

**Internal Revenue Service**

**Department of the Treasury**

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Date:  
May 17, 2002

**LEGEND:**

A =

B =

C =

Services =

Groups =

Executive =

\$X =

\$Y =

Dear :

This is in reply to your letter dated November 28, 2001, submitted on behalf of A and certain related subsidiaries requesting a ruling on the proper treatment of deductions relating to its proposed business expense reimbursement program under § 274(d) and the accountable plan requirements of § 62(c) of the Internal Revenue Code. (Hereinafter, "A" refers to both the entity A and its subsidiaries who participate in the described reimbursement arrangement.)

**FACTS**

According to the information submitted, A provides Services to Groups. A proposes to use a business expense reimbursement plan (the "Plan") under which B, provides a charge card to A's employees who hold the title of Executive or higher. With the approval of an Executive, a policy exception may be made for an employee under the

rank of Executive. If such an employee is determined to be a frequent traveler, she may be issued a card. The purpose of the charge card is to increase the convenience of paying business related expenses and to facilitate the collection and storage of adequate business expense substantiation.

Each card is issued in the individual employee's name and may be used for business purposes only. The employee may charge only business travel and entertainment expenses to the charge card. The card may not be used to obtain cash advances at automatic teller machines to pay for business travel and entertainment expenses. Employees who use the business charge card receive a monthly billing statement from B and are personally responsible for the charges billed as well as any late payment charges.

As part of the Plan, A has entered into an agreement with C, whereby C will provide time and expense data input and processing software services called Software. Through an internet connection, A's employees will enter all time and expense details for the then current pay period. C, through a third party provider, will be responsible for warehousing all the input information via electronic data storage. If an employee does not have access to an internet connection, the employee may mail a paper form to a processing location. A represents that the employee will submit all required substantiation in this instance as well.

A has also agreed with B that A will pay B directly for those business related expenses that employees charge to their corporate charge cards ("Direct Payment"). If charges exceed substantiated expenses or any late charges are incurred, the employee alone is responsible to pay B for the excess. A will also reimburse the employee for expenses paid from the employee's own funds.

As part of the Direct Payment and the Software, B will provide electronic records for the credit card charges incurred by A's employees. The electronic records will be transmitted to C and automatically "populated" into the Software. A record is populated into the Software when all items of information contained in the electronic record are transferred into the Software. Such items include the date, vendor, amount, location, purpose and other expense related items. Once populated into the Software, electronic records of expenses incurred cannot be altered. These records will be the basis for amounts A will pay B directly.

A's expense reimbursement policy requires that employees submit all business travel or entertainment expenses through the Software within 30 days of incurring the expense. The reimbursement submission must provide, in detail, information about the elements of each expenditure. Whatever the reimbursement may be, the employee is responsible for clearly identifying: 1) the purpose and nature of the expenditure; 2) when the expense was incurred; 3) all attendees including both third party vendors and other employees; and 4) where the expense took place.

As indicated, corporate card transactions received from a merchant by B will be populated directly into the Software. A will rely on the pre-population of transactions to

eliminate the need for receipts for general business expenses. A represents that one exception to the use of pre-populated data for substantiation will be in the case of lodging expenses. A's policy will require that a detailed hotel receipt, or paper "folio," be submitted for all lodging expenses. A hotel folio must contain expense details, which delineate each amount for lodging, meals and incidental items.

The electronic records received directly from B will serve to reduce employees' submission of paper receipts required for substantiation. These electronic records will consist primarily of records of charges made to the employee's charge card supplied by B and will provide the name of the vendor and date, place and amount of the transaction. Certain receipts will include additional information such as expense type (ground travel, car rental, airfare, etc.), car rental agreement number, airline ticket number, and airline itinerary. The electronic receipts will eliminate the employees requirement to submit paper receipts to substantiate charges on the charge card if the nature of the charge is clear on its face (such as a car rental). If the expense does not meet one of the above criteria or if the expense was not charged to the B charge card, employees will continue to be required to submit paper receipts for all expenses of \$Y or more and all expenditures for lodging.

Each reimbursement request must be reviewed and approved for payment by the employee's manager. The manager's primary responsibilities are to ensure that the charges are appropriate for the work performed, are charged to the correct matter or department, and are consistent with A's reimbursement policies.

All reports submitted via the Software are automatically audited for certain characteristics. The characteristics include, but are not limited to, expense reports submitted over a threshold dollar amount, automobile allowances within acceptable threshold, airfare and car rental bookings through acceptable service providers and hotel phone expenses within acceptable threshold. If the audit controls determine that the expense is not justified, the employee will be required to substantiate that expense by additional documentation or shall be required to repay A, whether the payment was made to the employee or to B.

The audit program will verify that the expenses reported by the employee without accompanying paper receipts conform to amounts reported to B by the vendors and is consistent with profile information (such as standard room rates) built into the computer program. If any item in an expense report exceeds these standards or if any expense item is not fully identified (e.g., is charged to the category "other") the reimbursement process will be suspended and the employee will be required to produce a receipt.

If circumstances preclude an employee from using the Software to submit an expense reimbursement request, the employee may fill out a paper form listing all expenses to be reimbursed. In this instance, the employee is responsible for substantiating all expenses in the traditional manner (i.e., provide paper receipts for all expenses submitted).

A represents that the use and retention of electronic records will meet the requirements

of Rev. Proc. 98-25, 1998-1 C.B. 689.

### APPLICABLE LAW

Employee reimbursement or other expense allowance arrangements are governed by § 62 of the Code. Section 62 generally defines "adjusted gross income" as gross income minus certain ("above-the-line") deductions. Section 62(a)(2)(A) allows an employee an above-the-line deduction for expenses paid by the employee, in connection with his performance of services as an employee, under a reimbursement or other expenses allowance arrangement with his employer.

Section 62(c) of the Code provides that an arrangement will not be treated as a reimbursement or other expense allowance arrangement for purposes of § 62(a)(2)(A) if (1) such arrangement does not require the employee to substantiate the expenses covered by the arrangement to the person providing the reimbursement or (2) such arrangement provides the employee with the right to retain any amount in excess of the substantiated expenses covered under the arrangement.

Under § 1.62-2(c)(1) of the Income Tax Regulations, a reimbursement or other expense allowance arrangement satisfies the requirements of § 62(c) of the Code if it meets the three requirements of business connection, substantiation, and returning amounts in excess of expenses, set forth in paragraphs (d), (e), and (f), respectively, of § 1.62-2 ("the three requirements").

If an arrangement meets the three requirements, § 1.62-2(c)(2)(i) of the regulations provides that all amounts paid under the arrangement are treated as paid under an "accountable plan." Under § 1.62-2(c)(4), amounts treated as paid under an accountable plan are excluded from the employee's gross income, are not required to be reported on the employee's Form W-2, and are exempt from the withholding and payment of employment taxes (Federal Insurance Contributions Act (FICA), Federal Unemployment Tax Act (FUTA) and income tax).

However, if an arrangement does not satisfy one or more of the three requirements, § 1.62-2(c)(3)(i) provides that all amounts paid under the arrangement are treated as paid under a "nonaccountable plan." Under § 1.62-2(c)(5), amounts treated as paid under a nonaccountable plan are included in the employee's gross income, must be reported on the employee's Form W-2, and are subject to withholding and payment of employment taxes.

An arrangement meets the business connection requirement of § 1.62-2(d) if it provides advances, allowances, or reimbursements only for business expenses that are allowable as deductions by Part VI (section 161 through section 198), subchapter B, Chapter 1 of the Code, and that are paid or incurred by the employee in connection with the performance of services as an employee of the employer. The reimbursement to the employee may include amounts charged directly or indirectly to the payor through credit card systems or otherwise. If both wages and the reimbursement or other expense allowance are combined in a single payment, the reimbursement or other

expense allowance must be identified either by making a separate payment or by specifically identifying the amount of the reimbursement or other expense allowance. Section 1.62-2(d)(3)(i) provides that the business connection requirement will not be satisfied if the payor arranges to pay an amount to an employee regardless of whether the employee incurs or is reasonably expected to incur bona fide business expenses related to the employer's business.

Under § 1.62-2(e), an arrangement meets the substantiation requirement if the arrangement requires each business expense to be substantiated to the payor within a reasonable period of time. An arrangement that reimburses travel, entertainment or other deductible business expenses governed by § 274(d) meets this requirement if information sufficient to satisfy the substantiation requirements of section 274(d) and the regulations thereunder is submitted to the payor.

Section 274(d) disallows a deduction under § 162 for any expense for travel away from home, including meals and lodging, or entertainment unless the taxpayer substantiates by adequate records or by sufficient evidence the requisite elements of each expenditure. For example, when substantiating expenses for travel away from home, § 1.274-5T(b)(2) of the temporary Income Tax Regulations requires that the elements to be proved are the amount of each expense, and the time, place, and business purpose of the travel. Furthermore, when substantiating entertainment expenses, § 1.274-5T(b)(3) requires that the elements to be proved are the amount of each expense, the time, place and business purpose of the entertainment, and the business relationship of the persons entertained.

Section 1.274-5T(c) provides that the taxpayer must substantiate each element by adequate records or by sufficient evidence corroborating his own statement. According to § 1.274-5T(c)(2), substantiation by adequate records requires the taxpayer to maintain 1) an account book, diary, log, statement of expense, trip sheets, or similar record and 2) documentary evidence which, in combination, are sufficient to establish each element of an expenditure.

The account book, diary, log, statement of expense, trip sheet, or similar record must be prepared or maintained in such manner that each recording of an element of an expenditure is made at or near the time of the expenditure. An expense account statement which is a transcription of an account book, diary, log, or similar record prepared or maintained at or near the time of the expenditure, shall be considered a record prepared or maintained at or near the time of the expenditure if such expense account statement is submitted by an employee to his employer in the regular course of good business practice. See § 1.274- 5T(c)(2)(ii).

Section 1.274-5(c)(2)(iii) provides that documentary evidence is required for any expenditure for lodging while traveling away from home and for any other expenditure of \$75 or more (except for transportation charges if the documentary evidence is not readily available). Acceptable documentary evidence includes receipts, paid bills, or similar evidence sufficient to support an expenditure. Ordinarily, documentary evidence will be considered adequate to support an expenditure if it includes sufficient

information to establish the amount, date, place, and the essential character of the expenditure. For example, a hotel receipt is sufficient to support expenditures for business travel if it contains the following: name, location, date, and separate amounts for charges such as lodging, meals, and telephone. See § 1.274-5(c)(2)(iii)(B).

Section 1.274-5T(f) provides rules for reporting and substantiating of certain expenses paid or incurred by employees in connection with the performance of services as employees. An employee need not report on his tax return business expenses for travel or entertainment paid or incurred by him solely for the benefit of his employer for which he is required to, and does, make an adequate accounting to his employer and which are charged directly or indirectly to the employer or for which the employee is paid through advances, reimbursements, or otherwise, provided that the total amount of such advances, reimbursements and charges is equal to such expenses.

For purposes of these employee substantiation requirements, "adequate accounting" is defined as the submission to the employer of information sufficient to meet the "adequate records" requirements. See § 1.274-5(f)(4). Section 1.274-5(f)(4) provides that, for purposes of an "adequate accounting," the alternative method of substantiation provided in paragraph (c)(3) (allowing substantiation by the taxpayer's own statement supported by corroborative evidence) is not permitted.

Under § 1.274-5T(f)(5), an employee who makes an adequate accounting to his employer will not again be required to substantiate such expense account information, unless (1) the employee claims a deduction for unreimbursed expenses; (2) the employee is a related employee within the meaning of § 267(b) of the Code; or (3) it is determined that the accounting procedures used by the employer for the reporting and substantiation of expenses by such employees are not adequate, or it cannot be determined that such procedures are adequate. This determination is made by the director by considering the facts and circumstances of each case, including the use of proper internal controls.

The third requirement of an accountable plan is satisfied if the arrangement requires the employee to return to the payor within a reasonable period of time any amount paid under the arrangement in excess of the substantiated expenses. See § 1.62-2(f). The determination of whether an arrangement requires an employee to return amounts in excess of substantiated expenses will depend on the facts and circumstances.

The regulations establish safe harbors for purposes of the "reasonable period of time" requirements discussed above. Section 1.62-2(g) provides that an expense substantiated to the payor within 60 days after it is paid or incurred or an amount returned to the payor within 120 days after an expense is paid or incurred will be treated as having occurred within a reasonable period of time.

## ANALYSIS

The employee reimbursement reporting procedures proposed by A provides reimbursements only for business expenses that are deductible under §§ 161 through

198. The charge cards are only provided to A's employees who are likely to incur business expenses and use of the cards for personal expenses is prohibited. Consequently, A's travel and entertainment expense reimbursement procedures, as proposed, satisfy the business connection requirement of § 1.62-2(d).

The above reporting procedures require the employee to submit a detailed expense report within a reasonable period of time (30 days) after incurring the travel or entertainment expense, providing each element of such expenditure. The employees currently must submit documentary evidence for all expenses over \$X. These electronic records will consist primarily of records of charges made to the employee's charge card supplied by B and will provide the name of the vendor and date, place and amount of the transaction. Certain receipts will include additional information such as expense type (ground travel, car rental, airfare, etc.), car rental agreement number, airline ticket number, and airline itinerary. The electronic receipts will eliminate the employees' requirement to submit paper receipts to substantiate charges on the charge card if the nature of the charge is clear on its face (such as a car rental). If the expense does not meet one of the above criteria or if the expense was not charged to the B charge card, employees will continue to be required to submit paper receipts for all expenses of \$Y or more and all expenditures for lodging.

The electronic receipts that will be forwarded to A directly from B for certain charge card expenses also qualify as "receipts, paid bills, or similar evidence" for purposes of the regulations. Based on the representations made by A, all of the documentary evidence submitted to A, whether paper or electronic, is sufficient to support the respective expenditure. Therefore, the proposed reimbursement procedures relating to travel and entertainment expenses require the employee to make an "adequate accounting" to the employer by submitting "adequate records" for all travel and entertainment expenses and, thus, satisfy the substantiation requirement of § 1.62-2(e). See also § 1.274-5T(f). As the taxpayer only requested rulings regarding the reporting procedures for reimbursement of travel and entertainment expenses, we do not address whether the substantiation requirements are met with respect to other business expenses reimbursable by A to which § 274 may or may not apply.

Under A's proposed reimbursement program, A does not allow employees to obtain cash advances to pay for business and travel related expenses. Any amount advanced to the employee through the charge card that exceeds the employee's substantiated expenses must be paid to B by the employee. A's employees are personally responsible for the charges billed as well as any late payment charges. Furthermore, A's employees are required to return to A, its agent, or a third party within a reasonable period of time any amount paid in excess of the substantiated expenses. The arrangement, thus, meets the return of excess requirement of § 1.62-2(f).

## CONCLUSION

The proposed reporting procedures for reimbursing the employees of company A for their travel and entertainment expenses satisfy the business connection, substantiation, and return of excess requirements of § 1.62-2(c) and, thus, qualify as an "accountable

plan" under § 62(c). Accordingly, amounts reimbursed thereunder for travel and entertainment expenses are excluded from the employee's gross income, are not reported as wages or other compensation on the employee's Form W-2 and are exempt from the withholding and payment of employment taxes (FICA, FUTA, and income tax).

Because the information submitted does not adequately describe the retention, documentation, and resource procedures and policies under the proposed plan for electronic records for the taxpayer and its contractors, no opinion is expressed on whether the taxpayer's use and retention of electronic records under the proposed plan will meet the requirements of Rev. Proc. 98-25, 1998-1 C.B. 689.

We express no opinion on the matters committed to the discretion of the director under § 1.274-5T(f)(5)(iii) nor as to any other federal tax consequences of the transaction described above under other provisions of the Code.

Pursuant to a power of attorney on file in this office, a copy of this ruling is being sent to each of A's authorized representatives.

This ruling is directed only to A. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,  
Gerald M. Horan  
Senior Technician Reviewer, Branch 6  
Office of Associate Chief Counsel  
(Income Tax & Accounting)

Enclosure:  
Copy for 6110 purposes

CC: