable plan. County U must report the monthly allowances as wages or other compensation on the employees' Forms W-2 and must withhold and pay employment taxes on the monthly allowances when paid. The nonaccountable plan providing the monthly allowances is treated as separate from the accountable plan providing reimbursements for lodging and meal expenses incurred for travel away from home on County U business.

*Example (5). Excessive advances.* In anticipation of employee business expenses that Corporation V does not reasonably expect to exceed \$400 in any quarter, Corporation V nonetheless advances \$1,000 to Employee A for such expenses. Whenever Employee A substantiates an expense in accordance with paragraph (e) of this section, Corporation V provides an additional advance in an amount equal to the amount substantiated, thereby providing a continuing advance of \$1,000. Because the amounts advanced under this arrangement are not reasonably calculated so as not to exceed the amount of anticipated expenditures and because the advance of money is not made on a day within a reasonable period of the day that the anticipated expenditures are paid or incurred, the arrangement is a nonaccountable plan. The arrangement fails to satisfy the requirements of paragraphs (d)(business connection) and (f) (reasonable calculation of advances) of this section. Thus, Corporation V in must report the entire amount of each advance as wages or other compensation and must withhold and pay employment taxes on the entire amount of each advance when paid.

*Example (6). Excess mileage advance.* Under an arrangement that meets the requirements of paragraphs (d), (e), and (f) of this section, Employer W pays its employees a mileage allowance at a rate of 30 cents per mile (when the amount deemed substantiated for each mile of travel substantiated is 26 cents per mile) to cover automobile business expenses. The allowance is paid at a rate for each mile of travel that is reasonably calculated not to exceed the amount of the employee's expenses or anticipated expenses. Employer W does not require the return of the portion of the mileage allowance (4 cents) that exceeds the amount deemed substantiated for each mile of travel substantiated in accordance with paragraph (e) of this section. In June, Employer W advances Employee B \$150 for 500 miles to be traveled by Employee B during the month. In July, Employee B substantiates 500 miles of business travel. The amount deemed substantiated by Employee B is \$130. However, Employer W does not require Employee B to return the remaining \$20 of the advance. No later than the first payroll period following the payroll period in which the business miles of travel are substantiated, Employer W must withhold and pay employment taxes on \$20 (500 miles x 4 cents per mile).

*Example (7). Excess per diem reimbursement.* Under an arrangement that meets the requirements of paragraphs (d), (e), and (f) of this section, Employer X pays its employees a per diem allowance to cover lodging, meal, and incidental expenses incurred for travel away from home on Employer X business at a rate equal to 120 percent of the amount deemed substantiated for each day of travel to the localities to which the employees travel. Employer X does not require the employees to return the 20 percent by which the reimbursement for those expenses exceeds the amount deemed substantiated for each day of travel substantiated in accordance with paragraph (e) of this section. Employee C substantiates six days of business travel away from home: two days in a locality for which the amount deemed substantiated is \$100 a day and four days in a locality for which the amount deemed substantiated is \$125 a day. Employer X reimburses Employee C \$840 for the six days of travel away from home ( $2 \times (120\% \times \$100) + 4 \times (120\% \times \$125)$ ), and does not require Employee C to return the excess portion (\$140 excess portion =  $2 \text{ days} \times \$20 (\$120 - \$100) + 4 \text{ days} \times \$25 (\$150 - \$125)$ ). For the payroll period in which Employer X reimburses the expenses, Employer X must withhold and pay employment taxes on \$140.

*Example (8). Return requirement.* Employer Y provides expense allowances to certain of its employees to cover business expenses of a type described in paragraph (d)(1) of this section under an arrangement that requires the employees to substantiate their expenses within a reasonable period of time and to return any excess amounts within a reasonable period of time. Each time an employee returns an excess amount to Employer Y, however, Employer Y pays the employee a "bonus" equal to the amount returned by the employee. The arrangement fails to satisfy the requirements of paragraph (f) (returning amounts in excess of expenses) of this section. Thus, Employer Y must report the entire amount of the expense allowance payments as wages or

other compensation and must withhold and pay employment taxes on the payments when paid. Compare example (6) (where the employee is not required to return the portion of the mileage allowance that exceeds the amount deemed substantiated for each mile of travel substantiated).

*Example (9). Timely substantiation.* Employer Z provides a \$500 advance to Employee D for a trip away from home on Employer Z business. Employee D incurs \$500 in business expenses on the trip. Employer Z uses the periodic statement method safe harbor. At the end of the quarter during which the trip occurred, Employer Z sends a quarterly statement to Employee D stating that \$500 was advanced to Employee D during the quarter and that no expenses were substantiated and no excess amounts returned. The statement advises Employee D that Employee D must substantiate any additional business expenses within 120 days of the date of the statement, and must return any unsubstantiated excess within the 120-day period. Employee D fails to substantiate any expenses or to return the excess within the 120-day period. Employer Z treats the \$500 as wages and withholds and pays employment taxes on the \$500. After the 120-day period has expired, Employee D substantiates the \$500 in travel expenses in accordance with paragraph (e) of this section. Employer Z properly reported and withheld and paid employment taxes on the \$500 and no adjustments may be made. Employee D must include the \$500 in gross income and may deduct the \$500 of expenses as a miscellaneous itemized deduction subject to the 2-percent floor provided in section 67.

(k) *Anti-abuse provision.* If a payor's reimbursement or other expense allowance arrangement evidences a pattern of abuse of the rules of section 62(c) and this section, all payments made under the arrangement will be treated as made under a nonaccountable plan.

(l) *Cross references.* For employment tax regulations relating to reimbursement and expense allowance arrangements, see §§31.3121(a)-3, 31.3231(e)-3, 31.3306(b)-2, and 31.3401(a)-4, which generally apply to payments made under reimbursement or other expense allowance arrangements received by an employee on or after July 1, 1990 with respect to expenses paid or incurred on or after July 1, 1990. For reporting requirements, see §1.6041-3(i), which generally applies to payments made under reimbursement or other expense allowance arrangements received by an employee on or after January 1, 1989 with respect to expenses paid or incurred on or after January 1, 1989.

(m) *Effective dates.* This section generally applies to payments made under reimbursement or other expense allowance arrangements received by an employee in taxable years of the employee beginning on or after January 1, 1989, with respect to expenses paid or incurred in taxable years beginning on or after January 1, 1989. Paragraph (h) of this section generally applies to payments made under reimbursement or other expense allowance arrangements received by an employee on or after July 1, 1990 with respect to expenses paid or incurred on or after July 1, 1990. Paragraphs (d)(3) and (h)(2)(i)(B) of this section apply to payments made under reimbursement or other expense allowance arrangements received by an employee on or after January 1, 1991 with respect to expenses paid or incurred on or after January 1, 1991.

Par. 4. In §1.162-17, paragraph (e)(3) is revised to read as follows:

*§1.162-17 Reporting and substantiation of certain business expenses of employees.*

\* \* \* \* \*

(e) *Applicability.* \* \* \*

(3) For taxable years beginning on or after January 1, 1989, the provisions of this section are superseded by the regulations under section 62(c) to the extent this section is inconsistent with those regulations. See §1.62-2.

Par. 5. In §1.6041-3, paragraph (i) is revised to read as follows:

*§1.6041-3 Payments for which no return of information is required under section 6041.*

\* \* \* \* \*

(i)(1) *In general.* Payments made under reimbursement or other expense allowance arrangements that meet the requirements of section 62(c) of the Code and §1.62-2, that do not exceed the amount of the expenses substantiated (i.e., amounts which are treated as paid under an accountable plan), and that are received by an employee on or after January 1, 1989, with respect to expenses paid or incurred on or after January 1, 1989;

(2) *Transition rule.* Payments made under reimbursement or other expense allowance arrangements that are received by an employee on or after January 1, 1989, but prior to July 1, 1990, to the extent that the employee is required to account (within the meaning of the term "account" as set forth in §1.162-17(b)(4) or 1.274-5T(f)(4), whichever is applicable) and does so account to the payor for such expenses, provided the payor has made a reasonable, good faith effort to comply with the requirements of section 62(c). In general, compliance with the provisions of this section, as in effect for payments made under reimbursement or other expense allowance arrangements that were received by an employee before January 1, 1989, with respect to expenses paid or incurred before January 1, 1989, will constitute such reasonable good faith compliance. In no event, however, will reasonable good faith compliance exist if a payor fails to report payments made under an arrangement (other than a per diem or mileage allowance type arrangement) under which an employee is not required to substantiate expenses paid or incurred or is not required to return amounts in excess of the substantiated expenses;

\* \* \* \* \*

PART 31--[AMENDED]

Par. 6. The authority citation for Part 31 continues to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \* Secs. 31.3121(a)-1, 31.3231(e)-1, 31.3306(b)-1, and 31.3401(a)-1 also issued under 26 U.S.C. 62.

Par. 7. In §31.3121(a)-1, the last sentence of paragraph (h) is revised to read as follows:

*§31.3121(a)-1 Wages.*

\* \* \* \* \*

(h) \* \* \* For amounts that are received by an employee on or after July 1, 1990, with respect to expenses paid or incurred on or after July 1, 1990, see §31.3121(a)-3.

\* \* \* \* \*

Par. 8. Section 31.3121(a)-2T is redesignated as §31.3121 (a)-3 and revised to read as follows:

*§31.3121(a)-3 Reimbursement and other expense allowance amounts--(a) When excluded from wages.* If a reimbursement or other expense allowance arrangement meets the requirements of section 62(c) of the Code and §1.62-2 and the expenses are substantiated within a reasonable period of time, payments made under the arrangement that do not exceed the substantiated expenses are treated as paid under an accountable plan and

are not wages. In addition; if both wages and the reimbursement or other expense allowance are combined in a single payment, the reimbursement or other expense allowance must be identified either by making a separate payment or by specifically identifying the amount of the reimbursement or other expense allowance.

(b) *When included in wages--(1) Accountable plans--(i) General rule.* Except as provided in paragraph (b)(1)(ii) of this section, if a reimbursement or other expense allowance arrangement satisfies the requirements of section 62(c) and §1.62-2, but the expenses are not substantiated within a reasonable period of time or amounts in excess of the substantiated expenses are not returned within a reasonable period of time, the amount paid under the arrangement in excess of the substantiated expenses is treated as paid under a nonaccountable plan, is included in wages, and is subject to withholding and payment of employment taxes no later than the first payroll period following the end of the reasonable period.

(ii) *Per diem or mileage allowances.* If a reimbursement or other expense allowance arrangement providing a per diem or mileage allowance satisfies the requirements of section 62(c) and §1.62-2, but the allowance is paid at a rate for each day or mile of travel that exceeds the amount of the employee's expenses deemed substantiated for a day or mile of travel, the excess portion is treated as paid under a nonaccountable plan and is included in wages. In the case of a per diem or mileage allowance paid as a reimbursement, the excess portion is subject to withholding and payment of employment taxes when paid. In the case of a per diem or mileage allowance paid as an advance, the excess portion is subject to withholding and payment of employment taxes no later than the first payroll period following the payroll period in which the expenses with respect to which the advance was paid (i.e., the days or miles of travel) are substantiated. The Commissioner may, in his discretion, prescribe special rules in pronouncements of general applicability regarding the timing of withholding and payment of employment taxes on per diem and mileage allowances.

(2) *Nonaccountable plans.* If a reimbursement or other expense allowance arrangement does not satisfy the requirements of section 62(c) and §1.62-2 (e.g., the arrangement does not require expenses to be substantiated or require amounts in excess of the substantiated expenses to be returned), all amounts paid under the arrangement are treated as paid under a nonaccountable plan, are included in wages, and are subject to withholding and payment of employment taxes when paid.

(c) *Effective dates.* This section generally applies to payments made under reimbursement or other expense allowance arrangements received by an employee on or after July 1, 1990, with respect to expenses paid or incurred on or after July 1, 1990. Paragraph (b)(1)(ii) of this section applies to payments made under reimbursement or other expense allowance arrangements received by an employee on or after January 1, 1991, with respect to expenses paid or incurred on or after January 1, 1991.

Par. 9. In §31.3231(e)-1, the last sentence of paragraph (a)(3)(iv) is revised to read as follows:

§31.3231(e)-1 *Compensation.*

(a) \* \* \*

(3) \* \* \*

(iv) \* \* \* For amounts that are received by an employee on or after July 1, 1990, with respect to expenses paid or incurred on or after July 1, 1990, see §31.3231(e)-3.

\* \* \* \* \*

Par. 10 Section 31.3231(e)-3T is redesignated as §31.3231(e)-3 and revised to read as follows:

*§31.3231(e)-3 Reimbursement and other expense allowance amounts--(a) When excluded from compensation.* If a reimbursement or other expense allowance arrangement meets the requirements of section 62(c) of the Code and §1.62-2 and the expenses are substantiated within a reasonable period of time, payments made under the arrangement that do not exceed the substantiated expenses are treated as paid under an accountable plan and are not compensation. In addition, if both wages and the reimbursement or other expense allowance are combined in a single payment, the reimbursement or other expense allowance must be identified either by making a separate payment or by specifically identifying the amount of the reimbursement or other expense allowance.

(b) *When included in compensation--(1) Accountable plans--(i) General rule.* Except as provided in paragraph (b)(1)(ii) of this section, if a reimbursement or other expense allowance arrangement satisfies the requirements of section 62(c) and §1.62-2, but the expenses are not substantiated within a reasonable period of time or amounts in excess of the substantiated expenses are not returned within a reasonable period of time, the amount paid under the arrangement in excess of the substantiated expenses is treated as paid under a nonaccountable plan, is included in compensation, and is subject to withholding and payment of employment taxes no later than the first payroll period following the end of the reasonable period.

(ii) *Per diem or mileage allowances.* If a reimbursement or other expense allowance arrangement providing a per diem or mileage allowance satisfies the requirements of section 62(c) and §1.62-2, but the allowance is paid at a rate for each day or mile of travel that exceeds the amount of the employee's expenses deemed substantiated for a day or mile of travel, the excess portion is treated as paid under a nonaccountable plan and is included in compensation. In the case of a per diem or mileage allowance paid as a reimbursement, the excess portion is subject to withholding and payment of employment taxes when paid. In the case of a per diem or mileage allowance paid as an advance, the excess portion is subject to withholding and payment of employment taxes no later than the first payroll period following the payroll period in which the expenses with respect to which the advance was paid (i.e., the days or miles of travel) are substantiated. The Commissioner may, in his discretion, prescribe special rules in pronouncements of general applicability regarding the timing of withholding and payment of employment taxes on per diem and mileage allowances.

(2) *Nonaccountable plans.* If a reimbursement or other expense allowance arrangement does not satisfy the requirements of section 62(c) and §1.62-2 (e.g., the arrangement does not require expenses to be substantiated or require amounts in excess of the substantiated expenses to be returned), all amounts paid under the arrangement are treated as paid under a nonaccountable plan, are included in compensation, and are subject to withholding and payment of employment taxes when paid.

(c) *Effective dates.* This section generally applies to payments made under reimbursement or other expense allowance arrangements received by an employee on or after July 1, 1990, with respect to expenses paid or incurred on or after July 1, 1990. Paragraph (b)(1)(ii) of this section applies to payments made under reimbursement or other expense allowance arrangements received by an employee on or after January 1, 1991, with respect to expenses paid or incurred on or after January 1, 1991.

Par. 11. In §31.3306(b)-1, the last sentence of paragraph (h) is revised to read as follows:

*§31.3306(b)-1 Wages.*

\* \* \* \* \*

(h) \* \* \* For amounts that are received by an employee on or after July 1, 1990, with respect to expenses paid or incurred on or after July 1, 1990, see §31.3306(b)-2.

\* \* \* \* \*

Par. 12 Section 31.3306(b)-2T is redesignated as §31.3306(b)-2 and revised to read as follows:

*§31.3306(b)-2 Reimbursement and other expense allowance amounts.*

(a) *When excluded from wages.* If a reimbursement or other expense allowance arrangement meets the requirements of section 62(c) of the Code and §1.62-2 and the expenses are substantiated within a reasonable period of time, payments made under the arrangement that do not exceed the substantiated expenses are treated as paid under an accountable plan and are not wages. In addition, if both wages and the reimbursement or other expense allowance are combined in a single payment, the reimbursement or other expense allowance must be identified either by making a separate payment or by specifically identifying the amount of the reimbursement or other expense allowance.

(b) *When included in wages--(1) Accountable plans--(i) General rule.* Except as provided in paragraph (b)(1)(ii) of this section, if a reimbursement or other expense allowance arrangement satisfies the requirements of section 62(c) and §1.62-2, but the expenses are not substantiated within a reasonable period of time or amounts in excess of the substantiated expenses are not returned within a reasonable period of time, the amount paid under the arrangement in excess of the substantiated expenses is treated as paid under a nonaccountable plan, is included in wages, and is subject to withholding and payment of employment taxes no later than the first payroll period following the end of the reasonable period.

(ii) *Per diem or mileage allowances.* If a reimbursement or other expense allowance arrangement providing a per diem or mileage allowance satisfies the requirements of section 62(c) and §1.62-2, but the allowance is paid at a rate for each day or mile of travel that exceeds the amount of the employee's expenses deemed substantiated for a day or mile of travel, the excess portion is treated as paid under a nonaccountable plan and is included in wages. In the case of a per diem or mileage allowance paid as a reimbursement, the excess portion is subject to withholding and payment of employment taxes when paid. In the case of a per diem or mileage allowance paid as an advance, the excess portion is subject to withholding and payment of employment taxes no later than the first payroll period following the payroll period in which the expenses with respect to which the advance was paid (i.e., the days or miles of travel) are substantiated. The Commissioner may, in his discretion, prescribe special rules in pronouncements of general applicability regarding the timing of withholding and payment of employment taxes on per diem and mileage allowances.

(2) *Nonaccountable plans.* If a reimbursement or other expense allowance arrangement does not satisfy the requirements of section 62(c) and §1.62-2 (e.g., the arrangement does not require expenses to be substantiated or require amounts in excess of the substantiated expenses to be returned), all amounts paid under the arrangement are treated as paid under a nonaccountable plan, are included in wages, and are subject to withholding and payment of employment taxes when paid.

(c) *Effective dates.* This section generally applies to payments made under reimbursement or other expense allowance arrangements received by an employee on or after July 1, 1990, with respect to expenses paid or incurred on or after July 1, 1990. Paragraph (b)(1)(ii) of this section applies to payments made under reimbursement or other expense allowance arrangements received by an employee on or after January 1, 1991, with respect to expenses paid or incurred on or after January 1, 1991.

Par. 13. In §31.3401(a)-1, the last sentence of paragraph (b)(2) is revised to read as follows:

*§31.3401(a)-1 Wages.*

\* \* \* \* \*

(b) \* \* \*

(2) *Traveling and other expenses.* \* \* \* For amounts that are received by an employee on or after July 1, 1990, with respect to expenses paid or incurred on or after July 1, 1990, see §31.3401(a)-4.

\* \* \* \* \*

Par. 14 Section 31.3401(a)-2T is redesignated as §31.3401(a)-4 and revised to read as follows:

*§31.3401(a)-4 Reimbursements and other expense allowance amounts.*

(a) *When excluded from wages.* If a reimbursement or other expense allowance arrangement meets the requirements of section 62(c) of the Code and §1.62-2 and the expenses are substantiated within a reasonable period of time, payments made under the arrangement that do not exceed the substantiated expenses are treated as paid under an accountable plan and are not wages. In addition, if both wages and the reimbursement or other expense allowance are combined in a single payment, the reimbursement or other expense allowance must be identified either by making a separate payment or by specifically identifying the amount of the reimbursement or other expense allowance.

(b) *When included in wages--(1) Accountable plans--(i) General rule.* Except as provided in paragraph (b)(1)(ii) of this section, if a reimbursement or other expense allowance arrangement satisfies the requirements of section 62(c) and §1.62-2, but the expenses are not substantiated within a reasonable period of time or amounts in excess of the substantiated expenses are not returned within a reasonable period of time, the amount paid under the arrangement in excess of the substantiated expenses is treated as paid under a nonaccountable plan, is included in wages, and is subject to withholding and payment of employment taxes no later than the first payroll period following the end of the reasonable period.

(ii) *Per diem or mileage allowances.* If a reimbursement or other expense allowance arrangement providing a per diem or mileage allowance satisfies the requirements of section 62(c) and §1.62-2, but the allowance is paid at a rate for each day or mile of travel that exceeds the amount of the employee's expenses deemed substantiated for a day or mile of travel, the excess portion is treated as paid under a nonaccountable plan and is included in wages. In the case of a per diem or mileage allowance paid as a reimbursement, the excess portion is subject to withholding and payment of employment taxes when paid. In the case of a per diem or mileage allowance paid as an advance, the excess portion is subject to withholding and payment of employment taxes no later than the first payroll period following the payroll period in which the expenses with respect to which the advance was paid (i.e., the days or miles of travel) are substantiated. The Commissioner may, in his discretion, prescribe special rules in pronouncements of general applicability regarding the timing of withholding and payment of employment taxes on per diem and mileage allowances.

(2) *Nonaccountable plans.* If a reimbursement or other expense allowance arrangement does not satisfy the requirements of section 62(c) and §1.62-2 (e.g., the arrangement does not require expenses to be substantiated or require amounts in excess of the substantiated expenses to be returned), all amounts paid under the arrangement are treated as paid under a nonaccountable plan, are included in wages, and are subject to withholding and payment of employment taxes when paid.

(c) *Withholding rate.* Employers may add any payments made under reimbursement or other expense allowance arrangements that are subject to income tax withholding to the employee's regular wages for a payroll period and compute withholding taxes on the total. Alternatively, the employer may withhold income tax from the reimbursement or other expense allowance at the flat 20-percent rate applicable to supplemental wages, provided the employer withholds income tax from the employee's regular wages and provided the reimbursement or

allowance is paid separately (or separately identified if wages and reimbursement amounts are combined in a single payment). See §31.3402(g)-1 regarding supplemental wage payments.

(d) *Effective dates.* This section generally applies to payments made under reimbursement or other expense allowance arrangements received by an employee on or after July 1, 1990, with respect to expenses paid or incurred on or after July 1, 1990. Paragraph (b)(1)(ii) of this section applies to payments made under reimbursement or other expense allowance arrangements received by an employee on or after January 1, 1991, with respect to expenses paid or incurred on or after January 1, 1991.

PART 602--[AMENDED]

Par. 15. The authority for Part 602 continues to read as follows:

26 U.S.C. 7805

Par. 16. The table of OMB control numbers in section 602.101(c) is amended as follows: The entry reading: "1.62.2 . . . 1545-1148" is revised to read: "1.62-2 . . . 1545-1148".