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Employee Expense Reimbursement/Per Diem Policies – Practical Considerations When Using The Services of Contingent Workers

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Although employees are subject to income and employment taxes on amounts paid to them as compensation, employees are not taxed on amounts paid to them as reimbursement of substantiated business expenses, including for meals and other incidental expenses while working away from home. [1] Employers can reimburse employees based upon documents substantiating the travel and related expenses. Alternatively, to simplify record-keeping for employers and employees, employers can provide, in certain circumstances, employees with a per diem allowance for lodging, meals, and incidental expenses incurred when traveling in an amount that does not exceed guidance approved annually by the Internal Revenue Service. Such a per diem allowance, commonly referred to as a *qualified per diem plan*, is deemed to satisfy the expenditure substantiation requirement without the need to maintain detailed records and receipts for expenditures. Nevertheless, the employee must still maintain a log recording the days worked away from home, the location where the services are performed, and the business purposes of the travel, and provide the log to the employer.

Many entities that utilize the services of contingent workers for specific or limited duration projects utilize the services of staffing firms and we will refer to them herein as customers of staffing firms. If a per diem plan is not a qualified per diem plan, the employee will be subject to various taxes and reporting obligations on the per diem payments, and could also lose his or her deduction for the expenses at issue. However, it is not just the employee who is at risk for participating in a non-qualifying per diem plan. The employer and potentially a customer using a staffing firm may be penalized for not properly withholding and paying employment related taxes on the disqualified per diem amounts, and for not properly reporting wages on a W-2. Such an employer and potentially a customer using a staffing firm may not be able to take a business expense deduction for the amounts at issue, and may not be able to avail itself of a compensation deduction on the re-characterized amounts. [2]

Merely interposing a per diem plan does not in and of itself make such payments tax-free to workers. Since a disqualified per diem plan affects the employee, the employer and potentially the customer, abuses and missteps should be avoided and the following requirements must be met:

? Per Diem Allowances Are Not Salary Alternatives. [3] Per diem policies may not be constructed to provide an alternative label for what is salary. Employees may not be offered the choice to accept a higher salary with no per diem or a lower salary with per diem so that the total compensation paid under either approach is substantially the same. Thus, the split of wages versus per diem allowances should not be at anyone's subjective discretion, similar jobs should be provided similar allowances, and the salary component should be comparable to the salary

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offered to local employees or other employees who are not eligible for per diem.

? *Business Connection Requirement.* Per diem allowances may only be used for qualifying traveling expenses. Qualifying traveling expenses are "ordinary and necessary" business expenses incurred, or that are reasonably expected to be incurred, by an employee for lodging, meal, and incidental expenses (or for meal and incidental expenses) for travel away from home in connection with the performance of services as an employee. Also, the per diem allowance must be reasonably calculated not to be greater than the amount of the expenses (or the expected expenses) that would otherwise be allowable deductions if incurred by the employee. [4]

? *Substantiate that the Employee is Away from His/Her "Tax Home".* Per diem allowances are only nontaxable as long as the employee is traveling sufficiently far away from his/her "tax home." The employee should establish that he/she in fact has a tax home and the location of the tax home in order to be eligible for business expense reimbursement. Such substantiation may include certification of the address used on the employee's most recent tax return, the address on the employee's driver's license, the address used by the employee on the job application, or a copy of the employee's lease of his "tax home" residence.Employers should be wary where the address on the employment application is inconsistent with the tax home or where the employee's prior work history does not indicate employment at the tax home.

- A customer using a staffing firm should make certain that the staffing firm is not arbitrarily allocating worker compensation between salary and per diem where the customer is paying the staffing firm a fixed daily or hourly amount based upon the applicable job classification irrespective of the distance between the work location and the employee's principal residence.

? *Does the Employee have a Tax Home?* It is possible for an employee not to have a tax home. If an employee habitually obtains temporary work assignments in different locations, such employee may not have a tax home. The result of not having a tax home is that an employee will not be considered to be working away from home and will not be eligible for the favorable tax treatment given to per diem arrangements. Employers should review the employee's prior work history to determine that the employee had sufficient work in the locale of his/her tax home to establish it as a regular or principal place of business. If the employee has no regular or principal place of business, that employee's "tax home" will usually be his/her residence, assuming a regular place of residence is maintained in a real and substantial sense. An employer should review the employee's economic and social ties to the area, including the degree of historical business activity at the claimed tax home, the extent of the employee's duplicated living costs (e.g., rent, utilities, etc.) and other evidence of ties to the community (e.g., family members, and the extent the employee's possessions are stored at the alleged "tax home").

- A customer using a staffing firm should make certain that the staffing firm has adequate policies and procedures in place to determine the tax home of any worker receiving per diem payments or accountable expense reimbursements.

? *Assignments Need to be Temporary.* [5] Expenses relating to job assignments that are treated (for purposes of these rules) as lasting more than one year are not eligible for tax exemption under the per diem tax rules. If employment at a work location is realistically expected to last (and does in fact last) for one year or less, the employment is generally treated as temporary. Otherwise, it is generally treated as not temporary. To prevent unanticipated tax consequences, the employer should determine the temporary or long-term nature of the assignment before assigning an employee to a project that involves long-term travel. If, at the start of an

assignment, the assignment is realistically expected to last one year or less, but later the employment is realistically expected to exceed one year, the employment is treated as temporary until the date that the expectation changes, and as not temporary after that date. Also, if at the start of an assignment at one location the assignment is realistically expected to last less than one year (e.g., ten months) and, at the end of the tenth month, the employee is assigned to a subsequent assignment at the same location that is expected to last six months, the assignments may be viewed together and neither may be considered to be temporary. This is because the one-year rule requires the employer to look at the total time spent at the temporary location. The employment must also not be indefinite and the term of the assignment should be documented.

Staffing firms and customers using staffing firms should also take note of prior or subsequent assignments the employee might have had, or may later have, in evaluating whether per diem is appropriate.

- A customer using a staffing firm should advise the firm at retention for a particular position of the expected time duration or whether the duration is indeterminate. The customer should also promptly advise the staffing firm of any change in the project duration expectations.

? *Breaks in Assignments do not Always Restart the Clock.* Employers need to make sure that any breaks in time between jobs at the same work location are respected and are not viewed as a "work-around" for the one-year rule discussed above. The Internal Revenue Service has issued guidance providing that breaks of three weeks or less may not be sufficient, but that breaks of seven months or more may be sufficient. [6] The employee's prior work history should be scrutinized to determine the location of the employee's last employment.

- A customer using a staffing firm should monitor that contingent workers are not switching from one staffing firm to another on an annual basis merely to disguise the fact that the project duration will exceed one year or the possibility that the worker's tax home will have changed to the employer's work location.

? *Certain Record Keeping Required for Per Diem Plans.* Although the need to substantiate expenditures and retain receipts is alleviated if the per diem reimbursement is paid pursuant to a qualified per diem plan, the employee must still maintain a written record of the time, place, and business purpose of the expense. For all other expense reimbursement plans, employees must substantiate their expenses within a reasonable time (ideally within 60 days after the expense is paid or incurred). Since the employee must provide the employer with copies of such records, staffing firms should institute a procedure to require that such information be provided on a regular basis.

? *Limited Repayment Requirement for Certain Per Diem Plans.* The general rule for business expense reimbursement plans is that employees need to repay (within a reasonable time, ideally within 120 days after the expenses are paid or incurred) any reimbursement in excess of the substantiated amount. If the plan is a qualified per diem plan, i.e., it meets all of the above requirements, the employee does not have to substantiate the amount expended and therefore would not have to repay the employer if the per diem reimbursement exceeds the employee's actual expenses. If the plan meets all of the above requirements except that the per diem rate exceeds the applicable federal per diem rate, the employee will also not be obligated to return the excess of the reimbursement over the actual expenditure; however, such excess will be taxable income to the employee. If, on the other hand, a per diem payment relates to days of travel with respect to which the employee cannot verify the time, place, and business purpose of the expense, the employee must be obligated to repay to the employer within a reasonable time the per diem paid for such unverified days.

? Anti-Abuse Rules Apply: Even if the technical requirements for per diem policies appear satisfied, if an expense reimbursement arrangement evidences a pattern of abuse, all payments under the arrangement will be disqualified (and therefore treated as normal wages, subject to all applicable compensation tax rules). Employers should therefore be careful and should continually monitor how their per diem policies are implemented, the types of jobs they apply to, and the types of employees receiving per diem.

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[1] To see the rules briefly summarized in this document, see §§ 62, 162, and 274 of the U.S. Internal Revenue Code of 1986, as amended, U.S. Treasury Regulations §§ 1.62-2(c), 1.274-5, and 1.274-5T, Revenue Procedure 2011-47, 2011-42 I.R.B. 520 (for allowances paid after September 2011), Revenue Ruling 99-7, 1999-1 C.B. 361, and IRS Publication 463 (Travel, Entertainment, Gift, and Car Expenses).

[2] See, e.g., *UAL Corp. & Subsidiaries v. Comm'r,* 117 T.C. 7 (2001) (where court analyzed amounts that could not be treated as deductible travel expense reimbursements to determine whether such amounts could be deducted as compensation payments; court analyzed facts such as relationship between "employer" and "employee" and obligation to pay such amounts to secure services).

[3] Various authorities establish this requirement. See, for example:

- U.S. Treasury Regulations §1.62-2(j) Example 1 ("Employer S pays its engineers $200 a day. On those days that an engineer travels away from home on business for Employer S, Employer S designates $50 of the $200 as paid to reimburse the engineer's travel expenses. Because Employer S would pay an engineer $200 a day regardless of whether the engineer was traveling away from home, … no part of the $50 Employer S designated as a reimbursement is treated as paid under [a qualifying] plan. Rather, all payments under the arrangement are treated as paid under a nonaccountable plan. Employer S must report the entire $200 as wages or other compensation on the employees' Forms W-2 and must withhold and pay employment taxes on the entire $200 when paid.").

- Revenue Ruling 2012-25, 2012-37 I.R.B. 337 ("Section 1.62-2(d)(3)(i) provides that the business connection requirement will not be satisfied if a payor pays an amount to an employee regardless of whether the employee incurs or is reasonably expected to incur deductible business expenses. Failure to meet this reimbursement requirement of business connection is referred to as *wage recharacterization* because the amount being paid is…a substitute for an amount that would otherwise be paid as wages….The presence of wage recharacterization is based on the totality of facts and circumstances. Generally, wage recharacterization is present when the employer structures compensation so that the employee receives the same or a substantially similar amount whether or not the employee has incurred deductible business expenses related to the employer's business…. For example, an employer recharacterizes wages if it temporarily reduces taxable wages, substituting the reduction in wages with a payment that is treated as a nontaxable reimbursement and then, after total expenses have been reimbursed, increases taxable wages to the prior wage level. Similarly, an employer recharacterizes wages if it pays a higher amount as wages to an employee only when the employee does not receive an amount treated as nontaxable reimbursement and pays a lower amount as wages to an employee only when the employee also receives an amount treated as nontaxable reimbursement.").

[4] The per diem allowance cannot be more than the applicable federal per diem rate, a specified flat rate, or an amount determined under a stated schedule. Rules relating to the applicable rates are not discussed in this summary.

[5] See, e.g., Revenue Ruling 99-7, 1999-1 C.B. 361.

[6] However, such guidance was issued for the benefit of the requesting taxpayer only and cannot generally be relied on by other taxpayers.

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