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Supreme Court Affirms Employer's Ability to Reimburse Employee Business Expenses with Additional Income

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On Monday, November 5, 2007, the California Supreme Court issued its long-awaited decision in *Gattuso v. Harte-Hanke Shoppers, Inc.*, confirming an employer's ability to satisfy its obligation under Labor Code section 2802 to reimburse employees for all their business expenses with additional income. In *Gattuso*, the Supreme Court held nothing in Labor Code section 2802 precluded an employer from paying additional income to cover employee business expenses as long as there was an agreement containing a method or formula to determine how much of the compensation was intended to cover employee business expenses. However, the additional compensation must be adequate, after taxes, to cover all of the business expenses incurred by the employee.

In our February 2007 [Employment Law Commentary](#), we described the *Gattuso* decision as issued by the Court of Appeal. We also reviewed the Labor Commissioner's proposed regulation dealing with how employers could satisfy their section 2802 regulations. Notably, these proposed regulations prohibited reimbursement for employee business expenses with increased compensation. These regulations have not been finalized; the Labor Commissioner has until the end of December 2007 to issue them or they will expire.

The *Gattuso* Decision

The Supreme Court's decision in *Gattuso v. Harte-Hanke Shoppers, Inc.* was unanimous and represents a slight modification of the Court of Appeal's decision described in the attached February 2007 [Employment Law Commentary](#).

Labor Code Section 2802 provides:

An employer shall indemnify his or her employee for all necessary expenditures or losses incurred by the employee in direct consequence of the discharge of his or her duties, or of his or her obedience to the directions of the employer, even though unlawful, unless the employee, at the time of obeying the directions, believed them to be unlawful.

Briefly, the employer in *Gattuso* employed two types of salespersons: inside and outside salespersons. It compensated the outside salespersons at a higher rate of pay, arguing that the higher rate of pay was intended to reimburse the outside salespersons for private vehicle costs and other business expenses. The plaintiffs argued that Labor Code section 2802 did not allow an employer to reimburse employees with additional salary; there had to be a "correlation" between the employee business expenses and the reimbursements.

Justice Kennard rejected plaintiffs' contentions and held that there is nothing in the language in Labor Code section 2802 that precludes an employer from paying an employee additional compensation in order to reimburse employees for their legitimate business expenses under section 2802. The Supreme Court held that an employer can comply with section 2802 when it

reimburses its employees for their business expenses with additional income if there is a formula or method in place that allows the employee and enforcement agencies to determine what portion of the compensation was intended to reimburse employees for their business expenses. However, the employer must take into account the employee's tax obligations on the additional income in order to determine whether the remaining compensation fully reimburses the employee for all incurred business expenses.

In her opinion, Justice Kennard reviewed the various methods available for employers to satisfy their section 2802 obligations in the context of employees' use of their own automobiles for business. The first method she suggested is reimbursement for actual expenses, which she found to be the most accurate but also the most burdensome considering the varying costs attendant to the very different types of cars employees have. The second method is mileage reimbursement, which she found to be less accurate but also less burdensome. The third method she suggested involved lump-sum payments such as a per diem, a car allowance or a gas stipend. She noted that both the mileage reimbursement and the lump-sum payment were subject to negotiation by the parties but that under Labor Code section 2804 any such agreement would be nullified if it did not provide for full reimbursement of all the employees' expenses. Justice Kennard wrote:

Because wages and expense reimbursement are conceptually distinct and subject to different statutory and sometimes also contractual restraints, an employer may not combine the payments for both in a way that would seriously hamper or effectively preclude enforcement of the various statutory and contractual obligations.

This does not mean, however, that an employer is prohibited from combining wages and business expense reimbursements in a single enhanced employee compensation payment or from discharging its section 2802 business expense reimbursement obligations through an increase in base salary or in commission rates (or an increase in both salary and commission rates). It simply means that the employer must provide some method or formula to identify the amount of the combined employee compensation payment that is intended to provide expense reimbursement.

Accordingly, as long as the employer can demonstrate that the enhanced compensation earmarked to cover employee business expenses is sufficient, after taxes, to cover those expenses the employer will have satisfied its section 2802 obligation to its employees.

Labor Commissioner Regulations

The Labor Commissioner regulations described in the attached *Employment Law Commentary* prescribe how employers must reimburse employees for their employee business expenses involving mileage reimbursement, employer-provided vehicle costs, per diem expenses, and other travel expenses. Because these regulations prohibit the type of reimbursement method approved by the Supreme Court in *Gattuso*, it is highly unlikely that they will be issued in their current form. Whether they will be amended consistent with *Gattuso* or simply allowed to expire at the end of December 2007 remains to be seen.

Conclusion

While the Supreme Court in *Gattuso* permitted the reimbursement of employee business expenses with additional income, employers need to be very careful, as noted in our previous *Employment Law Commentary*, in devising and monitoring these types of reimbursement policies. First, the portion of the compensation that is intended to cover employee business expenses must be specifically described so that both the employee and the enforcement agencies can determine what amount is intended to cover the expenses. Moreover, the reimbursement amount is an after-tax figure and, accordingly, employers will need to be sure that the after-tax amount paid to a particular employee covers all of that employee's business expenses. With these caveats, if a particular situation makes this reimbursement method appropriate and efficient, then the Supreme Court's decision in *Gattuso* specifically allows it.