

Reporting Reimbursed Expenses to Employees

In December 2011, the Puerto Rico Treasury Department (“PRTD”) released a proposed regulation for the exemption related to expenses reimbursed by an employer to its employees provided by Section 1031.02(a)(33) of the Internal Revenue Code for a New Puerto Rico (Act I-2011), as amended. The proposed regulation also covers the deduction for the use and maintenance of motor vehicles provided by Section 1033.07(a)(3)(G) of the same Act, which we have discussed in previous newsletters. The focus of our discussion in this bulletin will be the proposed provisions in connection with the exemption for the reimbursement of expenses that are not related to the use and maintenance of vehicles. Please pay particular attention to the requirements of the accountable plans and the effect of non-compliance with those requirements with regard to the reporting of income to employees.

Author



Vicente J. Cajigas
Manager

787-999-3010
vcajigas@zatax.com

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Accountable and Non-accountable Plans

Section 1031.02(a)(33) of Act I-2011, as amended, provides that the amounts paid by an employer to an employee as reimbursement of expenses for travel, meals, lodging, entertainment, and other expenses in connection with employment shall not be part of gross income, provided that the reimbursement is made under an expense reimbursement plan established by the employer which meets the requirements of the regulations approved by the Secretary of the PRTD to that effect. Article 1031.02(a)(33)-3 of the proposed regulation provides the following three requirements in order for the expense reimbursement plan to qualify for the aforementioned exemption:

1. the expenses must be incurred or paid by the employee while performing services as an employee for its employer and should be related to the employer’s business;
2. the employee must inform the expenses adequately and within a reasonable time (three months); and
3. the expense reimbursement plan must constitute an “Accountable Plan”.

An “Accountable Plan” is a plan which requires that employees submit a detailed report of the expense incurred, including date, place, name of client or work related activity, and a receipt of payment. To the extent that the expenses reimbursed to employees meet the above requirements, the reimbursements shall be excluded from the employees’ gross income and the employer shall be entitled to claim the related deduction, subject to the limitations of Act I-2011, as amended.

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For example, if an employer reimburses \$100 to its employee for meals and entertainment expenses (subject to 50% disallowance) under a plan that meets all the above requirements, the reimbursement of \$100 shall constitute exempt income to the employee.

Notwithstanding, the employer shall be allowed a deduction of only \$50 (\$100 x 50%) since Act 1-2011, as amended, provides a 50% limitation for the meals and entertainment deduction.

Up to this point, the requirements for reporting reimbursed expenses are not much different than what was required prior to the approval of Act 1-2011. However, there are additional rules to comply with regarding the determination of a plan as an "accountable plan" and there are consequences to the employee for the reimbursement of expenses under non-compliant plans. For example, if the employer reimburses expenses to its employees and, on a consistent basis, the amounts reimbursed exceed the amounts substantiated by the employees, the Secretary of the Treasury may argue the existence of a pattern of abuse and all the amounts reimbursed to these employees will be considered wages subject to income tax.

The tax treatment mentioned above is complemented with other provisions of the proposed regulation, which provide that amounts paid by an employer to an employee as reimbursed expenses under a "Non-accountable Plan" are treated as taxable income to the recipient. A "Non-accountable Plan" is a plan, which provides for the

payment of an allowance to cover those expenses that an employee may incur while performing its services and does not require substantiation from the employee. In these circumstances, the amounts received by the employee shall constitute taxable income, and shall be subject to the applicable payroll taxes (i.e. FICA, Unemployment, Disability, Income Tax Withholding, etc.). As a result, the employer shall be entitled to a deduction for wages paid, provided that these amounts are reported as taxable compensation to the employee.

For example, if an employer provides a monthly allowance of \$100 to an employee to cover lunch expenses with clients and does not require any kind of documentation about the expenses incurred, the \$100 shall be considered taxable income to the employee, subject to the applicable payroll taxes. Accordingly, the employer shall be entitled to an annual deduction of \$1,200 for the allowance paid and a deduction for its portion of the related payroll taxes, provided the amounts were paid or accrued and reported properly.

Other situations where a plan will not be considered an "accountable plan" are when the plan exclusively or mainly covers management employees, highly compensated employees, or employees who are members of the employer's family, nor a plan where the employer has an arrangement to recharacterize taxable wages as nontaxable expense reimbursements.

Most of the changes brought by this proposed regulation, including the determination

of what constitutes an "accountable plan", are very similar to those applicable in the United States under Section 62(c) and Regulation Section 1.62-2 of the United States Internal Revenue Code of 1986, as amended (the "US Code"). Last month, the Internal Revenue Service issued Revenue Ruling 2012-25 to clarify that an arrangement that recharacterizes taxable wages as nontaxable reimbursements does not satisfy the business connection requirement of the "accountable plan" rules under Section 62(c) of the US Code. In three out of the four cases presented as examples in the revenue ruling, the plan did not meet the requirements to be considered part of an "accountable plan".

Excess Reimbursements

Article 1031.02(a)(33)-4(a)(3) of the proposed regulation states that amounts received by the employee for expenses not related to work or for expenses not adequately substantiated to the employer, shall constitute an "excess reimbursement". Excess reimbursements are considered taxable income to the recipient.

For example, an employer reimburses \$40 to an employee for the purchase of office supplies to be used in the business. The employee's adequately substantiated expenses amount to \$35. Under this scenario, the documented expenses of \$35 shall constitute exempt income to the employee. However, the excess reimbursement of \$5 shall represent taxable compensation reportable as wages and subject to payroll taxes, provided that the employee does not return the excess within a

reasonable time (3 months). In this case, the employer shall be entitled to claim a \$35 expense for the office supplies, a \$5 deduction for compensation, and a deduction for its portion of payroll taxes.

On the other hand, if the employee returns the excess reimbursement within a reasonable time, no taxable

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Key Contacts at Zaragoza & Alvarado LLP:

Juan Zaragoza, CPA
Managing Partner
787-620-7740
jzaragoza@zatax.com

Juan Alvarado, Esq., CPA
Partner
787-620-7730
jalvarado@zatax.com

Felipe Mariani, CPA
Partner
787-620-7736
fmariani@zatax.com

Sandra Marie Torres, CPA
Partner
787-620-7728
storres@zatax.com

Edgardo Sanabria, CPA
Partner
787-999-3015
esanabria@zatax.com

Carlos González, CPA
Partner
787-620-7729
cgonzalez@zatax.com

104 Acuarela Marginal St.
Martínez Nadal Expressway
Guaynabo PR 00969

PO Box 195598
San Juan PR 00919-5598

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compensation shall be reported to him by the employer. In addition, the employer shall take a deduction for the office supplies expense of \$35.

**Business Credit Cards and
Advanced Reimbursements**

Expenses incurred by an employee that are paid with an employer's credit card and amounts that are paid as an advance for the expenses that will be incurred in the performance of services as an employee are also subject to the reporting and substantiation rules of the proposed regulation. Accordingly, if an employee does not properly report and substantiate the expenses incurred on behalf and for the benefit of the business of the employer within a reasonable time, the amounts paid by the employer under any of these circumstances will be considered taxable compensation to the

employee, subject to the applicable payroll taxes.

**Time to Report the
Reimbursement as Wages**

The proposed regulation provides specific guidelines for the timing of the reimbursed expenses that will be considered wages in the payroll and for making the appropriate income tax withholding at source. This requirement serves to determine the date when the employer would be required to deposit the income tax withheld to employees for purposes of the imposition of interest, surcharges and penalties in case of non-compliance.

Z&A Comments

Amounts paid by an employer to its employees as expense reimbursements which do not comply with the requirements of "accountable plans" shall be treated as taxable compensation under the

proposed regulations. This will most probably result in additional payroll tax costs to the employer. On the other hand, if the employer does not properly report the reimbursement made to an employee under a "non-accountable plan" as wages, it will not be allowed to take a deduction for the amount paid. Even though this proposed regulation has not been approved yet, its similarity with the rules applicable under the US Code and the fact that no general negative comments have been heard related to these specific rules, may represent the potential of approval at a near future.

We believe this matter is very important, because of the potential exposures it may represent to non-compliant employers. We suggest that you get acquainted with the proposed regulations so that you can react in the most suitable manner and mitigate any exposures that your business may have. Please

review your compensation and expense reimbursement plans in order to verify if they would comply with the above requirements of an "accountable plan" and, if they are not in compliance, then quantify the potential cost. Keep in mind that the reporting of these amounts must also be considered when preparing the payroll tax returns each quarter.

In the Firm, we have knowledgeable professionals who are ready to assist you in analyzing your existing plan in order to establish an expense reimbursement policy that meets the PRTD requirements to ascertain that it is aligned with the regulations.

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