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TO: Janice Davis, Chief Financial Officer

FROM: Leslie Ward, City Auditor

DATE: October 18, 2004

SUBJECT: Proposed Changes in City Policies and Procedures for Travel and Training Expense Reimbursements

We reviewed the Department of Finance's proposed changes to City policy and procedures on travel and training expense reimbursements. Our comments and recommendations are made to bring the City's travel policies in line with current best practices, to ensure compliance with the Internal Revenue Code (IRC) provisions for accountable and non-accountable plans, to ensure that employees are fairly reimbursed for reasonable expenses incurred while traveling, and to simplify administration of travel expense advances and reimbursements.

In reviewing the proposed changes, we compared them to best practices and to the IRC. The proposed changes need significant revision to make them consistent with these criteria.

Per diems are considered a best practice and have many advantages. Per diems, established by either the federal government or an independent third party source, promote both efficiency and cost savings. The Governmentwide Per Diem Advisory Board Report, issued by the federal government's General Services Administration, Office of Governmentwide Policy in July 2003, cited meal per diems, paid as a lump sum allowance, as a best practice. Per diems are used throughout the federal government and in 42 states that have adopted a per diem methodology for reimbursing employee travel expenses. Numerous benefits associated with paying flat rate per diems without receipts for meal and incidental expenses include:

- cost control;
- efficiency in processing travel vouchers;
- travelers are able to obtain meals at prices consistent with market conditions;
- travelers are free to select expensive restaurants or menu items, but the government's cost is capped;
- easy to audit, voucher, and perform accounting;
- process is repeatable and standard across locations; and
- politically acceptable to government, taxpayers, and travelers.

Internal Revenue Regulations exempt travel reimbursements from being taxed under certain conditions. The IRC states that all payments and reimbursements to employees for expenses incurred while traveling¹ are subject to all employment taxes and must be included as wages on the employee's Form W-2 *unless* they are paid under an "accountable plan", which requires that *all* three of the following tests be met:

- There must be a business connection. Acceptable proof for meeting this requirement is whether the expense would be an allowable business expense deduction on the employee's tax return.
- The employee must substantiate the expense by providing records showing the amount of the expense, the time and place of the travel, and the business purpose. The IRS allows a standard mileage rate and a per diem plan to satisfy this test, without receipts, *if the amounts are paid at or below the federal mileage rate and the federal per diem rate for the location where the expense was incurred.* The federal mileage rate and per diem rates for hotel and meal/incidental expenses are published annually in IRS Publication 1542, Per Diem Rates (For Travel Within the Continental United States).²
- The employee must return excess amounts of travel advances that are not substantiated to the employer.

Failure of an employee to substantiate his expenses and return to the employer within a reasonable period³ the amount by which a travel advance exceeds actual expenses results in a violation of the accountable plan rules. Noncompliance with the accountable plan rules requires the employer to report the entire travel advance as income to the employee and to withhold the appropriate taxes.

Deducting unresolved travel advances from employee paychecks promotes compliance. The federal government has established a requirement to ensure its employees comply with the accountable plan rules. Federal regulations require employers to take alternative steps to collect debts of employees who do not pay back their travel advances, including deducting the debt from the employee's salary or other amount owed the employee (41 CFR 301-71.307).

Proposed changes affect both the Code of Ordinances and administrative procedures.

The Department of Finance proposes four changes to the Atlanta Code of Ordinances:

- That lodging expenses for hotels not exceed the "federal discount rate" when applicable and that the term "standard hotel/motel" be deleted.
- That mileage be reimbursed at the Internal Revenue Service's current year's reimbursement rate.

¹ The Internal Revenue Service defines travel as being away from the general area of the employee's tax home substantially longer than an ordinary day's work and requiring the employee to need to sleep or rest to meet the demands of his/her work while away from home. Napping in a car does not satisfy the sleep requirement and the employee does not have to be away from his/her tax home for an entire day or from dusk to dawn as long as his/her relief from duty is long enough to get necessary sleep or rest. (Source: IRS Publication 463, Travel, Entertainment, Gift, and Car Expenses)

² The per diem rates, along with updates that during the year, can be found on the website of the General Services Administration at <http://policyworks.gov/org/main/mt/homepage/mtt/perdiem/travel.htm>.

³ The IRS describes a "reasonable period" as one in which an employee has adequately accounted for expenses within 60 days after they were paid or incurred and returned any excess reimbursement within 120 days after the expense was paid or incurred. (IRS Publication 463, Travel, Entertainment, Gift, and Car Expenses).

- That the current \$35.00 allowance for travel time be deleted and allowable expenses for travel be included with the cost of transportation.
- That a per diem range of \$35.00 to \$59.00 be allowed and that the Code specify what expenses are allowed in the per diem.

Additionally, the Department of Finance's proposed administrative procedures for payment would require:

- That Accounts Payable put a "remit hold" on employee vendor files for the employees who fail to return excess amounts of travel advances in order to prevent the employee from receiving future travel advances or reimbursements for out-of-pocket expenses incurred on behalf of the City.
- That employees submit receipts for every expense for which reimbursement is claimed, including meal and incidental expenses.

We have several concerns regarding the proposed changes to the Atlanta Code of Ordinances and procedures:

1. The use of the term "federal discount rate" is inconsistent with the term "federal lodging rate" that is used by the IRS. Using language that is inconsistent with the source from which the guidance is taken may cause confusion for City employees who are trying to implement the new procedures.
2. The recommended per diem range of \$35.00 to \$59.00 presents several issues:
 - The proposed per diem rates are not locality based, which the IRS explicitly states as a requirement for satisfying the accountable plan rules.
 - The proposed per diem rates are inconsistent with the rates provided in IRS Publication 1542. The \$35.00 rate exceeds the minimum rate allowed by the IRS, and the \$59.00 exceeds the maximum per diem rate allowed.⁴ Additionally, the proposed per diem rates would continue to include expenses other than meals and incidentals.
 - Providing specific per diem rates in the Atlanta Code of Ordinances does not ensure that the City's rates will be consistent with those allowed by the IRS at any given time.
 - Providing specific per diem rates does not ensure that the rates will reflect changes in the economy, and it imposes a requirement for a new ordinance to be adopted whenever a rate change is needed. This is a significant concern because the rates currently in the Atlanta Code of Ordinances have not been updated for almost 20 years. Using the federal rates would eliminate the need for the City to periodically update the rates because the federal government would do it for us.
 - Reimbursement would continue to be based on actual expenses with the per diem rates serving as a maximum daily reimbursement amount. This is inconsistent with the definition of a per diem rate, which the IRS defines as a *fixed amount* [emphasis added] of daily reimbursement.
 - Using per diem rates that are not locality based and include reimbursement for expenses other than meals and incidentals promotes inequitable reimbursement

⁴ The IRS provides a minimum rate of \$35.00 for locations not specifically identified as high-cost cities, but only when the "high-low" substantiation method is used to reimburse employee travel expenses. This method is not discussed in this memorandum because it has not been proposed by the Department of Finance as a method for reimbursing employee travel expenses.

among employees. Those who travel to high-cost cities have to spend more for their meals, which leaves less of the per diem to pay for other business expenses. This could result in those employees having to personally absorb the cost of some expenses that should be separately reimbursed.

3. The proposed procedures do not ensure compliance with the IRS regulations for an accountable plan:
 - The procedure of placing a remit hold on the employee vendor file does not ensure that the employee will account for and return any excess travel advance within a reasonable period. Remit holds do not provide sufficient incentive for employees to respond to requests from the Department of Finance to reconcile their travel advances.
 - The proposed changes do not include either a requirement or a procedure for the City to report travel advances as income to the employee and for the appropriate taxes to be withheld when a travel advance is not accounted for within a reasonable period. Because travel advances and reimbursements are paid through Accounts Payable, the City needs a specific procedure for reporting these payments through the payroll system on an employee's W-2. Alternatively, the City could recover the full amount of the travel advance as an after-tax deduction from the employee's pay check.
4. The requirement for receipts to be submitted for all expenses also presents several issues:
 - It is inconsistent with the concept of a per diem rate, which should allow reimbursement for meal and incidental expenses based on a *fixed amount* for the location rather than on itemized receipts.
 - It is inconsistent with best practices because reconciling individual receipts with the travel voucher is an administratively burdensome and costly process.
 - It does not ensure that employees are fairly reimbursed for expenses incurred while traveling because it precludes employees from being reimbursed for expenses for which receipts are often not provided (e.g., fees or tips for baggage carriers or hotel maid service). Expenses such as these are allowed to be reimbursed as "incidentals," without receipts, under the IRS guidelines for use of per diem rates.
5. Neither the current Code language nor the proposed changes include a provision to specify what expenses may be reimbursed for employees who incur expenses in the normal course of City business or while attending training that does not require an overnight stay.

Revising the City Code of Ordinances and administrative procedures will promote consistency, cost savings, and tax code compliance. Revisions to the City Code are needed to ensure compliance with the Internal Revenue Code and best practices, as well as to fairly reimburse employees for reasonable expenses incurred while traveling. We recommend the following changes in the Finance Department's proposal:

1. Define "travel" consistent with the IRS requirements that it include an overnight stay.
2. Establish a meal and incidentals per diem at the "prevailing federal rate for the location" and mileage reimbursement at the "prevailing federal rate."
3. Specify that hotel accommodations are limited to the federal lodging or convention rate, plus taxes. The Code should require employees to request a government rate when making their hotel reservations.

4. Specify that the per diem rate will include meals and incidental expenses, as defined by the IRS, and that other reasonable travel and business expenses (e.g., ground transportation, airport parking, laundry, business telephone calls) will be reimbursed separately when supported by receipts.
5. Establish a provision for reimbursing employees for training and business expenses incurred, other than when in an overnight travel status.

We also recommend the following changes to the administrative procedures proposed by the Finance Department:

6. Notify departments, at least annually, where they can locate the most current information regarding the prevailing federal per diem rates.
7. Notify departments of the current federal mileage rate. The notification should be provided when the annual rates are posted, and any interim changes should be provided to departments in a supplemental notification.
8. Provide timelines for employees to account for their travel expenses and return any excess travel advance to the Department of Finance. The timelines must be consistent with those provided by the IRS for compliance with the rules of an accountable plan.
9. Establish a procedure to deduct travel advances from employees' paychecks when an employee has not reconciled the travel advance within 30 days of his return. This should include a procedure for notifying affected employees that the deduction will be made from their pay check on [date] unless the travel advance is reconciled and any excess amount is returned at least seven days prior to that date. Alternatively, the Department of Finance could elect to establish a procedure to report the travel advance as income to the employee and withhold the appropriate taxes. This procedure would also require that employees be notified of the action that will be taken if their travel advance is not reconciled prior to a specific date. The notification should include a statement that the action is required to ensure compliance with Internal Revenue Service requirements for reporting taxable income to employees.
10. Delete the requirement for individual receipts to be submitted for meal and incidental expenses (receipts would still be required for other reimbursable expenses).
11. Add procedures to reimburse employees for business expenses incurred other than when in a travel status.

Thanks for the opportunity to comment. Please call me on ext. 6804 or Harriet Richardson on ext. 6750 if you have questions or desire any additional information from us.