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Client: Carnegie Mellon University
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Subject: Accountable Plan Substantiation Requirements

Memorandum

Guidance has been requested regarding the application of the accountable plan rules specifically, the substantiation requirements set forth in the Internal Revenue Code of 1986.

By way of background, if a University's expense reimbursement policy satisfies certain requirements, reimbursements made by the employer to the employee (up to the amount substantiated) are treated as paid under an "accountable plan." Accountable plan status is critical in order for employers to avoid unwarranted tax consequences for employees who incur expenditures in furtherance of the institution's charitable mission. Simply stated, if the reimbursement policy does not meet the requirements set forth in the Internal Revenue Code or the implementing regulations, the employee's reimbursement will be treated as taxable compensation, reported on Form W-2 and subject to withholding. A University must not only ensure that the plan satisfies the accountable plan requirements it must also develop implementing procedures and monitor compliance with the policy. This task requires discipline at the University employer and University employee level.

Overview of Accountable Plan

A plan is accountable if it satisfies three basic conditions that are set forth in IRC Sec. 62(c) and Treas. Reg. Sec. 1.62-2(c):

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1. It is for the purpose of reimbursing employees for business expenses paid or incurred in the course of performing services for the University employer.
2. Within a reasonable time period, it requires substantiation of the amount, time, place, and business purpose of the expenses to be reimbursed.
3. Within a reasonable time period, it requires the employee to return amounts received in excess of the amount substantiated.

If the **employer's** reimbursement policy fails to satisfy any of these requirements, the amounts are treated as paid under a non-accountable plan. Once again, all amounts paid under a non-accountable plan are treated as taxable compensation subject to withholding. Treas. Regs. 1.62-2(h)(2)(ii) and 31.3401(a)-4(b)(2). If a reimbursement or other expense allowance arrangement satisfies these requirements but the **employee** does not substantiate the expenses within a reasonable period the amount paid in excess of the amount substantiated is treated as paid under a nonaccountable plan and subject to income tax. As previously indicated, the optimal tax treatment of employee expense reimbursements requires compliance on behalf of the employer to adopt and monitor an accountable plan and for the individual employees to comply with the policy/plan provisions.

Safe Harbor Methods of Meeting the Reasonable Period Requirements

As a general rule, employees secure receipts to support expenses they incur on behalf of their University employers. More problematic however, is compliance with the timeliness of the reimbursement request. Under the accountable plan rules, employees are allowed a reasonable period from when they incur expenses to substantiate them or return excess (unsubstantiated) advances to the employer. From a practical perspective, timeliness often becomes the key element in determining whether and when unsubstantiated expenses or excess advances are treated as made under an accountable or nonaccountable plan.

Treasury Regulations recognize two safe harbor methods that may be used by employers to meet the timeliness requirement. The method is selected by policy adoption. Absent the adoption of a safe harbor that has been recognized by the Internal Revenue Code and/or Treasury Regulations, an institution must establish that their policy/plan satisfies a facts and circumstances reasonableness test. In order to provide certainty to their employees that a reimbursement will not be treated as taxable compensation, we strongly recommend that University employers adopt the fixed date method safe harbor.

Fixed Date Method Safe Harbor. This safe harbor establishes substantiation dates that are related to when the expense is paid or incurred. The timeliness requirement is met if (1) an advance is made within 30 days of when an expense is paid or incurred, (2) **an expense is substantiated within 60 days after it is paid or incurred**, or (3) an excess advance is returned to the employer within 120 days after the expense (against which the advance was made) is paid or incurred. Treas. Reg. 1.62-2(g)(2)(i).

It has been our experience that the majority of tax exempt and for-profit employers adopt the fixed date method safe harbor. The fixed date method facilitates compliance, budget and

financial statement reporting and provides set dates that promote employee compliance. It has been reported that the most frequent violation of the accountable plan rules occurs because employees fail to substantiate expenses within a reasonable period. The goal of integrating the fixed date safe harbor again is to avoid unintended tax consequences for individual employees.

Conclusion

If the employer's plan meets the requirements for an accountable plan, expense reimbursements to employees who properly comply with the terms of the plan are excluded from the employee's gross income, not reported as wages or other compensation on the employee's Form W-2, and are exempt from federal income tax withholding and employment taxes. Treas. Reg. 1.62-2(c)(4). An accountable plan must require substantiation of expenses within a reasonable period. Treasury Regulations provide a safe harbor regarding what constitutes a "reasonable period." This safe harbor is intended to provide employers and employees a method by which reimbursements may be made on a tax free basis. In order to ensure maximum compliance and to avoid unintended tax consequences for individual employees we recommend that Carnegie Mellon University adopt the fixed date method safe harbor. This method will require substantiation of expenses within 60 days after the expense is incurred by the individual employee.

This advice is not intended or written to be used for, and it cannot be used for, the purpose of avoiding any federal tax penalties that may be imposed, or for promoting, marketing or recommending to another person, any tax related matter.

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