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Unit08. Employee Benefits and Deferred Compensation (PAK Chapter 9)

Self-employed persons and employees often incur work-related expenses. The IRS views these expenses as tax deductible because they are related to trade or business. Efforts to curb potential for tax abuse have resulted in a rather complex set of special rules and limitations for employment-related expenses.



Outline

1. Classification and limitations of employee expenses
2. Travel expenses
3. Transportation expenses
4. Entertainment expenses
5. Reimbursed employee business expenses
6. Moving expenses
7. Education expenses
8. Office in home expenses
9. Deferred compensation
10. Tax planning considerations
11. Compliance and procedural considerations

1. Classification & Limitations of Employee Expenses

1) Nature of the Employment Relationship

- Significant tax consequences flow from the characterization of a taxpayer as an employee vs. self-employed (independent contractor).
 - EXAMPLE: A self-employed individual will be responsible for self-employment tax which is much higher than an employee's share of Social Security tax.
- A taxpayer is considered an employee where the employer has the right to direct and control both the end result and the way the result is accomplished.
- Study PAK Examples 9-1, 9-2.

1. Classification & Limitations of Employee Expenses

2) Limitations on Unreimbursed Employee Expenses

- Unreimbursed employee expenses are classified as miscellaneous itemized deductions. The total of miscellaneous itemized deductions is reduced by 2% of adjusted gross income before any tax benefit is realized.
- Therefore, unreimbursed employee business expenses may provide no tax benefit if total miscellaneous itemized deductions do not exceed 2% of AGI, or if total allowable itemized deductions do not exceed the standard deduction. These expenses may also be affected by the phase-out of itemized deductions for certain high-income taxpayers. (See Chapter 17)
- Study PAK Examples 9-3, 9-4.



2. Travel Expenses

1) Deductibility of travel expenses

- The deductibility of travel expenses is dependent on the nature of the expenditure and whether the employee is reimbursed.
 - Travel expenses for self-employed individuals and fully-reimbursed employee travel expenses are deducted for AGI.
 - Unreimbursed employee travel expenses (whether insufficient reimbursement occurs or no reimbursement occurs) are deducted as a miscellaneous itemized deduction (deduction from AGI) subject to the 2% nondeductible floor.
- Study Table 9-1.



2. Travel Expenses

2) Definition of Travel Expenses

- Travel includes transportation, meals, and lodging related to a trade, business, or employee status incurred while away from the taxpayer's tax home.
- The deductible amount of travel expenses may be reduced if actual expenses are lavish or extravagant.
- Study PAK Examples 9-5, 9-6.

2. Travel Expenses

3) General qualification requirements

- Travel expenses related to a trade, business, or employee status are deductible if incurred while away from the taxpayer's tax home.
- Transportation costs for day trips are deductible, even if the taxpayer does not stay away from home overnight.
- Study PAK Examples 9-7, 9-8.

2. Travel Expenses

4) Business vs. pleasure

- Travel expenses on combination business/personal trips will be only partially deductible.
- If a domestic trip is primarily business, travel expenses to and from the business destination are deductible even though there is some personal time during the trip. Expenses for personal days will not be deductible.
- No deduction is allowed for the travel expenses of a companion (i.e., spouse) unless the companion is also an employee and the travel is business-related and otherwise deductible.
- Study PAK Examples 9-10, 9-11.

2. Travel Expenses

5) Foreign travel

- Even more stringent allocation rules apply to the deductibility of travel expenses on foreign business/personal trips.
- Deductions for foreign conventions are only allowed for "directly related" activities for which the taxpayer can prove that a meeting held outside North America is reasonable.



2. Travel Expenses

6) Additional limitations on travel expenses

- Additional limitations on deduction for travel expenses exist for educational travel, certain conventions and seminars, luxury water travel, and charitable travel.
- Study PAK Examples 9-13, 9-14.



3. Transportation Expenses

1) Definition and classification

- Commuting costs are generally nondeductible personal expenses.
- Commuting costs between multiple jobs for the same taxpayer will be deductible.
- Transportation costs from an employee's regular place of work to a temporary work site are deductible.
- If a taxpayer has a regular place of business, commuting costs between home and temporary work sites are deductible (i.e. a self-employed CPA travels directly from home to an audit client).
- Study PAK Examples 9-15, 9-16, 9-17.

3. Transportation Expenses

2) Treatment of automobile expenses

- Actual business automobile expenses can be deducted, or a standard mileage rate (55 cents per mile) effective January 1, 2009, can be elected.
- For newer cars the deduction for actual expenses will generally exceed the standard mileage deduction. This advantage may be offset by the hassle of required recordkeeping.
- Study PAK Examples 9-21, 9-22.

3. Transportation Expenses

2) Reimbursement of automobile expenses

- An employee can deduct actual automobile expenses in excess of an employer reimbursement.
 - EXAMPLE: If a taxpayer received a \$5,000 annual car allowance and incurred \$6,000 of actual automobile expenses, he could deduct the \$1,000 excess as a miscellaneous itemized deduction.
- Study PAK Example 9-23.



4. Entertainment Expenses

1) Disallowance

- Deductions for business-related meals and entertainment are limited to 50% of incurred cost.
 - Self-employed individuals and employees who are fully reimbursed may deduct entertainment expenses for AGI.
 - Unreimbursed employee entertainment expenses are deducted as miscellaneous itemized deductions subject to the 2% floor.
- Study PAK Examples 9-24, 9-25.

4. Entertainment Expenses

2) Classification of expenses

- Entertainment expenses must be "directly related" to business activity or "associated with" business activity to be deductible.
- "Associated with" entertainment expenses must occur directly before or directly after a bona fide business discussion. This definition includes the evening preceding business discussions and the evening of the day of business discussions.
- Study PAK Examples 9-26, 9-27.

4. Entertainment Expenses

3) Business meals

- Business meals must also meet the "directly related" or "associated with" tests to be deductible.
- The deductible portion of any business meal does not include any lavish or extravagant component.
- Study PAK Examples 9-28, 9-29.



4. Entertainment Expenses

4) Entertainment facilities and club dues

- Generally, no deduction is allowed for the costs incurred to maintain entertainment facilities (i.e. yachts, hunting lodges).
- Entertainment facilities provided for employees (i.e. swimming pool, golf course) are excluded from this rule.
- No portion of country club dues is deductible.
- Study PAK Example 9-31.

4. Entertainment Expenses

5) Business gifts and 6) Limitations on entertainment tickets

- Business Gifts
 - Generally, deductible business gifts are limited to \$25 per donee.
 - Study PAK Example 9-32.
- Limitations on Entertainment Tickets
 - Deductions for entertainment tickets are limited to 50% of the ticket's face value.
 - Study PAK Example 9-33.



5. Reimbursed Employee Business Expenses

- Under an accountable plan, reimbursements are excluded from the employee's gross income, and expenses are not deducted by the employee (the employer gets the deduction).
- Under a nonaccountable plan, reimbursements are included in the employee's gross income, and expenses are deductible as miscellaneous itemized deductions (subject to 2% floor and 50% disallowance for meals and entertainment).
- Study PAK Examples 9-34, 9-36, 9-37.

6. Moving Expenses

1) Distance and Duration Requirements

- Employment-related moving expenses meeting certain distance requirements and certain employment duration requirements are deductible. The new job must be at least 50 miles farther from the taxpayer's old residence than the old job site was from the old residence.
- Also the new employee must be employed full-time at the new location for 39 weeks out of the year following the move. Self-employed individuals must remain employed for double the employee standard.

6. Moving Expenses

2) Definition of Moving Expenses

- Self-employed individuals and employees deduct moving expenses for AGI.
- Reasonableness is the only limitation on direct moving expenses.
- Moving expenses include the cost of moving all household goods and the traveling costs for all family members. Only 24 cents per mile is allowed for each car driven.
- Study PAK Example 9-42.



6. Moving Expenses

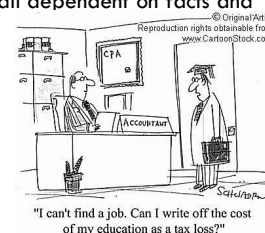
3) Non-deductible Indirect Moving Expenses

- Nondeductible Indirect Moving Expenses
 - House hunting trips, temporary living expense, and residence-related expenses are not deductible.
- Treatment of Employer Reimbursements
 - Only employer reimbursements in excess of deductible moving expenses for the same year are reported in gross income.
 - Study PAK Example 9-44.

7. Education Expenses

1) Classification of Education Expenses

- Education expenses may be nondeductible, offset against employer reimbursements, or be deductible for AGI or from AGI, all dependent on facts and circumstances.
- Study PAK Table 9-3.



7. Education Expenses

2) General Requirements for a Deduction

- Educational expenses are generally deductible if they maintain or improve skills used in employment, or meet legal or employer requirements for retention of employment.
- However, if the education is required to meet current minimum educational requirements of the taxpayer's job or qualifies the taxpayer for a new trade or business, the educational expenses are disallowed.
- Study PAK Examples 9-45, 9-46, 9-48, 9-49.

8. Office in Home Expenses

- General Requirement for a Deduction
 - The minimum requirements for a home office deduction include exclusive use on a regular basis as a principal place of business, or as a place for meeting with patients, clients, or customers. Employees must also prove the home office was for the convenience of the employer.
 - Study PAK Examples 9-50, 9-52.
- Deduction and Limitations
 - Home office deductions are limited by the gross income of the subject business activity. Unused expenses are carried forward subject to the same income limitations.
 - Study PAK Example 9-53

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9. Deferred Compensation

1) Qualified pension and profit-sharing plans



- Qualified retirement plans, such as pension plans, profit-sharing plans, and stock bonus plans, provide immediate tax deductions for employers while deferring taxes for employees.
- Study PAK Example 9-54; Topic Review 9-2.

9. Deferred Compensation

2) Qualification requirements for a qualified plan

- Pension plans
 - Defined benefit (DB)
 - Defined contribution (DC)
- Profit-sharing plans
 - Include 401(k) plans
- Stock bonus plans
 - DC plan where investments invested in company stock
- Must be for employees' exclusive benefit
- Does not discriminate in favor of highly compensated employees
 - >5% owners or comp >\$110K
- Contributions proportionate to comp
- Coverage requirements
- Vesting requirement

9. Deferred Compensation

3) Tax treatment to employees and employers

- Generally, employer contributions to a qualified plan are immediately deductible, and such amounts (plus accumulated income) are not taxable to the employee until received.
- Study PAK Example 9-57.



9. Deferred Compensation

4) Nonqualified plans

- Often used to provide incentives or supplementary retirement to execs
- No nondiscrimination or vesting rules
- Employer does not receive deduction until benefits available to employee
- Unfunded compensation plans
- Restricted property plans

9. Deferred Compensation

5) Employee Stock Options

- Incentive stock options and nonqualified stock option plans are used by corporate employers to attract and retain key employees.
- Qualified options
 - No tax to employee on exercise date
 - LTCG treatment when employee sells stock
 - (amount realized – exercise price)
 - Employer receives no deduction
- Nonqualified Stock Options (NQSOs)
 - Employee recognizes compensation income on exercise date
 - (FMV – exercise price)
- Employer receives deduction on exercise date
- Study PAK Example 9-62; Topic Review 9-4

9. Deferred Compensation

6) Plans for self-employed individuals

- H.R. 10 plans
 - Also called Keogh plans
- Generally same contribution and benefit limits as other qualified plans

Form (Rev. July 2007)	SS-4	App (For use by governments)
Department of the Treasury Internal Revenue Service		
▶ See		
1	Legal name of entity (or individual)	
2	Trade name of business (if any)	
4a	Mailing address (room and suite or apartment number, if any)	

9. Deferred Compensation

7) Traditional IRA (1 of 2)

- Fully deductible IRA contributions (lesser of \$5,000 or earned income) are available only to two groups of taxpayers:
 - taxpayers who are not active participants in a qualified employer retirement plan; and
 - taxpayers who are active participants, but their AGI is \$55,000 or less (single) or \$89,000 or less (married/filing jointly).
- Partial deductions are available to active participants with AGI's less than \$65,000 (single) or \$99,000 married/filing jointly. The deduction is phased out ratably over the \$10,000 AGI range.
 - EXAMPLE: A single active participant with \$60,000 AGI could make a \$2,500 deductible contribution.

9. Deferred Compensation

7) Traditional IRA (2 of 2)

- Nondeductible IRA contributions can be made by any taxpayer to the extent disqualified from making a deductible contribution.
 - EXAMPLE: A single active participant with \$66,000 AGI could make a \$5,000 nondeductible contribution to an IRA.
- A nonworking spouse may contribute up to \$5,000 as a deductible (or nondeductible) contribution to an IRA under the same rules as the working spouse.
- Study PAK Examples 9-66, 9-67, Topic Review 9-5.

9. Deferred Compensation

8) Roth IRA (1 of 2)

- In a Roth IRA no contribution is deductible, but all distributions (including earnings) are nontaxable.
- The maximum contribution to a Roth IRA is \$5,000. As with a traditional IRA, the ability to contribute is phased-out over certain AGI levels:
 - Single, between \$105,000 and \$120,000
 - Married/Joint, between \$166,000 and \$176,000.

9. Deferred Compensation

8) Roth IRA (1 of 2)

- No more than \$5,000 can be contributed in total to a traditional IRA and/or a Roth IRA.
- To achieve full nontaxability on a Roth IRA, there is a five-year holding period requirement.
- Pre-existing traditional IRAs can be rolled over into a Roth IRA. The tax on accrued income must be paid on rollover, but no penalty tax is extracted.
- PAK Examples 9-71, 9-73.

9. Deferred Compensation

9) Coverdell Education Savings Accounts (CESA)

- The CESA is available to cover qualified education expenses (including elementary, secondary, and higher education). The maximum contribution is \$2000 per year/per beneficiary under age 18.
- CESAs can be set up in addition to any traditional or Roth IRAs.
- No deduction is available for a CESA, but all qualified distributions are nontaxable.
- The right to contribute to a CESA is phased-out using the same AGI levels as used for the Roth IRA.
- Beneficiaries cannot claim an exclusion from a CESA for the same expenses used in any year to calculate a HOPE Scholarship Credit or Lifetime Learning Credit.
- PAK Examples 9-74, 9-75.

9. Deferred Compensation

10) Health Savings Accounts

- HSAs are available to certain individuals to accumulate funds on a tax free basis to pay qualified medical expenses.
- PAK Examples 9-76, 9-77.



9. Deferred Compensation

11) Simplified Employee Pensions (SEP), 12) SIMPLE

- Simplified employee pensions (SEP)
 - For small companies
 - Employers make contributions that are tax-deductible
 - Reduced administrative complexity
- SIMPLE retirement plans (SIMPLE)
 - Savings incentive match plan for employees
 - For employers with < 100 employees who received at least \$5,000 in compensation

10. Tax Planning Considerations

- Moving Expenses (Examples 19-78, 19-79)
 - Employees may want to negotiate tax protection from their employer in situations where moving reimbursements will exceed deductible moving expenses.
- Providing Nontaxable Compensation to Employees
 - Nontaxable fringe benefits and tax-deferred compensation plans are valuable to employees while providing current deductions to the employer.
- Rollover of Traditional IRA to Roth IRA
 - The advisability of rolling over funds from a traditional IRA to a Roth IRA is based on the following factors:
 - (1) anticipated marginal tax rate at retirement,
 - (2) taxpayer's age, and
 - (3) availability of funds to pay tax.

11. Compliance and Procedural Considerations

- Substantiating Travel and Entertainment Expenses
 - Travel and entertainment expenses may be disallowed if the taxpayer does not maintain adequate records.
- Reporting Employee Business Expenses
 - Employee business expenses are reported on Form 2106.
- Reporting Moving Expenses
 - Moving expenses are reported on Form 3903.
- Reporting Office in Home Expenses
 - Home office expenses are reported on Form 8829.
- Qualification of Pension and Profit-Sharing Plans
- Reports for qualified retirement plans are required to be filed with the IRS, and in some cases with the Department of Labor.

Addition Things to Study

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- Answers to Selected Textbook Problems:
 - <http://www.fcs.utah.edu/~fan/fcs5530/Answers%20to%20Selected%20Problems/AnswersSelectedUnit08.pdf>
- Self-study Quizzes on Publisher's website:
 - http://wps.prenhall.com/bp_pope_fedtax_2010/120/30827/789196_1.cw/index.html
- Homework Assignment for Unit08 (Graded)
 - PAK Chapter 9 Problems: 9-58, 9-67, 9-73, 9-74, 9-75, 9-77
 - Please go to Week 9 folder on course Homepage to find the link. You can also access it directly through the "Assignments" link.
- Discussion Topic for Unit08 (Graded)
 - Don't forget to post your thoughts on the discussion topic of the week.
 - Go to the Week 9 folder on course Homepage to find the link. You can also access it directly through the "Discussions" link.