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Tax considerations on expense reimbursements

STAFFING

Whether you are an insurance agency shareholder, partner, employee or independent agent, you need to be aware of the tax treatment of reimbursed and unreimbursed business expenses. Like most businesses, agencies typically reimburse employees for ordinary and necessary business expenses. Depending on the circumstances, expense reimbursements may be treated as taxable income subject to federal income and employment taxes.

Ordinary expenses are common business expenses incurred in most insurance agencies. Necessary expenses are helpful to conducting business. Examples include: travel, lodging, meals, entertainment, gifts, automobile expenses, home-office expenses, promotional expenses (e.g., advertising, brochures and other collateral), malpractice insurance premiums, continuing education and certifications, as well as professional association membership dues.

For an agency to deduct expenses on its income tax return, the expenses must be both ordinary and necessary business expenses. In other words, the expense must be common and accepted in your business and must be helpful and appropriate for your business. An expense does not have to be required to be considered necessary.

The tax treatment of reimbursed and unreimbursed business expenses depends on many factors, including:

Type of expense reimbursement plan. An agency can have an accountable or non-accountable expense reimbursement plan. To qualify as an accountable plan, the IRS requires:

- the agency to pay for only deductible business-related expenses;
- employees to substantiate business expenses in a timely manner (within 60 days) by submitting documentation such as an expense report, travel log or receipts; and
- employees to return reimbursements that exceed substantiated expenses to the employer (within 120 days after the expense was paid or incurred).

Generally, the agency can deduct reimbursement expenses (limited to 50 percent for meals and entertainment expenses) in an accountable plan. Reimbursements made under an accountable plan are excluded from a taxpayer's gross income for federal and employment purposes.

A non-accountable plan does not require employees to substantiate business expenses or return reimbursements that are more than the expenses

incurred. Although the agency can still deduct non-accountable business expenses, employee reimbursements are considered as income for the employee and must be reported on the taxpayer's Form W-2.

Under-reimbursed expenses. If an employee's actual expenses are more than the amount reimbursed by the employer, an itemized deduction (subject to personal income tax limitations) can be taken on Form 2106 (Unreimbursed Employee Business Expenses). The 50 percent disallowance of meal and entertainment expenses is shifted to the individual taxpayer.

Payroll deductions. If an agency incorrectly reports all or part of expense reimbursements under an accountable plan as income to the employee, both the agency and employee will overpay payroll withholding taxes. The employee should ask for a corrected Form W-2 or take an above-the-line deduction in the amount of the reported income. The taxpayer also can file Form 843 (Claim for Refund and Request for Abatement) for employment tax overpayments.

Per-diems exception. An employer may reimburse employees using a per-diem rate for travel-related expenses. Per diems may be treated as expenses under an accountable plan, even if documentation is not

required for the amount reimbursed. The employee must substantiate the time, place and business purposes related to the expenses. If per diems are higher than the federal rate, the excess must be treated as employee compensation subject to federal income and employment taxes. If your actual expenses exceed the federal rate, you may itemize your deductions to deduct the excess.

S corporation shareholders. Unreimbursed business expenses paid by S corporation shareholders generally are treated as miscellaneous itemized deductions because shareholders are categorized as employees when performing services for the corporation. These expenses are subject to the 2 percent of adjusted gross income floor.

Unreimbursed partner expenses. Deductible expenses paid by partners are reported on Schedule E and reduce both taxable income and the self-employment tax. The deduction is not allowed *unless* the partner substantiates the:

- amount of the expense;
- time and place of the expense;
- business purpose of the expense; and
- business relationship to the partner of the persons involved.

If a partner was reimbursed or would have reimburse by the partnership for the expenses, a deduction cannot be taken.

Partnership agreements. Generally, the terms of a partnership agreement will determine if a partner can deduct unreimbursed expenses paid with personal funds on their individual return. If a partnership agreement does not provide direction on the treatment partner expenses, the partnership's standard reimbursement policy can be considered in determining the deductibility of expenses paid personally by partners.

Partnership non-reimbursement policies. If a partnership agreement includes a non-reimbursement policy for certain expenses incurred outside of the partnership or for expenses that partners are not required to pay, a deduction may be disallowed at the partner level.

Independent agents. The treatment of travel and entertainment expense allowances for independent agents depends if documentary evidence (e.g., receipts, canceled checks and bills) is submitted to the agency. If so, the agency generally can deduct such expenses as business expenses (limited to 50 percent for meals and entertainment expenses). The agency must keep separate records on the details of these expenses. It does not have to file an information return to report T&E expense reimbursements.

If the independent agent does not submit documentary evidence on T&E expenses, the agency is not required to keep separate records. It is up to the independent agent to do so. The agency would deduct the T&E expenses along with other fees paid to the independent agent as nonemployee compensation. In this situation, the agency is not subject to the 50 percent disallowance rule for meals and entertainment. It would however apply to the independent agent. The agency is required to file Form-1099 MISC (Miscellaneous Income) to report nonemployee compensation of \$600 or more during the calendar year.

There are many other things to consider on reporting reimbursed and non-reimbursed expenses. It always is advisable to consult a tax professional to ensure that you are in compliance with federal and employee tax laws. ■

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