Tax and Managerial Implications of Employer Travel Reimbursement Policies: How to Use Policies to Maximize Employee Productivity and Satisfaction

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Abstract: *Employers who reimburse employees for work-related travel expenses must have a policy that complies with current tax laws in order for those expenses to be deductible by the employer as a business expense. Some policies might seem to save the employer money by severely limiting reimbursable expenses or making the reimbursement process cumbersome for the individual employee. However, employer policies that are less restrictive and easy for employees to follow may increase employee productivity and commitment and avoid creating a "stick it to the man" attitude by those employees. This paper examines the legal restrictions on employee travel expenses as well as employee perceptions of fairness and justice in the application of these policies and recommends policies that conform with the law as well as create increased employee productivity and satisfaction.*

I. Introduction

Employees are often expected to travel or make other expenditures as part of their employment responsibilities. Some employers have policies to provide reimbursement to their employees who make such out-of-pocket expenditures on behalf of their employer's trade or business. For employers that have reimbursement policies, there is an important trade-off between easy-to-administer employment policies and compliance with existing laws. Employers must be compliant with exacting state and federal tax laws; employees want fair policies that are not unduly burdensome to follow. Management must also be aware of the morale and productivity concerns with the administration of various travel and expense policies.

Ideally, the employer will have a travel policy that meets the federal income tax standard as an accountable plan. An accountable plan allows the employer to exclude amounts paid or reimbursed for employee travel and related expenses as reportable wages, thus avoiding payment of various taxes on those amounts. Those amounts would not be treated as income to the employee and would not be subject to withholding. From a tax perspective, this is a win-win for both employer and employee.

This article will examine the differences between travel reimbursement policies that meet the federal requirements for an accountable plan and those that do not, as well as the management implications involving employee morale, productivity, and satisfaction with policies that are perceived as fair and not unduly burdensome.

II. Understanding the Legal Requirements

Section 62 of the Internal Revenue Code [Code] provides that an individual is taxed on his or her adjusted gross income. An individual's adjusted gross income is all of his or her gross taxable income less any allowable deductions. Section 62 provides that an individual may deduct from his or her gross income reimbursements paid by the individual's employer for expenses incurred on behalf of the employer's business if the expense is related to "a reimbursement or other expense allowance arrangement made with the employer." (Code § 62(a)(2)(A)). Any personal expenses of an individual are generally not deductible (Code § 262(a)).

An expense must be "ordinary and necessary" in order to be an allowable deduction (Treas. Reg. § 1.62-2(f)(2)). What is actually considered ordinary and necessary is determined on an industry by industry standard (Bittker, McMahon, & Zelenak 2002). One type of ordinary and necessary business expense is the expense for travel. This travel expense category should not be confused with daily commuting expenses of the employee that are not deductible. The travel expense includes those expenses incurred while traveling away from home on behalf of a trade or business such as meals, lodging, and transportation (Code § 162(a)).

A. Unreimbursed Employee Business Expense Deductions

If an unreimbursed travel expense is incurred by an employee related to his or her employer's business, an out-of-pocket payment of this expense by the employee carries with it a financial burden. The employee who expends money on behalf of the employer's business must carry this expense for the entire year, ultimately deducting the expense on that year's federal income tax return. With proper documentation, a taxpayer can deduct unreimbursed transportation costs as well as the unreimbursed costs of meals and lodging incurred while away from home on business as travel expenses (Miller and Pikowsky 2010).

Substantiation must include the receipts for the incurred expenses, notation of the business purpose, dates of travel, and descriptions of the expenses (Code § 274(d)). Those employees with detailed contemporaneously-kept journals, diaries, or logbooks will find that these documents assist with the substantiation process. Without substantiation, should the IRS audit an individual's federal income tax return, there is a risk that all or part of the deduction will be disallowed. Even without complete documentation and substantiation, the IRS's per diem rules may still allow the employee to take a deduction for some of the incurred business expenses. As an example, the IRS provides periodically updated mileage per diem amounts (Rev. Proc. 2008-59). Regardless of the tax-reporting method selected by the employee, unreimbursed travel expenses are costly. From the perspective of the Internal Revenue Service [IRS], the substantiation of business expenses and the related income tax implications to the employers and their employees have the potential for much abuse.

B. Employer Accountable Plans

Reimbursements for travel expenses to employees are generally made under employer arrangements called accountable plans. An accountable plan is an employer's reimbursement plan for business expenses that complies with the provisions of the Code. Three requirements exist in order for the reimbursement policy to be deemed accountable. The reimbursement policy for the employee's business expense must

(1) reimburse the employee only for expenses with a connection to the employer's business;
(2) reimburse only for timely made requests that are substantiated by the employee; and
(3) the employee must return any excess payment of expenses to the employer (in the case of any advanced payment by the employer) (Treas. Reg. 1.62-2).

These rules apply to accountable plans for all employees, including citizens, resident aliens, and nonresident aliens.

For accountable reimbursement plans or arrangements between the employer and its employees, the tax result is considered a wash, meaning that the employee does not have to claim the reimbursement as income and is also not entitled to a business expense deduction. This simplifies the employee's individual income tax return preparation. The timely reimbursement to the employee also eliminates the economic burden that no-reimbursement policies create.

Accountable plans can provide for either substantiation for all actual expenses incurred by the employee or can provide per diem rates for some of the expenses such as meals and incidental expenses. Under Treasury Regulation section 1.62-2(f)(2), the Commissioner may prescribe rules under which an accountable plan may provide for per diem allowances and be treated as satisfying the requirement of returning any excess reimbursement amounts to the employer. The per diem allowance must be reasonably calculated not to exceed the amount of the employee's expenses or anticipated expenses and the employee is required to reasonably return any portion of the per diem allowance that relates to travel not substantiated (Treas. Reg. § 1.62(f)(2)).

In the per diem allowance arrangement, the employee does not actually have to return the excess as long as the excess is properly taxed by the employer (Treas. Reg. § 1.62-2(h)(2)(i)(B)). Per diem allowances should be paid at or below the applicable federal per diem rate, a flat rate, or in accordance with any other IRS specified rate (Rev. Proc. 2008-59, sec. 3). The federal rates are set by the U.S. General Services Administration on a fiscal year basis beginning October 1. Rates for lodging, meals, and incidental expenses are provided for locations within the United States adjusted for the market in those locations (GSA per diem rates).

C. Employer Unaccountable Plans

When the employer's reimbursement policy for business expenses incurred by its employees does not comply with the Code, it is referred to as an unaccountable or non-accountable plan. If the reimbursement policy fails on any one of the three requirements—expenses connected to the employer's business; expenses substantiated; and any excess reimbursement returned to the employer—the policy will be considered non-accountable. In this situation, the employees must fully claim the reimbursement received from the employer as income (Treas. Reg. 1.62-2). The employer must also report the payment of these reimbursements on the employee's W-2 form. These payments are also subject to all employment tax withholdings. The failure by an employer to do so can lead to costly penalties, interest, and unpaid taxes.

Several cases illustrate situations where the IRS determined that the reimbursement policy of the employer did not amount to an accountable plan. In a case that involved both failure to substantiate the expenses and a failure to return any excess reimbursement to the employer, the employee agreed to continue working for his employer without a salary rather than lose his job. The employer agreed to reimburse the employee for all expenses incurred. While the employee kept records of his expenses, he could not show substantiation for the entire amounts received from his employer. Moreover, the payments from the employer were often issued in round numbers, suggesting a lack of correlation with the actual expenses incurred. Finally, the employee did not return any excess payment to the employer. Therefore the payments were not made under a qualified accountable plan and all of the payments, not just those unsubstantiated, were to be taxed as ordinary income to the employee (*Namyst v. Commissioner*, 2006).

There are two cases involving travel by referees employed by the National Basketball Association [NBA]. Under a collective bargaining agreement between the NBA and the union, the employee was entitled to reimbursement for first-class travel but could choose to fly by a less expensive means and keep the difference as income. The difference was reported by the NBA on the referee's W-2 form as taxable income and subject to withholding. This particular employee chose to fly using a cheaper means, but falsified documents to the employer showing first class travel rather than coach in an attempt to avoid the income. The court determined that the reimbursement plan of the employer was a non-accountable plan because of the ability of its employees to keep the excess reimbursements. Meals and incidental expenses are the only type that can be reimbursed via per diem where the employee is not required to return the excess reimbursement. The employee was also indicted for endeavoring to obstruct or impede the due administration of the tax laws (*U.S. v. Armstrong*, 1997).

In the second case, the NBA allowed the referees to incur actual airline expenses that were less than the reimbursement payments by downgrading their first-class tickets to coach or using their frequent flier miles to pay for the tickets. Pursuant to the policy, the employees were allowed to retain the excess reimbursement amounts. The employer required the referees to submit ticket receipts or vouchers to account for their travel expenses. The IRS determined that the NBA reimbursement plan was not an accountable plan and the court agreed because the employees were allowed to keep the excess amounts paid (*U.S. v. Mathis*, 1997). In order for a plan to meet the Code requirements, excess amounts paid must be returned to the employer because the employer's payment must be for expenses actually incurred (Treas. Reg. § 1.62-2(d)(3)(i).

Lastly, an employer provided temporary skilled workers for a large manufacturing company with a per diem travel expense reimbursement. It paid the non-local employees (those that lived more than 100 miles from the work site) an hourly wage and also an hourly per diem for lodging, meals, and incidental expenses. The hourly per diem was calculated on both regular and overtime hours. Because many non-local workers remained at the worksite seven days a week, some received a larger per diem amount than others based on hours worked, even though they were away from home the same amount of time. The IRS challenged the arrangement alleging that the plan was non-accountable because of this discrepancy. The key issue, according to the court, was whether the employer's per diem reimbursement plan was reasonably calculated not to exceed the amount of expenses incurred by its employees. That issue was held to be a question of fact for a jury to determine (*Worldwide Labor Support of Mississippi, Inc. v. U.S.*, 2002).

Unaccountable plans provide accounting nightmares for both the employer and its employees. Employers are required to properly withhold all employment taxes from reimbursement distributions to the employees. The reimbursed amounts must show up on the employees' Form W-2s. The employees must retain substantiation for their own income tax returns and calculate any deduction to offset the income received from the reimbursement payments. It is also likely that the employee will not receive a complete recovery of this additional income because the deduction will likely not be at 100-percent as an itemized deduction.

III. Implications for Management

The per diem method of reimbursing employees for employment-related travel expenses can provide flexibility for both employers and employees while encouraging professional development and providing a financial incentive (Vian, 2009). Because a per diem method of reimbursement that meets the Code for an accountable plan allows the employee to keep any excess over the employee's actual costs for travel, some employees may choose to eat at lower-cost restaurants and minimize incidental expenses in order to supplement their income (Vian, 2009). On the other hand, the per diem method can be seen as an opportunity for employees to exploit their employer for travel that is not really necessary, for supervisors to send themselves to training rather than a more appropriate junior staff member, or to create opportunities for fraud (Vian, 2009).

Ultimately, the decisions made by the employer as to which expenses are considered "ordinary and necessary" and as to how the expenses are presented for reimbursement are not a tax-compliance decision alone. Rather, these decisions send an important message to employees concerning the fairness of their dealings with the organization. Namely, they may affect employee perceptions of organizational justice.

A. Organizational Justice

One way to understand how various travel reimbursement policies impact employee attitudes and behavior (and ultimately employee morale) is to consider their perceptions of distributive and procedural justice provided by the policies and offices that oversee them. Distributive justice is the perceived fairness associated with decision outcomes and the ultimate distribution of resources (Adams, 1965). On the other hand, procedural justice is perceived fairness of the processes involved in decision making (Levanthal, 1980). When employees feel that the process is consistent, accurate, and unbiased, and that it involves a mechanism for appeals, procedural justice is enhanced.

According to organizational justice theory, employees size up the fairness of both the processes and outcomes of the travel reimbursement policies and respond in predictable ways. Namely, when employees believe both the process and the resulting decision are fair, they are more likely to show organizational commitment, to go above and beyond their job roles, and to trust in their leaders.

In the case of distributive justice, employees would look for travel reimbursements that included adequate caps for expenses that are reasonably incurred as a result of doing business. Responsibility for such decisions resides with the organization, and may vary both across organizations (as varying degrees of profitability and solvency may lead to more generous travel budgets) or within a single organization (as position within the organization may also dictate the level of comfort and convenience for which the organization will reimburse.)

While distributive justice is important, procedural justice may be even more critical to employee morale. When determining the degree of procedural justice, employees look to the requirements of the travel reimbursement policy (such as the degree of reporting and documentation necessary) and the means by which decisions to reimburse are made. Studies have shown that employees are willing to give up concern about the distribution of reimbursements if they have a voice in the process by which decisions are made (Folger, 1977; Thibaut and Walker, 1975). In other words, employees will accept the reimbursements more readily if they feel as though they are able to adequately and accurately communicate the reasons for expenses within the guidelines set by the policy and that the policy itself takes into account the often unpredictable realities of travel.

While organizational policy-makers may not always consider the messages travel reimbursement policies send about distributive and procedural justice, both employee morale and performance improve when those messages are positive. Research has shown that when decisions are thought to have distributive justice, personal satisfaction with those decisions increases (Folger & Konovsky, 1989; McFarlin & Sweeney, 1992). Procedural justice is also related to more global impressions such as the degree to which employees are committed to the organization and the level of trust with their leaders (Konovsky & Pugh, 1994; McFarlin & Sweeney, 1992).

It has also been found that both distributive and procedural justice are related to organizational citizenship behaviors, those extra-role contributions on which many organizations depend, and that impressions of distributive and procedural *injustice* were related to withdrawal behaviors (such as absenteeism, turnover, and neglect) and other negative reactions such as theft and sabotage (Colquitt, Conlon, Wesson, Porter, & Ng, 2001; Hom, Griffeth, and Sellaro, 1984; Masterson, Lewis, Goldman, and Taylor, 2000).

Perhaps the finding with the most implications for managers is that justice perceptions have long-term effects. Ambrose and Cropanzano (2003) found that perceptions of procedural and distributive justice impacted outcomes such as job satisfaction, organizational commitment, and turnover intentions in the two years surrounding decisions to grant tenure at academic institutions and Hausknecht, Sturman, and Roberson (2011) found that justice trends influenced satisfaction, commitment, and turnover when measured over a one-year period.

Regardless of the degree of distributive and procedural justice that exists within the policy itself, leaders still have the ability to mitigate the negative outcomes of policies that are seen to be unfair. As defined by Bies and Moag (1986), interactional justice refers to the quality of interpersonal treatment that individuals receive once the policy has taken affect. In the case of reimbursements, employees would be considering the nature of communications with those who are ultimately responsible for granting the reimbursement. When communications are respectful and complete, employees are likely to perceive them as fair and just. Many researchers (Colquitt, Conlon, Wesson, Porter, & Ng, 2001; Masterson, Lewis, Goldman, and Taylor, 2000) have found that interactional justice is related to the same types of favorable results as distributive and procedural justice. And, Cropanzano and his colleagues (Cropanzano, Prehar, & Chen, 2002; Rupp & Cropanzano, 2002) have also found the trust built through interactional justice motivated higher job performance.

In sum, above and beyond compliance with tax laws, organizations and their managers have an opportunity to build employee morale through travel reimbursement policies. As Cropanzano, Bowen, and Gilliland (2007) point out, perceptions of just policies are not only related to the favorability of individual outcomes. They also signal to employees how they will be treated over the long term, how accepted and valued they are within the organization, and the ethical standards of their leaders and managers. Travel reimbursements are one example of a policy that may fall into the economic functions of doing business on the surface, but the implications of the perceived distributive, procedural, and interactional justice present in such policies goes far beyond such rational concerns.

B. Examples and Policies

An institution with a strict travel reimbursement policy that covers actual expenses only with no per diem option for domestic travel may well be considered an accountable plan for tax purposes but not a plan that encourages good corporate citizenship behavior or fosters employee morale. For example, strict construction of the policy might deny a traveler reimbursement for a five dollar bag of popcorn that the employee chose to purchase and eat rather than a regular meal because the employer considers the popcorn a snack, not a meal, and only reimburses for "meals."

Many institutions do not reimburse employees for meals when that meal is provided as part of a conference the employee attends. An employer that takes a strict reading of its policy may refuse to reimburse an employee for a healthier purchased breakfast because juice and rolls were offered at a continental breakfast at 6:30 a.m. as part of the conference.

Some employers do not reimburse for alcohol purchased as part of a meal during travel, while some reimburse for alcohol depending on the employees and clients/prospects that the employees are entertaining. Failure to clearly explain why some expenses are covered in certain situations and not others can lead disgruntled employees to choose expensive meal options because that employer will reimburse for "meals" but will not reimburse for lower cost options eaten at atypical times.

What may seem to the employer as a strict policy that will save the organization money may well cost the employer in the long run in both increased permissible expenses under the policy and in decreased employee commitment and morale to the organization. Stories such as the above have an uncanny way of making the rounds among employees. Thus, the employee who was denied a reasonable expense has a reduced sense of organizational justice, but every employee she or he tells also interprets it as a message about fairness and responds accordingly.

Carnegie Mellon University adopted a revised Business and Travel Expense Policy in early 2011 (Carnegie Mellon, 2011). The policy provides the organization with an accountable plan for tax purposes while valuing the individual employee and clearly explaining the circumstances under which travel expenses will be reimbursed. Here are some examples, in pertinent part:

- Assuming a reasonable level of safety and convenience for the individual, every effort should be made to keep university business and travel expenses to a minimum.
- The class of air travel chosen is expected to be the lowest-priced coach airfare ticket available using a commercial discount or coach class or standard accommodations. ***In some cases, premium (e.g., first class, business class) fares may be an appropriate business expense subject to budget availability and approval by the president, the provost, the department's dean, a vice-president, or the designated departmental finance representative. Examples include but are not limited to the following:
    - Overnight "red-eye" flights;
    - Flights exceeding eight (8) continuous hours;
- Travelers may personally retain frequent flyer plan rewards or other bonuses that may accrue from business travel. However, in no case may the traveler choose a reservation at a higher cost in order to accumulate additional plan rewards. The university will not purchase frequent flyer miles from travelers or reimburse them for tickets purchased with frequent flyer miles. Any membership fees to join frequent flyer clubs are considered personal expenses and will not be reimbursed by the university.
- Employees may choose from one of the following travel per diem options:
    - 1) A per diem for lodging, meals, and incidental expenses (tips, etc.); or
    - 2) A per diem for meals and incidental expenses (with lodging being either reimbursed on the basis of actual expenses incurred or directly paid by the University) (Carnegie Mellon, 2011).

IV. Conclusion and Recommendations

Employees should strive to have an employee business expense reimbursement policy that complies with the Code as an accountable plan. Deviations from the Code requirements should be avoided. Policies that do not provide for reimbursement to employees or do not qualify as an accountable plan are fiscally burdensome to their employees and also perceived as unfair. Perceptions of unfairness lead to disgruntled employees.

Of course, each aspect of organizational justice also rests upon good communication. Employees will feel reimbursements are fairly distributed if they understand the reasoning behind the size of the organization's travel budget or the different demands that travel places upon those at different levels of the organization. Likewise, when employees understand the tax implications of a sound reporting system and the rationale behind additional reporting requirements of the organization, they are more likely to trust in the fairness of the processes. Interactional justice also rests on communication, but whereas the previous aspects of justice can be influenced by the amount of communication, interactional justice requires those communications to be respectful and complete. Unfortunately, in many cases, no face-to-face communication is necessary, which means the quality of interactions is limited by written reports and notifications.

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