



# MEMO #11

Pensions and Benefits USA

## Auto and Other Business Expense Reimbursements



**Caution!** Church employees may deduct from their taxes only such business expenses as the church *specifically refuses* to reimburse.



**Idea!** Set up an “accountable reimbursement plan” to maximize tax-free reimbursements.



**Remember!** Business reimbursements must be included on Form W-2 as taxable income *unless* they are paid through an “accountable reimbursement plan” which has been “formally” adopted by the church.

### Importance of Full Reimbursement

Tax rules make it very important for full reimbursement of business transportation, travel, and other business and professional expenses. Any *unreimbursed* expenses you wish to deduct from federal income taxes may be lost since they are deductible only to the extent they exceed 2 percent of Adjusted Gross Income (AGI) and to the extent that all itemized deductions on Schedule A exceed the Standard Deduction. Also, the IRS states you may deduct only those expenses your employer *specifically refuses* to reimburse. If you are entitled to an expense reimbursement but do not request it, you cannot take a deduction for unreimbursed business expenses.

Furthermore, ministers may not deduct unreimbursed business expenses to the extent that they are allocable to a tax-exempt housing allowance. Many ministers with nonaccountable expense reimbursement plans are not allocating business expenses under this concept and therefore are underpaying their income taxes. The allocated expenses are still deductible for Social Security (SECA) tax purposes.

The use of an accountable expense reimbursement plan is the best solution for ministers and other church employees.

### IRS Regulations

Requirements for business expense reimbursements are based on IRS Regulation 1.62-2(d)(3). These requirements apply to every church and affect all employees. They are not optional—they must be followed, or the church employee may pay significantly greater amounts of unnecessary taxes.

**The IRS regulations** require that business reimbursements be included on Form W-2 as taxable income to the individual *unless* paid through an “accountable reimbursement plan” which has been “formally” adopted by the church board. The requirements for the accountable reimbursement plan are three-fold: (1) The church may reimburse only those business expenses that an employee substantiates within 60 days of the expenditure with receipts and/or in writing as to the date, amount, place, and business nature. (2) The employee must return any “excess” reimbursements (i.e., unused expense advances) within 120 days of the expenditure. The excess reimbursement may not be treated as a bonus or gift. (3) Any advance must be made within 30 days of when the expense is paid or incurred.



**Caution!** The IRS will not allow reimbursements to be paid through a retroactive reduction of W-2 salary.

**Form W-2 income** cannot simply be reduced “after-the-fact.” In other words, the IRS will not allow the reimbursements to be paid through a retroactive reduction of salary. In order for reimbursements to be paid and qualify under an accountable reimbursement plan, properly substantiated expense reimbursements must be paid separately from the employee’s salary. The salary amount and the accountable reimbursement plan must be established in advance of payment. If the church establishes a dollar limit on the expense plan (instead of reimbursing 100% of expenses), any balance remaining in the expense plan at year-end should remain with the church. The payment of the balance to the employee makes all payments made to the employee under the plan during the year reportable as taxable income on Form W-2.

### Transportation, Travel, and Other Business and Professional Expenses

Most church employees incur business transportation and travel expenses while conducting the ministry of the local church. Many churches are careful to reimburse their employees *in full* for these expenses, properly recognizing them as local church operating expenses.



**Remember!** The IRS allows churches to reimburse employees for business and professional expenses tax-free *if* the reimbursements are paid through an “accountable reimbursement plan.”

Often, church employees also incur business and professional expenses in their ministry. Examples include: business-related entertainment, professional books and magazines, memberships and dues in professional organizations, stationery and supplies, and other ministry expenses. Normally, the church board recognizes these as necessary for the work of the church and views them as local church expenses. The employee should be reimbursed in full. If these expenses are paid properly through an accountable reimbursement plan, the IRS says they are not reportable as income.

For example, reimbursable phone expenses may include long-distance calls, a second line, special equipment, and services such as call-waiting if there is a business relationship. Basic local service charges (including taxes) for the first line in the home are not considered a business expense.

Another example is entertainment expenses for church business. Only 50% of meals and entertainment as a business expense are deductible on Form 2106 (or Form 2106-EZ) and Schedule A. However, if the business meals and entertainment are presented to the church with proper documentation under an accountable reimbursement plan, then 100% may be reimbursed. This illustrates how important it is for every church employee to utilize an accountable reimbursement plan.



**Remember!** Qualifying educational expenses also may be reimbursed tax free if an “accountable reimbursement plan” is used.

Likewise, qualifying educational expenses may be reimbursed *in full* under an accountable reimbursement plan. Typical expenses include tuition, books, supplies, transportation away from your hometown, meals, lodging (if necessary to be away from home overnight to attend classes), and correspondence courses. Qualifying educational expenses are those incurred to meet the requirements of your church to keep your present position, or to maintain or improve skills in your present employment. Expenses do not qualify, even though these requirements are met, if the education is required for you to meet the minimum educational requirements of your occupation, or part of a program of study that will qualify you for a new occupation. For example, a minister who has not been gainfully employed as a minister will not be able to count his seminary education. However, a pastor who is obtaining additional education likely will qualify. You must not be absent from your profession for more than a year. The IRS considers it a career change if you work a secular job for more than a year while obtaining additional education. Also, travel costs claimed as a “form of education” (i.e. a trip to the Holy Land) do not qualify. However, enrollment in a formal course of study overseas may qualify.



**Caution!** Education expenses incurred for meeting the minimum qualifications of your occupation are not reimbursable.



**Caution!** A *nonaccountable* “car allowance” must be reported as income on Form W-2.

### The Automobile “Allowance” Method

Probably the largest business expense for a minister is the auto expense. Some churches continue to provide a nonaccountable “car allowance.” However, the IRS says such nonaccountable “allowances” are to be reported as income on Form W-2. The ministerial employee *may or may not* benefit by using Form 2106 (or Form 2106-EZ) to document the expenses and the “allowance” paid, thereby deducting the unreimbursed expenses as itemized deductions on Schedule A. Such an “allowance” method provides no dependable tax benefits.

### The Automobile Reimbursement Method

A good plan is for the church board to adopt an accountable reimbursement plan and include auto expense reimbursement on a business mileage basis. Actual auto expenses may be reimbursed. However, the simplicity of using the Standard Mileage Rate is compelling.

If you account to your church for all your business miles and are reimbursed at the Standard Mileage Rate, the reimbursement is not included as income on Form W-2. Records providing evidence for business miles are provided by you to your church treasurer to support the reimbursement. The IRS can supply details about accounting and record keeping for reimbursements. (1-800-TAX-FORM)

Employees who are reimbursed the Standard Mileage Rate or less per mile are not required to make any report on their tax return of the reimbursement unless they want to try to deduct any business auto expenses not fully reimbursed.

If the reimbursement *exceeds* the Standard Mileage Rate, then the entire amount of the reimbursement should appear on Form W-2 as taxable income. This means any tax benefit may be lost under the deductibility rules mentioned earlier. (You may want to request a copy of IRS Publication 463, “Travel, Entertainment, Gift, and Car Expenses,” for more details. 1-800-TAX-FORM)

The simplest method to handle auto expenses is to receive full reimbursement at the Standard Mileage Rate allowed by the IRS for all business miles.



**See:** IRS Publication 463 for travel, entertainment, gift, and car expense details.



**Remember!** The simplest method is full reimbursement at the Standard Mileage Rate.



**Caution!** Detailed auto records must be kept for a church-owned automobile, including odometer readings for the year and an accurate description of business mileage.

### The Church-Owned Automobile

Some churches provide some or all of their staff with the use of a church-owned vehicle. When an employee uses a church-owned vehicle for both business and personal use, certain procedures are required for tax purposes. (Personal use generally includes commuting between home and the church.)

The employee must keep adequate records of the business use miles for which the church-owned car is driven. The records for business miles should indicate date, purpose, destination, and miles for all business transportation/travel. It is not enough to just keep personal use miles. The total miles the car is driven during the year should be determined based on odometer readings at the beginning and end of the year. Total miles driven less business miles provides the personal miles on which to determine personal use value.

If the employee fully reimburses the employer for the “value” of the personal use of the vehicle, then no “value” would be reported as taxable income on Form W-2. Otherwise, the “value” of personal use of a church-owned vehicle is a taxable benefit to the employee and must be included on an employee’s Form W-2. Income tax is not required to be withheld for lay employees as long as the employer advises all employees that no withholding will be done for the “value” of the benefit. Notification must be made



**Caution!** If a church employee does not reimburse the church for personal mileage of a church-owned vehicle, the “value” of the personal use must be declared as income on Form W-2.

by January 1 of the year in which no withholding will be done. FICA Social Security taxes must be withheld on the full amount of the “value added” for each staff member affected who is not ordained or district-licensed.

The “value” of the availability of a church-owned vehicle to be added to Form W-2 (or reimbursed to the employer by the employee) is the cost to the employee of renting or leasing a comparable vehicle. The IRS has standard tables which determine the Annual Lease Value of a vehicle based on the vehicle’s Fair Market Value. The “value” of the fuel used is another benefit that must be added if the church pays for all the fuel. An employer should contact the IRS (1-800-TAX-FORM) and request the most recent information when determining these values for tax and income reporting purposes (IRS Publication 535, “Business Expenses”).

Likewise, the church board and staff of any church providing vehicles to employees for both personal and business use will want to work closely with their personal tax advisors to make certain the “value” of the benefit is determined and reported properly.



**See:** IRS Publication 535 for information on determining values of personal use of a church-owned vehicle.



**Remember!** Accurate and detailed written records are essential.

### Documentation of Mileage

Regardless of the method in which auto expenses are handled, accurate and detailed written records are essential to document the following: the amount of expense and/or mileage, the time and place of transportation/travel, and the business purpose. The taxpayer is required to have “adequate records” or “sufficient evidence” to support the taxpayer’s own statement. The best method is to keep a detailed daily log.

### Depreciation Restrictions

Rules governing depreciation deductions for automobiles continue to change. Certain transition rules may be applicable to some situations. If you are using depreciation under the actual expense auto deduction rules, work closely with your personal tax advisors.

### Conclusion

All business and professional expenses should be reimbursed in full to each employee through an accountable reimbursement plan adopted by the church board which results in the proper substantiation to the church of all reimbursements. This method is the easiest for the church and employee to use with regard to record keeping and tax forms. It is the least costly in taxes. And, it is an IRS approved method.