

BUSINESS EXPENSES – Are they taxable income?

Recently several questions have been brought to my attention regarding reimbursement of business expenses and whether or not the reimbursement becomes taxable income to the worker. The method of reimbursement determines how the business expense is treated on the employee's W-2 and 1040. Out-of-pocket business expenses can be handled in one of three ways:

- **Unreimbursed expenses** – these are business expenses in excess of what the congregation is willing to reimburse. *Unreimbursed expenses can be deducted as a miscellaneous itemized deduction on Schedule A of Form 1040 but only to the extent that they exceed 2% of adjusted gross income.*
- **Nonaccountable reimbursed expenses** – these are business expenses reimbursed by the congregation without requiring substantiation of actual expenses or a return of excess funds. A common example would be an auto allowance given to the worker by the congregation without the requirement to substantiate actual expenses. Neither does the worker have to return the unused portion of the allowance. *The entire amount of the allowance must be reported as income on the worker's W-2 and expenses can be deducted as a miscellaneous itemized deduction on Schedule A of Form 1040 but only to the extent that they exceed 2% of adjusted gross income.*
- **Accountable reimbursed expenses** – these are business expenses reimbursed by the congregation under an accountable plan. An accountable plan is one that reimburses employees for allowable business expenses, requires each business expense to be substantiated to the employer in a reasonable period of time, and requires the return of excess reimbursements within a reasonable period of time. *If the congregation adopts an accountable plan, none of the reimbursement needs to be reported on the W-2 (or 1040) and there are no expenses for the worker to deduct. The employee reports to the employer rather than to the IRS.*

A CAUTION:

- Some congregations elect to reimburse business expenses out of the worker's own compensation via a salary reduction or salary restructuring agreement. A 1993 IRS ruling states that these arrangements cannot be considered accountable. In 1999 the IRS issued a private letter ruling stating that appropriate salary restructuring arrangements could allow the use of salary reduction arrangements to reimburse business expenses under an accountable plan. HOWEVER, the 1999 ruling was withdrawn by the IRS in 2000. Therefore, **salary reduction or salary restructuring agreements continue to be viewed as nonaccountable plans by the IRS.** *The amount paid to the worker must be reported on the worker's W-2 as taxable income and expenses can be deducted on Schedule A of Form 1040 but only to the extent that they exceed 2% of adjusted gross income.*

Chapter six of the Congregational Treasurers Manual provides more information regarding Business Expenses, including a sample Accountable Plan Reimbursement Policy.