



*Holston
Conference
of The
United
Methodist
Church*

MEMO

TO: Holston Conference of the UMC District Superintendents
FROM: Rick Cherry, Controller
DATE: May 30, 2008
SUBJECT: Church & Clergy 2008 Business Expenses

The following pages contain information relating to business expenses, itemized deductions, and use of cell phones by church employees from the *2008 Church & Clergy Tax Guide*, Richard R. Hammar, J.D., LL.M., CPA, author.

Please read this document carefully. I have summarized for you in this section information from the standard IRS Business Tax Codes, Section 280 F; ...*the tax code imposes stricter substantiation requirements on the business use of certain kinds of property. The code refers to these kinds of property as "listed property." Three conditions must exist in order for cell phone expenses to be reimbursed by an employer.*

- The employee's use of the phone is for the convenience of the employer;
- The employee's use of the phone is required as a condition of employment; and
- The employee adequately substantiates the business use of the phone.

These conditions apply to the reimbursement of the cost of such phones by employers under an accountable business expense reimbursement arrangement. Unless these conditions are met in full (very difficult to satisfy these conditions), the employer **can not** reimburse the employee for any portion of the cost of using the cell phone under an accountable business reimbursement arrangement.

For employees that meet the strict requirements of the conditions listed above, the following substantiation requirements must be applied or reimbursement shall not be approved.

- The amount of each separate expense, such as the cost of acquiring the phone, maintenance and repair costs, and any other expense;
- The amount of each business uses (based on an appropriate measure, such as time) and the total use of the property for the period;
- The date of the expenditure or use; and
- The business purpose for the expenditure or use.
- The accountable reimbursement will be calculated on a percentage basis of total use of the listed property.
- The substantiation must occur within 60 days of the date the expenses are incurred.

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Cellular phones

⚠ **CAUTION.** *A church cannot reimburse employees' expenses under an accountable reimbursement arrangement that do not qualify as business expenses. Such reimbursements, as well as a church's reimbursement of employees' unsubstantiated business expenses, are nonaccountable. If these reimbursements are not reported as taxable income to the employee in the year the reimbursements are paid, two consequences result: (1) the employee is subject to back taxes plus penalties and interest on the unreported income; and (2) if the benefits are provided to an officer or director of the church (a "disqualified person"), or a relative of such a person, they will expose the recipient and possibly other members of the church's governing board to intermediate sanctions in the form of substantial excise taxes, since the IRS views these benefits as automatic excess benefits unless reported as taxable income by the church or recipient in the year provided. This topic is covered fully in Chapter 4, section A.3. The lesson is clear: sloppy church accounting practices can be costly to church staff.*

⚡ **KEY POINT.** The IRS has issued audit guidelines for its agents to follow when auditing corporate executives. The guidelines are instructive in evaluating the compensation packages provided to senior pastors and other church employees. The guidelines specify: "Special record-keeping rules apply to computers except for those used exclusively at the business establishment and owned or leased by the person operating the business. Detailed records are required to establish business use of computers that can be taken home or are kept at home by the executives. There are no record keeping exceptions like 'no personal use' available for computers. Similar recordkeeping problems arise for cellular and car phones. This requires documentation of business usage in order for the purchase and operational cost to be an allowable deduction and not included as income to the executive."

Several churches have provided their pastor or other staff members with a cell phone. The tax treatment associated with the use of cell phones is complex. Consider the following four options.

Option 1—reasonable estimates

The cost of cell phones and usage fees have dropped so significantly that some church leaders have concluded that the burden of complying with the technical requirements summarized in Table 7-6 is not warranted. For example, assume that Pastor T owns a cell phone for which the church pays the monthly usage fee of \$40. Pastor T estimates that he uses the phone 60 percent for business, and the church treasurer reimburses him 60 percent of each monthly bill, for a total of \$288 during the year (under an accountable reimbursement arrangement). While the use of estimates generally is not available for cell phones, it may be permitted because the minimal costs associated with cell phones do not warrant compliance with the substantiation requirements. But this aggressive position has not been endorsed by the IRS or any court.

Going back to our example, assume that Pastor T keeps meticulous records throughout the year to substantiate his business use of the phone and demonstrates that he uses the phone 50 percent for business. The church treasurer reimburses him \$240 during the year, or \$48 less than if Pastor T had estimated his business use to be 60 percent. What are the tax consequences of this difference? By estimating his business use of the phone, Pastor T was reimbursed by \$48 more than his actual expenses, meaning that his income was understated by this amount. At the 15 percent tax bracket, this translates into an underpayment of tax of \$7. Hardly worth, some would say, the hours spent in keeping detailed records of every minute of cell phone use throughout the year.

⚠ **CAUTION.** *Before using reasonable estimates to compute a tax deduction for the business use of a cell phone, note that cell phones are "listed property" under section 280F of the tax code. This means they are subject to strict substantiation requirements (explained later in this chapter) that ordinarily cannot be met using estimates. Also note that a church should not reimburse cell phone use under an accountable reimbursement plan based solely on estimates of business use.*

Option 2—sampling

You may maintain an adequate record for parts of a year and use that record to substantiate the amount of business expense for the entire year if you can demonstrate by other evidence that the periods for which an adequate record is kept are representative of your expenses throughout the entire year. The income tax regulations specify that "a taxpayer may maintain an adequate record for portions of a taxable year and use that record to substantiate the business use of listed property [such as a cell phone] for all or a portion of the taxable year if the taxpayer can demonstrate by other evidence that the periods for which an adequate record is maintained are representative of the use for the taxable year or a portion thereof." *Treas. Reg. 1.274-5T(c)(3)(ii)(A).*

Pastors and other church staff who use cell phones in the course of their work may want to keep records documenting the total use of their phone for a month or quarter, and the business use of the phone during the same period. They can then compute a "business use percentage" that they can apply to their cell phone charges for the remainder of the year in lieu of keeping actual records substantiating their business use percentage. This approach assumes that the period for which they keep records is representative of the remainder of the year.

EXAMPLE. A church provided cell phones to its senior pastor, his wife, and their two sons. The church paid most, if not all, of the charges associated with the phones. The church claimed it had a policy limiting cell phones to church business and requiring any personal calls to be fully reimbursed to the church. The church provided the IRS with "voluminous records listing calls from the church's cellular phones." However, the documents "list

TABLE 7-6
**USE OF CELL PHONES BY CHURCH EMPLOYEES:
 THE TAX CONSEQUENCES**

| TAX CONSEQUENCES | RECOMMENDATIONS |
|---|--|
| <p><i>Church owns phone and pays usage fees.</i> The tax consequences depend on whether the church has an accountable or nonaccountable plan:</p> <p>Nonaccountable plan. The church requires no substantiation of the business use percentage (the percentage of total phone time that is devoted to business). If nonaccountable, or if the "condition of employment" and "convenience of the employer" tests are not met (defined above), the church's reimbursements must be reported as taxable income to the employee. The church must report the full amount of all monthly usage bills it pays as taxable income on Forms W-2 and 941. If the user is not a minister (or is a minister who has elected voluntary tax withholding), the church also must withhold taxes on the reported amounts.</p> <p>Accountable plan. The church requires the user to keep a diary, log, or other record documenting the duration and business or personal nature of each call. From this data the church can determine the business use percentage (the percentage of total phone time devoted to business). This percentage is multiplied by the amount of each monthly bill, and the resulting amount is not reported as taxable income for the employee, since business use has been properly accounted for. This assumes that the "condition of employment" and "convenience of employer" tests (defined above) are met and that the substantiation occurs within 60 days of the date the expenses are incurred. The church can reimburse only the business use percentage of each bill, or it can pay the entire amount. If it pays the entire amount, the reimbursements in excess of substantiated business use represent taxable income. The church must report these excess payments as taxable income for the employee on Forms W-2 and 941. If the user is not a minister (or a minister who has elected voluntary tax withholding), the church also must withhold taxes on the reported amounts. The substantiation requirements for cell phones can be met using sampling (explained above).</p> | <p>Be sure the church pays cell phone charges under an accountable arrangement that requires employees to substantiate the business use percentage.</p> |
| <p><i>Employee owns phone and pays usage fees.</i></p> <p>Depreciation. An employee can claim a section 179 deduction (on Form 2106) for the unreimbursed cost of the phone in the year of purchase if three requirements are met: (1) The employee uses the phone more than 50 percent of the time for business. The section 179 deduction is for the cost of the phone multiplied by the business use percentage. If business use does not exceed 50 percent, the employee can depreciate the cost of the phone over five years. (2) The use of the phone must be required for the employee to perform duties properly. The employer does not have to explicitly require the employee to use the phone. However, a mere statement by the employer that the use of the phone is a condition of employment is not sufficient. (3) The use of a cell phone by an employee is for the convenience of the employer if it is for a substantial business reason of the employer. The use of the phone during the employee's regular working hours to carry on the employer's business is generally for the employer's convenience.</p> <p>User's fees. The employee can claim a business expense deduction (computed on Form 2106) for the business use of the phone if (1) the employee has adequate records to prove the business use percentage of the phone; (2) the deduction is limited to the business use percentage multiplied by all monthly charges; (3) the "condition of employment" test (defined above) is met; and (4) the "convenience of the employer" test (defined above) is met.</p> | <p>Employees should be urged to keep adequate records to prove that the business use percentage exceeds 50 percent. This will allow a deduction for the cost of the phone (multiplied by the phone's business use percentage) in the year of purchase.</p> |



only the telephone numbers, and do not indicate with whom [the caller] spoke and the business reasons for the conversation. Aside from phone calls made to church phones that would most likely be church business, all other calls were not substantiated as required." As a result, the IRS determined that the church's reimbursements of the cell phone charges were nonaccountable, and since they were not reported as taxable income on the users' Forms W-2, they constituted automatic excess benefits resulting in intermediate sanctions of up to 225 percent times the amount of the excess benefits. *IRS Letter Rulings 200435019, 200435020, 200435021, and 200435022.*

EXAMPLE. An employee claimed an income tax deduction of \$700 for costs associated with the business use of his cell phone. The IRS denied the deduction due to a lack of substantiation. The Tax Court agreed. It noted that the tax code imposes "stringent substantiation requirements" on "listed property" described in section 280F, including cell phones. For such expenses, "substantiation of the amounts claimed by adequate records or by other sufficient evidence corroborating the claimed expenses is required," and to meet the adequate records requirements, a taxpayer "shall maintain an account book, diary, log, statement of expense, trip sheets, or similar record which, in combination, are sufficient to establish each element of an expenditure." The court noted that the taxpayer kept "no contemporaneously prepared records to document his employee-related uses of these devices." Instead, he presented a worksheet that simply listed his alleged expenses. This was inadequate, concluded the court, since a mere listing of expenses "does not suffice to satisfy the substantiation requirements for use of the cellular telephone." *Jones v. United States, T.C. Summary Opinion 2004-76. See also Woods v. Commissioner, T.C. Memo 2004-114; Farran v. Commissioner, T.C. Memo. 2007-151 (2007); Sobolt v. Commissioner, T.C. Summary Opinion 2007-49 (2007).*

EXAMPLE. A taxpayer claimed a business expense deduction of \$1,200 for the use of a cell phone and pager. The Tax Court denied a deduction for any of these expenses, since the taxpayer did not comply with the strict substantiation requirements that apply to cell phones. The court concluded, "The deduction for cell phone and pager expenses is subject to the same strict substantiation requirements as the car expenses. The taxpayer's failure to substantiate the expense by original or reasonably reconstructed records is grounds for disallowing the deduction." *Lemos v. Commissioner, T.C. Summary Opinion 2002-29 (2002).*

EXAMPLE. A taxpayer claimed a business expense deduction of \$750 for the use of a cell phone. The court denied a deduction, since the taxpayer did not comply with the strict substantiation requirements that apply to cell phones. The court concluded, "Cellular telephones are 'listed property' subject to

the substantiation requirements of [the tax code]. The taxpayer failed to submit any documentation to establish the business use of his cellular telephone, the amount he paid for the service, or even the identity of the telephone company." *Vaksman v. Commissioner, 2003-1 USTC 50,126 (5th Cir. 2002).*

Option 3—salary adjustment

Some church leaders believe the best option for handling cell phones is to simply provide church staff members with a small salary increase each year to cover the business use of a cell phone. Employees can use the salary increase to purchase their own cell phones and pay the monthly usage fees without any reporting back to the church. The salary increase is reported as taxable income on the employees' Forms W-2, and the employees are free to claim a deduction on their tax returns for the business use of their cell phone if they choose to do so (and can substantiate the business use of their phone as described below). In practice, many employees will not attempt to claim a deduction because the complexity of doing so outweighs the minimal benefit.

This approach relieves the church of the responsibility of deciding if every call on an employee's monthly cell phone invoice is adequately substantiated.

Option 4—full compliance with the law

This section describes how ministers and other church employees can fully comply with the tax law with regard to cell phone expenses and reimbursements. There is no doubt that cell phones are a tremendous convenience and make ministers and other staff members accessible in the event of emergencies. But few church leaders have a clear understanding of the tax implications associated with the use of these phones. Consider the following.

Listed property

Section 280F of the tax code imposes stricter substantiation requirements on the business use of certain kinds of property. The tax code refers to these kinds of property as "listed property." Cell phones are included in the list. As a result, three important conditions must be met in order to treat an employee's use of a cell phone as a business expense:

- the employee's use of the phone is for the convenience of the employer;
- the employee's use of the phone is required as a condition of employment; and
- the employee adequately substantiates the business use of the phone.

These conditions apply not only to the deductibility of an employee's use of a cell phone in the course of his or her employment but also to the reimbursement of the cost of such phones by employers under an accountable business expense reimbursement

arrangement. As a result, it is important for church leaders to be familiar with these rules.

Convenience of the employer

When is a cell phone used for the convenience of one's employer? The income tax regulations note:

In order to satisfy the "condition of employment" requirement, the use of the property must be required in order for the employee to perform the duties of his or her employment properly. Whether the use of the property is so required depends on all the facts and circumstances. Thus, the employer need not explicitly require the employee to use the property. Similarly, a mere statement by the employer that the use of the property is a condition of employment is not sufficient.

The regulations also clarify that the term "convenience of the employer" generally has the same meaning as it does under section 119 of the tax code, which excludes from taxable income meals or lodging "furnished for the convenience of an employer." Section 119 provides that meals furnished by an employer without charge to the employee will be regarded as furnished for the convenience of the employer if the meals are furnished for a substantial "noncompensatory business reason" of the employer. If an employer furnishes meals as a means of providing additional compensation to an employee, the meals so furnished will not be regarded as furnished for the convenience of the employer. On the other hand, if the employer furnishes meals to an employee for a substantial noncompensatory business reason, the meals will be regarded as furnished for the convenience of the employer. The income tax regulations list a number of examples of meals that are provided to employees for "substantial noncompensatory business reasons," including the following two:

- **The "emergency" rule.** Meals furnished to employees during working hours in order to have them available for emergency calls during their meal period are one example of a substantial noncompensatory business reason. To satisfy this test, the regulations caution that "it must be shown that emergencies have actually occurred, or can reasonably be expected to occur, in the employer's business which have resulted, or will result, in the employer calling on the employee to perform his job during his meal period."
- **The "no adequate facilities available" rule.** Another example of a substantial noncompensatory business reason are meals furnished to employees during working hours because they could not otherwise secure meals within a reasonable meal period. For example, meals may qualify under this rule when there are insufficient eating facilities in the vicinity of the employer's premises.

✿ **KEY POINT.** In summary, for a cell phone to satisfy the "convenience of the employer" requirement, it must meet two

requirements: (1) it must be required in order for the employee to properly perform his or her job; and (2) it must be provided for a substantial noncompensatory business reason, such as the immediate accessibility of the employee in the event of an emergency, or the inadequacy of the employee's office telephone.

EXAMPLE. Pastor B is the senior pastor of his church. His church provides Pastor B with a telephone in his church office, and it also provides him with a cell phone. There is little doubt that the cell phone is for the convenience of Pastor B's employer, since it is needed for him to properly perform his job and it is provided to him for substantial noncompensatory business reasons. In particular, it meets the "emergency rule," since the cell phone makes Pastor B accessible in the event of an emergency (such as the sudden death or hospitalization of a church member) during those frequent times when he is not in his church office; and it meets the "no adequate facilities available" rule, since the telephone provided by the church in Pastor B's office is not an adequate means of reaching him when he is not in his office.

EXAMPLE. A church provides its bookkeeper with a cell phone. The bookkeeper rarely leaves her office for business purposes, and the church provides her with a telephone in her church office. The cell phone is not for the convenience of the employer, since it is not necessary in order for her to properly perform her job, and no substantial noncompensatory business reason exists for her to have it. The "emergency rule" probably cannot be met, since it is unlikely that emergencies will occur that would require the bookkeeper to be contacted immediately on a cell phone. This is so for two reasons: first, it is rare for emergencies to occur that will require the immediate assistance of a bookkeeper; second, since she rarely leaves her office during business hours, the telephone the church provides in her office is sufficient. As a result, providing the cell phone to the bookkeeper does not have a substantial noncompensatory business purpose, so it is not for the convenience of the employer.

Church treasurers should be familiar with the following tax consequences of failing the "convenience of the employer" test: (1) the employee cannot claim an employee business expense for any portion of the cost of using the cell phone that she pays (i.e., the cost of the cell phone is an unreimbursed expense); (2) the church cannot reimburse any portion of the cost of the cell phone under an accountable business expense reimbursement arrangement; (3) any expenses associated with the cost and use of the cell phone paid by the church must be treated as nonaccountable reimbursements, meaning they must be reported as taxable compensation to the employee (and included on her Form W-2); and (4) in the case of nonminister employees, the church must withhold income taxes and FICA taxes from the amount of its reimbursements of cell phone expenses.

Ministers often pay a small annual renewal fee to maintain their credentials, which constitutes a deductible expense. However, ministers' contributions to the church are not deductible as business expenses. They may argue that they are expected to donate generously to the church as part of their employment. This is not sufficient to convert charitable contributions to business expenses. The distinction is that charitable contributions are given to a qualifying organization (such as a church) for the furtherance of its charitable activities. Dues, on the other hand, are usually paid with the expectation that a financial benefit will result to the individual, as in a realtor's multilist dues or an electrician's union dues. A minister's salary and benefits are not likely to directly depend on the donations made to the church. They may still be deducted as contributions on Schedule A but may not be used as a business expense to reduce self-employment tax.

→ **OBSERVATION.** The guidelines acknowledge that "small annual renewal fees" that are required to maintain a minister's credentials are deductible. This is an important clarification, since the IRS has challenged this proposition in several audits of ministers. There is no doubt that mandatory contributions to a denominational agency to maintain one's professional credentials represent a business expense, whether the taxpayer is a minister or an attorney or any other professional.

→ **OBSERVATION.** The guidelines inform agents that ministers' contributions to an employing church are not deductible as business expenses. They can be claimed only as charitable contributions. The guidelines reject the conclusion reached by the Tax Court in the *Forbes* case (discussed above). Ministers who treat contributions to their employing church as a business expense are taking an aggressive position that is now more likely to be scrutinized and questioned.

EXAMPLE. The United States Tax Court ruled that the IRS can ignore a pastor's tithes as a "living expense" in evaluating an offer in compromise. The court noted that the IRS *Internal Revenue Manual* concedes that if a minister is required "as a condition of employment" to tithe to a church, then this is a necessary living expense that can be considered in evaluating an offer in compromise submitted by the minister. The "only thing to consider is whether the amount being contributed equals the amount actually required and does not include a voluntary portion."

In this case the court concluded that there was no evidence that the pastor was employed as a pastor, and it rejected his argument that tithing was a condition of employment, even with respect to earnings from a secular employer, since he was required by church doctrine to tithe on such earnings. The court's decision, and the *Internal Revenue Manual* provision it cited, both acknowledge that a minister's contributions to a church can be

a condition of employment. This is indirect support for treating these same contributions as a business expense. *Pixley v. Commissioner*, 123 T.C. 15 (2004).

D. RECORDKEEPING

1. KEEPING ADEQUATE RECORDS

You need to keep adequate records of business expenses for two reasons:

- to substantiate a deduction that you claim on your tax return for a business expense you incurred; and
- to substantiate reimbursements of business expenses under an accountable business expense reimbursement arrangement adopted by your employer.

If you fail to keep the records prescribed by law, then you cannot claim a deduction for your business expenses, and you cannot obtain a reimbursement from your employer under an accountable reimbursement arrangement for business expenses you incur.

The kinds of records you need to substantiate a business expense depends on the type of business expense. The tax code divides business expenses into three categories for purposes of substantiating business expenses:

- **Local business transportation, overnight travel, entertainment, and gift expenses.** Section 274(d) of the tax code states that no deduction for local business transportation, overnight business travel (including meals and lodging), business entertainment, or gift expenses will be allowed unless a taxpayer can substantiate the information summarized in Table 7-7. You must be able to substantiate each item by adequate records or by sufficient evidence corroborating your own statement.
- **Expenses associated with "listed property."** The tax code defines "listed property" to include automobiles, cellular phones, and computers (and peripheral equipment) that are used for business purposes. In order to substantiate a business expense for the use of any of these items of listed property, a taxpayer must prove (1) the amount of the expense; (2) the business use percentage (the percentage of total use of the listed property for the year that consisted of business use); (3) the date of the expense; and (4) business purpose.

If you cannot prove that you use listed property more than 50 percent for business purposes, you cannot take a section 179 deduction (you cannot deduct the full cost in the year of



purchase) but rather must depreciate the property using the straight-line method over the property's "recovery period."

- **Other business expenses.** For other business expenses, you should be able to substantiate that such expenses were not only paid or incurred but also that they constitute ordinary and necessary business expenses.

Special rules for employee business expenses

Employees who incur transportation, travel, entertainment, or gift expenses, or expenses associated with the purchase or use of listed property, in connection with their employment must prove that each expense was for the convenience of the employer and required as a condition of employment. These terms are defined below.

For the convenience of the employer

In general, "convenience of the employer" means that a particular expense or use of listed property is for a substantial business reason of the employer. The use of listed property during an employee's regular working hours to carry on the employer's business is generally for the employer's convenience.

A condition of employment

An expense or use of listed property is a condition of employment if it is required in order for the employee to properly perform the duties of the job. An employer need not explicitly require the employee to use the property. On the other hand, a mere statement by the employer that the use of the property is a condition of employment is not sufficient.

Estimating business expenses

Employees who incur transportation, travel, entertainment, or gift expenses, or expenses associated with the purchase or use of listed property, in connection with their employment must substantiate each element of an expense or use as noted above. Estimating the amount of such expenses is strictly prohibited, even though it is clear that a taxpayer incurred some expenses. This limitation supersedes the "Cohan rule," which allows taxpayers to estimate the amount of business expenses other than transportation, travel, entertainment or gift expenses, or expenses connected with listed property. *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930).

Adequate records

To maintain adequate records, you should keep the proof you need in an account book, diary, statement of expense, or similar record. You should also keep documentary evidence that, together with your record, will support each element of an expense.

Documentary evidence

You generally must have documentary evidence, such as receipts, canceled checks, or bills, to support your expenses. Documentary evidence is not needed if any of the following conditions apply:

- (1) You have meals or lodging expenses while traveling away from home for which you account to your employer under an accountable plan, and you use a per diem allowance method that includes meals and/or lodging.
- (2) Your expense, other than lodging, is less than \$75.
- (3) You have a transportation expense for which a receipt is not readily available.

Documentary evidence ordinarily will be considered adequate if it shows the amount, date, place, and essential character of the expense. A canceled check, together with a bill from the payee, ordinarily establishes the cost. However, a canceled check by itself does not prove a business expense without other evidence to show that it was for a business purpose.

EXAMPLE. For example, a hotel receipt is enough to support expenses for business travel if it has all of the following information: (1) the name and location of the hotel; (2) the dates you stayed there; and (3) separate amounts for charges such as lodging, meals, and telephone calls.

EXAMPLE. A restaurant receipt is enough to prove an expense for a business meal if it has all of the following information: (1) the name and location of the restaurant; (2) the number of people served; and (3) the date and amount of the expense. If a charge is made for items other than food and beverages, the receipt must show that this is the case.

You do not have to record information in your account book or other record that duplicates information shown on a receipt as long as your records and receipts complement each other in an orderly manner.

You do not have to record amounts your employer pays directly for any ticket or other travel item. However, if you charge these items to your employer, through a credit card or otherwise, you must keep a record of the amounts you spend.

You should record the elements of an expense or of a business use at or near the time of the expense or use and support it with sufficient documentary evidence. A timely kept record has more value than a statement prepared later, when generally there is a lack of accurate recall. You do not need to write down the elements of every expense on the day of the expense. If you maintain a log on a weekly basis that accounts for use during the week, the log is considered a timely kept record. If you give your employer an expense account statement, it can also be considered a timely kept record. This is true if you copy it from your account book, diary, statement of expense, or similar record.

Proving business purpose

You must generally provide a written statement of the business purpose of an expense. However, the degree of proof varies accord-

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ing to the circumstances in each case. If the business purpose of an expense is clear from the surrounding circumstances, you do not need to give a written explanation.

EXAMPLE. A minister who frequently visits church members in a local hospital does not have to give a written explanation of the business purpose for traveling to that destination. He can

TABLE 7-7 HOW TO PROVE CERTAIN BUSINESS EXPENSES

| IF YOU HAVE EXPENSES FOR: | THEN YOU MUST KEEP RECORDS THAT SHOW DETAILS OF THE FOLLOWING ELEMENTS: | | | |
|---------------------------|--|--|---|---|
| | AMOUNT | TIME | PLACE OR DESCRIPTION | BUSINESS PURPOSE & BUSINESS RELATIONSHIP |
| TRAVEL | Cost of each separate expense for travel, lodging, and meals (Incidental expenses may be totaled in reasonable categories such as taxis, daily meals, etc.) | Dates you left and returned for each trip and number of days spent on business | Destination or area of your travel; name of city or other destination | <p>Purpose: Business purpose for the expense or the business benefit gained or expected to be gained</p> <p>Relationship: Not applicable</p> |
| ENTERTAINMENT | Cost of each separate expense (Incidental expenses such as taxis, telephones, etc., may be totaled on a daily basis.) | Date of entertainment | Name and address or location of place of entertainment; type of entertainment if not otherwise apparent | <p>Purpose: Business purpose for the expense or the business benefit gained or expected to be gained (For entertainment, the nature of the business discussion or activity. If the entertainment was directly before or after a business discussion: the date, place, nature, and duration of the business discussion, and the identities of the persons who took part in both the business discussion and the entertainment activity.)</p> <p>Relationship: Occupations or other information (such as names, titles, or other designations) about the recipients that shows their business relationship to you (For entertainment you must also prove that you or your employee was present if the entertainment was a business meal.)</p> |
| GIFTS | Cost of the gift | Date of the gift | Description of the gift | <p>Purpose: Business purpose for the expense</p> <p>Relationship: Not applicable</p> |
| TRANSPORTATION (VEHICLE) | Cost of each separate expense (For vehicle expenses, the cost of the vehicle and any improvements, the date you started using it for business, the mileage for each business use, and the total miles for the year.) | Date of the expense (for vehicle expenses, the date of the use of the vehicle) | Your business destination (name of city or other destination) | <p>Purpose: Business purpose for the expense</p> <p>Relationship: Not applicable</p> |



satisfy the requirements by recording the length of the route once, the date of each trip at or near the time of the trips, and the total miles he drove the car during the tax year.

Confidential information

You do not need to put confidential information relating to an element of a deductible expense (such as the place, business purpose, or business relationship) in your account book, diary, or other record. However, you do have to record the information elsewhere at or near the time of the expense and have it available to fully prove that element of the expense.

2. INCOMPLETE RECORDS

If you do not have complete records to prove an element of an expense, then you must prove the element with: (1) your own written or oral statement containing specific information about the element, and (2) other supporting evidence that is sufficient to establish the element. If the element is the cost, time, place, or date of an expense, the supporting evidence must be either direct evidence or documentary evidence. Direct evidence can be written statements or the oral testimony of your guests or other witnesses, setting forth detailed information about the element. Documentary evidence can be receipts, paid bills, or similar evidence. If the element is either the business relationship of your guests or the business purpose of the amount spent, the supporting evidence can be circumstantial rather than direct.

Sampling

The income tax regulations specify: “[A] taxpayer may maintain an adequate record for portions of a taxable year and use that record to substantiate the business use of listed property [such as a cell phone] for all or a portion of the taxable year if the taxpayer can demonstrate by other evidence that the periods for which an adequate record is maintained are representative of the use for the taxable year or a portion thereof.” *Treas. Reg. 1.274-5T(c)(3)(ii)(A)*.

EXAMPLE. You keep adequate records during the first week of each month that show that 75 percent of the use of your car is for business. Invoices and bills show that your business use continues at the same rate during the later weeks of each month. Your weekly records are representative of the use of the car each month and are sufficient evidence to support the percentage of business use for the year.

Destroyed records

If you cannot produce a receipt for reasons beyond your control, you can prove a deduction by reconstructing your records or expenses. Reasons beyond your control include fire, flood, and other casualty.

3. SEPARATING AND COMBINING EXPENSES

Each separate payment is generally considered a separate expense that must be recorded separately in your records. You can make

one daily entry in your record for reasonable categories of expenses. Examples are taxi fares, telephone calls, or other incidental travel costs. Meals should be in a separate category. You can include tips for meal-related services with the costs of the meals. Expenses of a similar nature occurring during the course of a single event are considered a single expense.

4. HOW LONG TO KEEP RECORDS AND RECEIPTS

You must keep records as long as they may be needed for the administration of any provision of the tax code. Generally, this means you must keep records that support your deduction for three years from the date you file the income tax return on which the deduction is claimed. A return filed early is considered filed on the due date. Employees who give their records and documentation to their employers and are reimbursed for their expenses generally do not have to keep copies of this information. However, you may have to prove your expenses if any of the following conditions apply: (1) you claim deductions for expenses that are more than reimbursements; or (2) your expenses are reimbursed under a nonaccountable plan.

5. EXAMPLES OF RECORDS

Examples of records that show the information you need to keep for different types of expenses are included as Illustrations 7-1 and 7-2.

E. REIMBURSEMENT OF BUSINESS EXPENSES

Most ministers and lay employees incur out-of-pocket business expenses during the course of the year for transportation, travel, entertainment, education, books, and similar items. These expenses can be handled and reported in any one of three ways: (1) unreimbursed, (2) nonaccountable reimbursements, or (3) accountable reimbursements. These methods are summarized below.

1. UNREIMBURSED EXPENSES

Many churches do not reimburse their employees' business and professional expenses. Such employees have *unreimbursed* business expenses. Some churches reimburse employees' business expenses only up to a specified amount. Such employees have unreimbursed expenses to the extent that they incur expenses in excess of what the church is willing to reimburse.

Church employees can deduct their business expenses only as a miscellaneous itemized deduction on Schedule A (of Form 1040), and then only to the extent such expenses exceed 2 percent of AGI.

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These rules have resulted in the nondeductibility of unreimbursed business expenses for many ministers and lay employees, since it is estimated that only about 30 percent of all taxpayers have sufficient expenses to be able to itemize deductions on Schedule A.

❖ **KEY POINT.** Employees cannot claim any deduction for unreimbursed employee business expenses for which an employer reimbursement was available.

Church staff who are self-employed for federal income tax reporting purposes can deduct their unreimbursed business expenses directly on Schedule C, regardless of whether they are able to itemize their deductions.

2. NONACCOUNTABLE REIMBURSED EXPENSES

⚠ **CAUTION.** *If a church's reimbursement of an employee's expenses under a nonaccountable plan are not reported as taxable income in the year the reimbursements are paid, two consequences result: (1) the employee is subject to back taxes plus penalties and interest on the unreported income; and (2) if the reimbursed expenses were incurred by an officer or director of the church (a "disqualified person"), or a relative of such a person, they will expose the recipient and possibly other members of the church's governing board to intermediate sanctions in the form of substantial excise taxes, since the IRS views these benefits as automatic excess benefits unless reported as taxable income by the church or recipient in the year provided. This topic is covered fully in Chapter 4, section A.3. The lesson is clear: sloppy church accounting practices can be costly to church staff.*

Churches commonly reimburse an employee's business expenses without requiring any substantiation of actual expenses or a return of reimbursements in excess of substantiated expenses (e.g., "excess

reimbursements"). The most common example is the "car allowance." Many churches pay their minister a monthly allowance to cover business use of an automobile without requiring any substantiation of actual expenses or a return of the amount by which the allowance exceeds actual expenses. Such a reimbursement arrangement is called a nonaccountable reimbursement arrangement, since the minister is not required to account for (substantiate) the actual amount, date, place, and business purpose of each reimbursed expense.

A reimbursement arrangement is nonaccountable if it either (1) fails to require substantiation of the actual amount, date, place, and business purpose of each reimbursed expense within a reasonable time; or (2) fails to require excess reimbursements to be returned to the employer within a reasonable time.

What are the tax consequences of a nonaccountable plan? That depends on whether a worker is an employee or self-employed for federal income tax reporting purposes.

Employees

For employees, the full amount of the church's reimbursements must be reported as income on Forms W-2 and 1040. An employee can deduct actual expenses only as a miscellaneous itemized deduction on Schedule A to the extent these expenses exceed 2 percent of AGI. These rules can be harsh, since the church's reimbursements are fully reported as income for the employee, who in many cases is unable to claim any deduction because of insufficient itemized expenses to use Schedule A.

Self-employed

For church staff who are self-employed for federal income tax reporting purposes, the full amount of the church's reimbursements

ILLUSTRATION 7-1 DAILY BUSINESS MILEAGE AND EXPENSE LOG

| DATE | DESTINATION | BUSINESS PURPOSE | START | STOP | MILES THIS TRIP | TYPE OF EXPENSE | AMOUNT |
|---------------------------|---------------------|-------------------------|--------------|--------------|-----------------|-------------------------|-------------------|
| 4/22 | Local (St. Louis) | Visiting church members | 8,097 | 8,188 | 91 | Gas | \$18.25 |
| 4/23 | Indianapolis | Church conference | 8,211 | 8,486 | 275 | Parking | \$2.00 |
| 4/24 | Louisville | Seminary board | 8,486 | 8,599 | 113 | Gas Repair flat tire | \$16.50 \$8.00 |
| 4/25 | Return to St. Louis | | 8,599 | 8,875 | 276 | Gas | \$17.25 |
| 4/26 | Local | Hospital calls | 8,914 | 9,005 | 91 | | |
| WEEKLY TOTAL | | | 8,097 | 9,005 | 908 | | \$62.00 |
| TOTAL YEAR-TO-DATE | | | | | 6,236 | | \$993.00 |

must be reported by the church as income on Form 1099-MISC (and by the worker on Schedule C). The worker is then able to deduct expenses on Schedule C regardless of whether he or she is able to itemize expenses on Schedule A. This is seen by some to be an advantage of reporting income taxes as self-employed. However, because the IRS considers most workers (including ministers) to be employees for income tax reporting purposes, those who report their income taxes as self-employed should not assume that they are unaffected by the limitations on the deductibility of employee business expenses. In fact, this is one of the primary reasons the IRS targets self-employed workers. If it succeeds in reclassifying self-employed workers as employees, then their business expenses are shifted from Schedule C to Schedule A. For employees who do not have enough deductions to itemize on Schedule A, this means they receive no deduction for any of their business expenses.

❖ **KEY POINT.** The IRS has ruled that a minister may be able to deduct business expenses in computing self-employment taxes on Schedule SE even though the expenses were not deductible in computing income taxes because the minister could not use Schedule A. *Revenue Ruling 80-110.*

❖ **KEY POINT.** Church staff members who report their income taxes as employees cannot deduct any of their unreimbursed business expenses if they have insufficient itemized deductions to use Schedule A. If their church reimburses some or all of their expenses under a nonaccountable arrangement, all of the reimbursements must be reported as taxable income, without any offsetting deduction. For this reason, churches should avoid nonaccountable reimbursement arrangements.

Church staff who are self-employed for income tax reporting purposes are not affected by the limitations on the deductibility of employee business expenses, since they can deduct all of their business expenses (only 50 percent of business meals and entertainment) directly on Schedule C.

Examples of nonaccountable arrangements

Here are some common examples of nonaccountable reimbursement arrangements that should be avoided. If you currently have any of these arrangements, it is recommended that you consider switching to an accountable arrangement.

- Your church pays a monthly vehicle allowance to ministers or lay staff members without requiring any accounting or substantiation.
- Your church reimburses business expenses without requiring adequate written substantiation (with receipts for all expenses of \$75 or more) of the amount, date, place, and business purpose of each expense.
- Your church only reimburses business expenses once each year. Business expenses must be accounted for within a

“reasonable time” under an accountable arrangement. Generally, this means within 60 days.

- Your church provides ministers or lay staff with travel advances and requires no accounting for the use of these funds.

EXAMPLE. Pastor B serves as a senior minister of a church and reports his federal income taxes as an employee. The church expects Pastor B to pay business expenses out of his own salary, so it reimburses none of Pastor B’s business expenses. In other words, all of Pastor B’s business expenses are unreimbursed. For 2007 Pastor B had total church compensation of \$35,000 and unreimbursed business expenses of \$3,000. He did not have enough itemized deductions to use Schedule A.

As an employee, the only way for Pastor B to deduct his unreimbursed business expenses is as an itemized deduction on Schedule A (to the extent that such expenses exceed 2 percent of his AGI). Since Pastor B does not have enough deductions to itemize on Schedule A, he cannot deduct any portion of his unreimbursed business expenses. According to IRS statistics, two-thirds of all taxpayers cannot use Schedule A. This means that two out of three taxpayers who report their income taxes as employees (or who would be classified as employees by the IRS in an audit) will be unable to deduct their unreimbursed business expenses or expenses reimbursed under a nonaccountable arrangement. This result can be avoided if a church simply adopts an accountable business expense reimbursement arrangement.

EXAMPLE. Pastor H receives a monthly car allowance of \$300. Pastor H is not required to account for the use of any of these funds. This is an example of a nonaccountable reimbursement arrangement. The church is reimbursing business expenses (through a monthly car allowance) without requiring any accounting or substantiation.

If Pastor H reports her income taxes as an employee (or as self-employed but is reclassified as an employee by the IRS in an audit) and has insufficient itemized deductions to use Schedule A, the following reporting requirements apply: (1) the church must report all of the monthly allowances (\$3,600) on Pastor H’s Form W-2; (2) Pastor H must report all of the monthly allowances (\$3,600) as income on her Form 1040; and (3) Pastor H cannot deduct any of her car expenses, since these are deductible only as itemized deductions on Schedule A.

This result is even worse than the previous example, since in this case all of the monthly car allowances are includable on Pastor H’s Form W-2, but she is unable to claim any offsetting deduction for her car expenses. This result can be avoided if a church adopts an accountable reimbursement arrangement. Also, note that a failure to report the \$3,600 as taxable income will expose

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ILLUSTRATION 7-2

WEEKLY TRAVELING EXPENSE AND ENTERTAINMENT RECORD
THIS IS NOT AN OFFICIAL INTERNAL REVENUE FORM

| EXPENSES | SUN. | MON. | TUES. | WED. | THURS. | FRI. | SAT. | TOTAL |
|--|------|-------|--------|--------|--------|-------|------|--------|
| 1. TRAVEL EXPENSES | | | | | | | | |
| Airport | | | | | | | | |
| Excess baggage | | | | | | | | |
| Bus, train | | | | | | | | |
| Cab, limousine | | | | | | | | |
| Excess baggage | | | | | | | | |
| Tips | | | | | | | | |
| Porter | | | | | | | | |
| 2. MEALS AND LODGING | | | | | | | | |
| Breakfast | | | 6 75 | 6 00 | 5 25 | 7 00 | | 25 00 |
| Lunch | | 9 75 | 10 00 | 9 25 | 8 25 | 8 50 | | 45 75 |
| Dinner | | 22 00 | 18 25 | 17 50 | | | | 57 75 |
| Hotel, motel | | 50 00 | 50 00 | 50 00 | 45 00 | | | 195 00 |
| <i>(Detail in Schedule B)</i> | | | | | | | | |
| 3. ENTERTAINMENT | | | | | | | | |
| <i>(Detail in Schedule C)</i> | | | | | | | | |
| | | | | | 50 00 | | | 50 00 |
| 4. OTHER EXPENSES | | | | | | | | |
| Postage | | | | | | | | |
| Telephone, telegraph | | 1 50 | | | | 1 00 | | 2 50 |
| Stationery, printing | | | | | | | | |
| Stenographer | | | | | | | | |
| Sample room | | | 15 00 | 15 00 | | | | 30 00 |
| Advertising | | | | | | | | |
| Assistant(s), model(s) | | | 20 00 | 20 00 | | | | 40 00 |
| Trade shows | | | | | | | | |
| 5. CAR EXPENSES (List all car expenses—the division between business and personal expenses may be made at the end of the year.) | | | | | | | | |
| <i>(Detail mileage in Schedule A)</i> | | | | | | | | |
| Gas, oil, lube, wash | | | | | | | | |
| Repairs, parts | | | | | | | | |
| Tires, supplies | | | | | | | | |
| Parking fees, tolls | | 4 00 | | | 3 00 | 3 00 | | 10 00 |
| 6. OTHER (Identify) | | | | | | | | |
| | | | | | | | | |
| TOTAL | | 87 25 | 120 00 | 117 75 | 111 50 | 19 50 | | 456 00 |

Note: Attach receipted bills for (1) ALL lodging and (2) any other expenses of \$75.00 or more.

SCHEDULE A—CAR

| | | | | | | | | |
|------------------|--|--------|--------|--------|--------|--------|--|-----|
| Mileage: End | | 57,600 | 57,620 | 57,650 | 57,660 | 57,840 | | |
| Start | | 57,445 | 57,600 | 57,620 | 57,650 | 57,660 | | |
| Total | | 155 | 20 | 30 | 10 | 180 | | 395 |
| Business Mileage | | 155 | 20 | 30 | 10 | 170 | | 385 |

SCHEDULE B—LODGING

| Hotel, motel | NAME | | | | | | | |
|--------------|-----------|-----------|-----------|--------|--|--|--|--|
| | CITY | | | | | | | |
| | Bay Hotel | Bay Hotel | Bay Hotel | Modern | | | | |
| | Albany | Albany | Albany | Troy | | | | |

SCHEDULE C—ENTERTAINMENT

| Date | ITEM | PLACE | AMOUNT | BUSINESS PURPOSE | BUSINESS RELATIONSHIP |
|-----------|--------|--------------------|--------|-------------------|-----------------------|
| August 9. | Lunch | John's Steak House | 15 00 | Discuss purchases | Smith Construction |
| | Dinner | Troy | 35 00 | | |

Pastor H, and possibly other members of the church board, to substantial excise taxes (called intermediate sanctions) if she is an officer or director. See Chapter 4, section A.3, for details.

3. ACCOUNTABLE REIMBURSED EXPENSES

❖ **KEY POINT.** A church's reimbursements of employee business expenses under an accountable plan are not reported as compensation on the employee's Form W-2 or 1040, and they are not taken into account in computing automatic excess benefits, as explained in Chapter 4, section A.3.

The adverse tax consequences associated with both unreimbursed and nonaccountable reimbursed expenses can be eliminated if a church adopts an accountable expense reimbursement arrangement. This is one of the most important components of the compensation packages of ministers and lay church employees.

If a church adopts an accountable reimbursement arrangement, none of the church's reimbursements needs to appear on an employee's Form W-2 (or 1040), and there are no expenses for the employee to deduct. The employee, in effect, accounts to his or her employer rather than to the IRS. This is the ideal way for churches to handle the business expenses of ministers and any other church worker.

To be an accountable plan, your employer's reimbursement or allowance arrangement must comply with all four of the following rules.

- **Business connection.** Your expenses must have a business connection—that is, you must have paid or incurred deductible expenses while performing services as an employee of your employer.
- **Adequate accounting.** You must adequately account to your employer for these expenses within a reasonable period of time (not more than 60 days after an expense is incurred).
- **Returning excess reimbursements.** You must return any excess reimbursement or allowance within a reasonable period of time (not more than 120 days after an excess reimbursement is paid). An excess reimbursement or allowance is any amount you are paid that is more than the business-related expenses you adequately accounted for to your employer.
- **Reimbursements not made out of salary reductions.** The income tax regulations caution that in order for an employer's reimbursement arrangement to be accountable, it must meet a reimbursement requirement in addition to the three requirements summarized above. The reimbursement requirement means that an employer's reimbursements of an employee's business expenses come out of the employer's funds and not by reducing the employee's salary.

Each of these requirements is explained in the following sections.

ADVANTAGES OF AN ACCOUNTABLE REIMBURSEMENT PLAN

The implementation of an accountable reimbursement plan by a church is an important component of compensation planning. Consider the following benefits of such a plan:

- Employees report their business expenses to the church rather than to the IRS.
- Staff members who report their income taxes as employees (or who report as self-employed and who are reclassified as employees by the IRS in an audit) avoid the limitations on the deductibility of employee business expenses. These include (1) the elimination of any deduction if the employee cannot itemize deductions on Schedule A (two-thirds of all taxpayers cannot), and (2) the deductibility of business expenses on Schedule A as an itemized expense only to the extent these expenses exceed 2 percent of the employee's adjusted gross income.
- The *Deason* allocation rule (discussed earlier and in section F) is avoided. Under this rule, ministers must reduce their business expense deduction by the percentage of their total compensation that consists of a tax-exempt housing allowance.
- The 50 percent limitation that applies to the deductibility of business meals and entertainment expenses is avoided. Unless these expenses are reimbursed by an employer under an accountable arrangement, only 50 percent of them are deductible by either employees or the self-employed. See IRS Publication 463.
- Ministers who report their income taxes as self-employed minimize the tax impact of being reclassified as an employee by the IRS in an audit. One of the reasons the IRS targets self-employed workers is that by reclassifying them as employees, the IRS forces the business expense deduction to be moved from Schedule C (where it is deductible even if the taxpayer cannot itemize deductions on Schedule A) to Schedule A (where it is deductible only if the taxpayer can itemize deductions). Since only one-third of taxpayers can use Schedule A, the IRS often collects more taxes by reclassifying self-employed workers as employees. But if a self-employed worker's business expenses are reimbursed under an accountable arrangement, the IRS has much less incentive to reclassify the person as an employee.

❖ **KEY POINT.** The income tax regulations that list the four requirements for an accountable plan refer to "employees." However, the regulations clarify that workers who are self-employed

may have their business expenses reimbursed by an "employer" under an accountable arrangement.

❖ **KEY POINT.** The IRS has issued audit guidelines for its agents to follow when auditing ministers. The guidelines state: "If [a reimbursement] arrangement meets all the requirements for an accountable plan, the amounts paid under the arrangement are excluded from the minister's gross income and are not required to be reported on his or her Form W-2. If, however, the arrangement does not meet one or more of the requirements, all payments under the arrangement are included in the minister's gross income and are reported as wages on the Form W-2, even though no withholding at the source is required."

❖ **KEY POINT.** Taxpayers must have sufficient documentary evidence to substantiate the amount, date, place, and business purpose of most business expenses, but they will not need a receipt for any expense of less than \$75.

Business connection

A reimbursement arrangement meets the business connection requirement if it reimburses employee expenses that could be claimed by the employee as a business expense deduction and that are paid or incurred by the employee in connection with the performance of services as an employee. The business connection requirement will not be satisfied if the employer "arranges to pay an amount to an employee regardless of whether the employee incurs or is reasonably expected to incur business expenses." See Tables 7-7 and 7-8.

Churches occasionally reimburse ministers for nonbusiness expenses. Such reimbursements, though they require an accounting, ordinarily must be included in the minister's wages for income tax reporting purposes, and they are not deductible by the minister. Such "personal, living, or family expenses" are not deductible, and the entire amount of a church's reimbursement must be included on the minister's Form W-2 and Form 1040.

Adequate accounting

You must adequately account to your employer for any business expense it reimburses. Following are the rules.

Adequate accounting—the general rule

Section 1.162-17 of the income tax regulations, which applies to all business and professional expenses *other than* listed property or transportation, travel, entertainment, and gift expenses, provides:

The employee [or self-employed person] need not report on his tax return (either itemized or in total amount) expenses . . . paid or incurred by him solely for the benefit of his employer for which he is required to account and does account to his employer and which are charged directly or indirectly to the

employer (for example, through credit cards) or for which the employee is paid through advances, reimbursements, or otherwise, provided the total amount of such advances, reimbursements, and charges is equal to such expenses. In such a case the taxpayer need only state in his return that the total of amounts charged directly or indirectly to his employer through credit cards or otherwise and received from the employer as advances or reimbursements did not exceed the ordinary and necessary business expenses paid or incurred by the employee. . . . To "account" to his employer . . . means to submit an expense account or other required written statement to the employer showing the business nature and the amount of all the employee's expenses (including those charged directly or indirectly to the employer through credit cards or otherwise) broken down into such broad categories as transportation, meals and lodging while away from home overnight, entertainment expenses, and other business expenses.

Adequate accounting—transportation, travel, entertainment, and gift expenses

The substantiation requirements for transportation, travel, entertainment, and gift expenses are set forth in section 1.274-5T(f) of the income tax regulations:

For purposes of computing tax liability, an employee [or self-employed person] need not report on his tax return business expenses for travel, transportation, entertainment, gifts, or with respect to listed property, 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 (for example, through credit cards) 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. . . . [A]n adequate accounting means the submission to the employer of an account book, diary, log, statement of expense, trip sheet, or similar record maintained by the employee in which the information as to each element of an expenditure or use [amount, time and place, business purpose, and business relationship] is recorded at or near the time of the expenditure or use, together with supporting documentary evidence, in a manner which conforms to all the "adequate records" requirements [described in section D of this chapter]. An adequate accounting requires that the employee account for all amounts received from his employer during the taxable year as advances, reimbursements, or allowances (including those charged directly or indirectly to the employer through credit cards or otherwise) for travel, entertainment, gifts, and the use of listed property.

Section 1.274-5T(f) goes on to provide that "an employee who makes an adequate accounting to his employer . . . will not again

be required to substantiate such expense account information," except in the following cases: (1) an employee whose business expenses exceed the total of amounts charged to his employer and amounts received through advances, reimbursements, or otherwise and who claims a deduction on his return for such excess; or (2) employees in cases where 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 where it cannot be determined that such procedures are adequate.

✳ **KEY POINT.** Note that an "adequate accounting" must be based on "adequate records." The adequate records requirement, including receipts for expenses of \$75 or more, is explained in section D of this chapter.

Adequate accounting—listed property

The tax code defines "listed property" to include automobiles, cellular phones, and computers (and peripheral equipment) that are used for business purposes. In order to substantiate a business expense for the use of any of these items of listed property, a taxpayer must prove (1) the amount of the expense; (2) the business use percentage (the percentage of total use of the listed property for the year that consisted of business use); (3) the date of the expense; and (4) the business purpose.

✳ **KEY POINT.** Accounting procedures will be considered inadequate to the extent that the employer does not require an adequate accounting from its employees or does not maintain such substantiation. The regulation cautions that "to the extent an employer fails to maintain adequate accounting procedures

TABLE 7-8
REPORTING TRAVEL, ENTERTAINMENT,
GIFT, AND CAR EXPENSES AND REIMBURSEMENTS

| IF THE TYPE OF REIMBURSEMENT ARRANGEMENT IS | THEN THE EMPLOYER REPORTS ON FORM W-2 | AND THE EMPLOYEE REPORTS ON FORM 2106 |
|---|--|---|
| AN ACCOUNTABLE PLAN WITH | | |
| <i>Actual expense reimbursements:</i> adequate accounting made within 60 days of each expense AND excess reimbursements returned within 120 days | No amount | No amount |
| <i>Actual expense reimbursements:</i> adequate accounting within 60 days of each expense AND return of excess reimbursements both required BUT excess not returned | The excess amount as wages in box 1 | No amount |
| <i>Per diem or mileage allowance up to IRS-allowed rate:</i> adequate accounting within 60 days of each expense AND excess reimbursements returned within 120 days | No amount | All expenses and reimbursements only if excess expenses are claimed; otherwise, form is not filed |
| <i>Per diem or mileage allowance up to IRS-allowed rate:</i> adequate accounting AND return of excess reimbursements both required BUT excess not returned | The excess amount as wages in box 1 (The amount up to the IRS-approved rate is reported only in box 12 [code L]. It is not reported in box 1.) | No amount |
| <i>Per diem or mileage allowance EXCEEDS IRS-allowed rate:</i> adequate accounting up to IRS-approved rate only AND excess reimbursements not returned | The excess amount as wages in box 1 (The amount up to the IRS-approved rate is reported only in box 12 [code L]. It is not reported in box 1.) | All expenses (and reimbursements reported on Form W-2, box 12) only if expenses in excess of the federal rate are claimed; otherwise, form is not filed |
| A NONACCOUNTABLE PLAN WITH | | |
| No requirement that the employee adequately account for business expenses within 60 days, or return excess reimbursements to the employer within 120 days (or both) | The entire amount as wages in box 1 | All expenses |
| NO REIMBURSEMENT PLAN | | |
| | The entire amount as wages in box 1 | All expenses |

it will thereby obligate its employees to substantiate separately their expense account information.”

✦ **KEY POINT.** Most churches implement an accountable reimbursement plan by having the church board pass an appropriate resolution containing the requirements summarized above. A reimbursement policy should be in writing, and it should clearly specify what expenses the church will reimburse. It also should describe the documentation and reporting that will be required. The church should retain the records and receipts presented by a minister in documenting the business nature and amount of business expenses he or she incurs (discussed more fully later).

✦ **KEY POINT.** A sample accountable reimbursement policy is reproduced as Illustration 7-3. Illustration 7-4 is a “short form” of this resolution.

Credit cards

The IRS has issued audit guidelines for its agents to follow when auditing corporate executives. The guidelines are instructive in evaluating the compensation packages provided to senior pastors and other church employees. The guidelines specify:

Many employers provide corporate credit cards to executives and other employees. The difference between the rank and file credit card accounts and those maintained for executives is generally the method of reimbursement. Top level executives are permitted to use the card at will. A monthly statement may be mailed directly to the employer and the account may be paid in full without the submission of a business expense report. Lower level executives are generally required to submit an expense report and are reimbursed for business related expenses. Personal expenses paid on behalf of executives are taxable fringe benefits that should be included in wages. The determination of whether the corporation has an accountable plan should be made at the beginning of the examination. If executives are not required to substantiate that the expenses charged to the corporate credit card were for business expenses, the reimbursement is considered to have been made under a nonaccountable plan and the entire reimbursement is taxable to the executive, and wages for employment tax purposes.

When employees should account for their business expenses

The income tax regulations specify that under an accountable reimbursement arrangement, an employee’s accounting or substantiation of business expenses and the return of any excess reimbursements must occur within a reasonable time. The regulations state that “the determination of a reasonable period of time will depend on the facts and circumstances.” However,

the regulations provide the following two “safe harbors” that will satisfy the reasonable time requirement:

Fixed date method. Under the fixed date method, business expenses will be deemed substantiated within a reasonable amount of time if done within 60 days after the expenses are paid or incurred, and excess reimbursements will be deemed to have been returned to the employer within a reasonable amount of time if done within 120 days after the expenses are paid or incurred.

Periodic statement method. Under the periodic statement method, an employer gives employees a periodic statement (not less often than quarterly) setting forth the amount by which the employer’s reimbursements exceed the amount of business expenses substantiated by the employee and requesting the employee to either substantiate the difference or return it within 120 days of the statement. Expenses that are substantiated or returned during the 120-day period satisfy the reasonable time requirement.

✦ **KEY POINT.** The regulations specify that if an employer has a plan or practice to provide amounts to employees in excess of expenses that are properly substantiated to avoid reporting and withholding on such amounts, the employer may not use either of the safe harbors for any years during which such plan or practice exists.

Tax withholding

Churches must recognize that business expense reimbursements or allowances paid to employees must be included on the employees’ Forms W-2 and are subject to income tax and FICA withholding when paid—*unless* the reimbursements are paid under an accountable reimbursement plan. The withholding requirements will not apply to ministers, who are exempt from tax withholding (unless they have elected voluntary withholding). Nonminister church employees will be covered by these same rules.

How churches pay for expense reimbursements

A church can fund an accountable reimbursement plan in a variety of ways. First, it can agree to reimburse all substantiated business expenses without limitation. Second, it can agree to reimburse substantiated expenses up to a fixed limit (e.g., \$4,000 per year). Any business expenses incurred by the minister in excess of this amount would be unreimbursed. Third, prior to 1991 many churches agreed to reimburse a minister’s substantiated business expenses out of his or her own compensation. This approach was popular, since it did not “cost” the church anything. Under this approach, churches typically agreed to pay a minister’s monthly business expenses out of the first weekly paycheck of the following month. Whatever was left after the substantiated expenses were reimbursed was classified as salary and reported on the minister’s Form W-2. Unfortunately, this practice was repudiated by the IRS in 1991. Salary reduction arrangements are fully addressed later in this chapter.