APPEALS INDUSTRY SPECIALIZATION PROGRAM

SETTLEMENT GUIDELINES

INDUSTRY: Construction/Real Estate

ISSUE: Per Diem Allowances for Temporary Technical Services Employees

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APPEALS SETTLEMENT GUIDELINE

CONSTRUCTION/REAL ESTATE INDUSTRY

PER DIEM ALLOWANCES FOR TEMPORARY TECHNICAL SERVICES EMPLOYEES

ISSUES:

1) Whether the payment of a per diem allowance or expense reimbursement to a "temporary" technical services employee is paid under either (1) an "accountable plan" and, therefore, excluded from the employee's gross income, or (2) a "nonaccountable plan" and, therefore, included in the employee's gross income.

2) If the allowance or reimbursement is includible in gross income of the temporary technical services employee, whether the amount constitutes wages for federal employment tax purposes (federal income tax withholding, the Federal Insurance Contributions Act (FICA), the Railroad Retirement Tax Act (RRTA), and the Federal Unemployment Tax Act (FUTA)).

Compliance's Position:

The Examination Coordinated Issue Paper, effective January 21, 1997, discusses a typical scenario in the temporary technical services industry to illustrate these issues. Following is a summary of the facts, legal analysis and conclusions reached with respect to these issues in the Examination Coordinated Issue Paper:

FACTS:

Businesses in the construction, aerospace, defense contracting, nuclear power generation and other similar industries fill many of their technical positions with "temporary" employees provided by technical services firms, also known as "job shops." The job shops are employment agencies specializing in locating highly skilled technical employees, including engineers, designers, architects, programmers and toolmakers. The duration of the employee's job may vary from a few days to several years, depending on the length of the contract between the business and the technical services firm.

An employer (in this scenario, a technical services firm) gives the employee a daily allowance of up to $50 to cover "travel expenses" associated with the job assignment even though, in many cases, the employee resides in the vicinity of the job assignment. The employer makes no attempt to verify that the employee qualifies for travel status (being away from home overnight) and there is no requirement that the employee account back to the employer for funds expended. The employer does not include the daily

allowance in the employee's income, does not report it on Form W-2, and does not classify it as wages for employment tax purposes.

This paper does not address the determination of whether the workers are employees rather than independent contractors of the technical service firm. However, an employment status determination must be made prior to evaluating the plan. This paper also does not address the determination of whether the technical services firm or the industry business is the employer, but rather assumes for discussion purposes that the technical services firm is both the common-law employer and has control of the payment of the employee's wages (i.e. not a section 3401(d)(1) scenario). Therefore, this paper is relevant only where the workers are employees of the technical services firm.

LAW & ANALYSIS - ISSUE 1

Rules in section 62, which generally define "adjusted gross income" as gross income minus certain deductions, govern the tax treatment of expenses paid or incurred by employees under a reimbursement or other expense allowance arrangement with his or her employer. Section 62(a)(2)(A) authorizes an employee to deduct from gross income certain trade or business expenses paid or incurred in connection with services performed as an employee. However, under section 62(c), the deduction will not be allowed if the arrangement does not require the employee to substantiate covered expenses to the person providing the reimbursement or provides the employee the right to retain any amount in excess of substantiated expenses. Under Treas. Reg. section 1.62-2(c)(1), a reimbursement or other expense allowance arrangement satisfies the conditions of section 62(c) if it satisfies the requirements of (1) business connection, (2) substantiation, and (3) returning amounts in excess of expenses, as set forth in Treas. Reg. sections 1.62-2(d), (e), and (f), respectively (referred to hereafter as the "three requirements"). The three requirements are applied on an employee-by-employee basis. Treas. Reg. section 1.62-2(i). For example, the failure by one employee to properly substantiate expenses would not cause amounts paid to other employees to be treated as paid under a nonaccountable plan.

If an arrangement meets the three requirements listed above, Treas. Reg. section 1.62-2(c)(2)(i) provides that all amounts paid thereunder are treated as paid under an "accountable plan." Per Treas. Reg. section 1.62-2(c)(4), amounts treated as paid under an accountable plan are excluded from the employee's gross income, are not reported on the employee's Form W-2, and are not subject to income tax withholding and payment of employment taxes.

On the other hand, if an arrangement does not satisfy one or more of the three requirements, Treas. Reg. section 1.62-2(c)(3)(i) states that all amounts paid under the arrangement are treated as paid under a "nonaccountable plan." Under Treas. Reg. section 1.62-2(c)(5), amounts treated as paid under a nonaccountable plan are included in the employee's gross income for the taxable year, must be reported as wages or other compensation to the employee on Form W-2, and are subject to withholding and payment of employment taxes. Furthermore, if the arrangement evidences a pattern of abuse of the accountable plan rules under section 62(c) of the Code or the underlying regulations, all payments made under the arrangement must be treated as made under a nonaccountable plan. Treas. Reg. section 1.62-2(k).

Thus, whether the daily allowance described in the facts is treated as paid under an accountable or nonaccountable plan requires further analysis of the three requirements. To be an accountable plan, the arrangement must fulfill all three requirements discussed below. If the arrangement fails to meet any one requirement it is a nonaccountable plan, and should be treated accordingly.

Requirement 1: Business Connection

The business connection requirement of Treas. Reg. section 1.62-2(d) is met only if an arrangement provides allowances (including per diem allowances), advances, or reimbursements for business expenses that are allowable as deductions by sections 161 - 198; for example, travel expenses while away from home under section 162(a)(2). In addition, the expenses must be paid or incurred by the employee in connection with the performance of services as an employee of the employer.

The business connection requirement is not satisfied if an amount is paid to an employee without regard to whether the employee incurs or is reasonably expected to incur bona fide expenses (whether or not deductible) related to the employer's business. See Treas. Reg. section 1.62-2(d)(3)(i). In addition, reimbursement or expense allowances must either be paid separately from wages or specifically identify the reimbursement or expense allowance amounts.

Section 162(a)(2) allows a deduction for all ordinary and necessary trade or business expenses paid or incurred during the taxable year, including traveling expenses (including amounts expended for meals and lodging other than amounts that are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business. This paper does not consider the deductibility of local transportation expenses of the type discussed in Rev. Rul. 99-7, 1999-1 C.B. 351. Local transportation expenses are not similar to the expenses discussed in this paper and are beyond its scope.

The Supreme Court has held that an employee's traveling expenses while away from home are deductible under section 162(a)(2) if they are: (1) ordinary and necessary, (2) incurred in pursuit of a trade or business, and (3) incurred while away from home. See Commissioner v. Flowers, 326 U.S. 465 (1946). Travel expenses paid or incurred in connection with a temporary work assignment away from home meet these requirements. However, travel expenses paid or incurred in connection with an indefinite or permanent work assignment are generally nondeductible. Thus, to meet the business connection requirement, the employment must be both away from home and temporary. And, as discussed below, an employee is not treated as temporarily away from home if the period of employment in any single location exceeds one year.

An employee's "home" for purposes of section 162(a)(2) is (1) the regular or principal (if more than one regular) place of business, or (2) if the employee has no regular or principal place of business, then at the regular place of abode "in a real and substantial sense." If an employee fails to come within either category, the employee is considered to be an itinerant whose "home" is wherever the employee happens to work. No deduction from gross income is allowed to an itinerant under section 162 for travel expenses because the employee is never away from home (Rev. Rul. 73-529, 1973-2 C.B. 37 and

Rev. Rul. 60-189, 1960-1 C.B. 60, obsoleted by Rev. Rul. 93-86, 1993-2 C.B. 71, for costs paid or incurred after Dec. 31, 1992). All of an itinerant's expenses associated with lodging, meals, transportation, etc. are deemed personal in nature and nondeductible under section 262.

Determining the tax home of an employee who does not have a regular or principal place of business at a specific location requires consideration of all the facts and circumstances. For example, one common situation is described in Case 1 in Rev. Rul. 60-189. That case describes a construction worker who faces a shortage of jobs in the city in which he regularly works, maintains his regular place of abode, and is a union member. Consequently, the worker accepts employment in other locations for various periods not expected to last, and not actually lasting, one year. Observing that the home of a construction worker is usually the city or general area in which the worker usually works, the ruling (as amplified by Rev. Rul. 83-82, 1983-1 C.B. 45, obsoleted by Rev. Rul. 93-86, 1993-2 C.B. 71, for costs paid or incurred after Dec. 31, 1992) concludes that the Service generally will consider all the facts and circumstances to determine whether the construction worker in Case 1 is temporarily away from home. See also Rev. Rul. 93-86, 1993-2 C.B. 71, which limits the duration of temporary employment in a single location to a year or less and which (as discussed below) superseded Rev. Rul. 83-82.

In some cases, however, the employee does not have a "regular" or "principal" place of business either at a specific location or in a city or general area. This would be the case, for example, if the worker does not customarily or frequently work in any one city or general area but, instead, frequently changes work locations. In such cases, the employee's tax home is located at the employee's "regular place of abode in a real and substantial sense," if any. The factors to be considered, as set forth in Rev. Rul. 73-529, are:

(1) Whether the employee performs services in the vicinity of the claimed abode and uses such abode (for purposes of his lodging) while performing such services there;
(2) Whether the employee's living expenses incurred at the claimed abode are duplicated because employment requires the employee to be away from it; and
(3) Whether the employee:

   (a) has not abandoned the vicinity in which the historical place of lodging and the claimed abode are both located,
   (b) has family members (marital or lineal only) currently residing at the claimed abode, or
   (c) uses the claimed abode frequently for lodging purposes.

An employee satisfying all three of the above factors is recognized as having a tax home at a regular place of abode. If only two of the three factors are satisfied, then all the facts and circumstances will be scrutinized closely to determine whether the employee has a tax home at a regular place of abode. If not, or if only one of the factors is satisfied, the employee will be treated as an itinerant and no travel expenses will be allowable. See also, Rev. Rul. 71-247, 1971-1 C.B. 54, concerning an employee who worked for one employer, but not in any specific location.

If it is found that the employee has a tax home (i.e., the employee has either a regular or principal place of business or, failing that, an abode in a real and substantial sense), further analysis is required concerning the duration of the employee's absence from that home to determine if it is "temporary" or "indefinite" in nature (Rev. Rul. 93-86, 1993-2 C.B. 71).

The rules governing whether an absence from home is temporary or indefinite were changed by Section 1938 of the Energy Policy Act of 1992, Pub. L. No. 102-486, which amended section 162(a)(2). The new rule (discussed below) applies to travel expenses paid or incurred after December 31, 1992. Therefore, to make a proper determination, it is necessary to know when the travel costs were paid or incurred.

Travel costs paid or incurred prior to 1/1/93: Determination of whether an employee's absence from home is temporary is governed by Rev. Rul. 83-82, 1983-1 C.B. 45. If the employee reasonably anticipates employment away from home to last less than 1 year, then all the facts and circumstances are considered to determine whether such employment is temporary. If the employee anticipates employment to last (and it does in fact last) between 1 and 2 years, there is a rebuttable presumption that the employment is indefinite. The employee may rebut the presumption by demonstrating certain objective factors set forth in the revenue ruling. Employment with an anticipated or actual stay of 2 years or more is deemed to be indefinite, regardless of any other facts or circumstances.

Travel costs paid or incurred after 12/31/92: Section 162(a)(2) (as amended by the Energy Policy Act of 1992) provides that an employee shall not be treated as being temporarily away from home during any period of employment exceeding 1 year. This eliminates the rebuttable presumption category under Rev. Rul. 83-82 for employment lasting between 1 and 2 years, and shortens the 2-year threshold for deemed indefinite travel to 1 year and 1 day. As explained by Rev. Rul. 93-86, 1993-2 C.B. 71, if employment away from home in a single location is realistically expected to last (and does in fact last) for 1 year or less, the employment will be treated as temporary in the absence of facts and circumstances indicating otherwise. If employment away from home in a single location is realistically expected to last for more than 1 year or there is no realistic expectation that the employment will last for 1 year or less, the employment will be treated as indefinite, regardless of whether it actually exceeds 1 year. If employment away from home in a single location initially is realistically expected to last for 1 year or less, but at some later date the employment is realistically expected to exceed 1 year, that employment will be treated as temporary (in the absence of facts and circumstances indicating otherwise) until the date the realistic expectation changed. Thus, if the employment is away from home and temporary, it meets the business connection requirement.

Requirement 2: Substantiation

To meet the substantiation requirement of Treas. Reg. section 1.62-2(e), the particular arrangement must require the employee to substantiate expenses covered thereunder to the payor (i.e., the employer, its agent or a third party) within a reasonable period of time. (For purposes of this analysis, it will be assumed that the payor is also the employer.) The substantiation of all expenses governed by section 274(d) (including travel expenses) must be sufficient to satisfy the requirements of Treas. Reg. Sections 1.274-5 and 1.274-

5T. For other reimbursed expenses, information must be submitted that is sufficient to enable the payor to identify the specific nature of each expense and to conclude that it is an employee business expense (Treas. Reg. section 1.62-2(e)).

An employee must provide an "adequate accounting" of travel expenses to his employer by submitting adequate records to sufficiently document the amount, time, place, and business purpose of the expense. (See Treas. Reg. sections 1.274-5T(b)(2), (c)(2), and (f).) An adequate record may be an account book, diary, log, statement of expense, trip sheet, or similar record maintained by the employee in which the expense is recorded at or near the time it is made, along with documentary evidence (such as a receipt), if required, sufficient to document the expense. Employees are not permitted to substantiate expenses with their own statements or corroborative evidence in providing an adequate accounting to the employer (as taxpayers may do in substantiating travel expense deductions on their personal returns).

In lieu of substantiating actual travel-related meals and lodging costs, an adequate accounting to the employer for the amount of such costs can be made by using certain specified types of per diem rates, (i.e., the federal per diem rate or the federal meals and incidental expenses (M&IE) rate). However, rates may be used only if the employee also substantiates the time, place, and business purpose of the travel in accordance with the rules of Treas. Reg. sections 1.274-5(c) and 1.274-5T(c). The following revenue procedures apply to expenses paid or incurred between the listed dates:

Date Travel Expense was Paid or Incurred and applicable Revenue Procedure:

On or after 10/01/01	Rev. Proc. 2001-47, 2001-42 I.R.B. 332
On or between 10/01/00 and 09/30/01	Rev. Proc. 2000-39, 2000-41 I.R.B. 340
On or between 01/01/00 and 9/30/00	Rev. Proc. 2000-9, 2000-2 I.R.B. 280
On or between 01/01/99 and 12/31/99	Rev. Proc. 98-64, 1998-52 I.R.B. 32
On or between 01/01/98 and 12/31/98	Rev. Proc. 97-59, 1997-52 I.R.B. 31
On or between 01/01/97 and 12/31/97	Rev. Proc. 96-64, 1996-53 I.R.B. 52
On or between 04/01/96 and 12/31/96	Rev. Proc. 96-28, 1996-14 I.R.B. 31
On or between 01/1/95 and 3/31/96	Rev. Proc. 94-77, 1994-2 C.B. 825
On or between 01/1/94 and 12/31/94	Rev. Proc. 93-50, 1993-2 C.B. 586
On or between 03/12/93 and 12/31/93	Rev. Proc. 93-21, 1993-1 C.B. 529
On or between 03/1/92 and 3/11/93	Rev. Proc. 92-17, 1992-1 C.B. 679
On or between 01/1/91 and 02/29/92	Rev. Proc. 90-60, 1990-2 C.B. 651
On or between 01/1/90 and 12/31/90	Rev. Proc. 89-67, 1989-2 C.B. 797.

An amount of expenses (up to the specified rates) is "deemed" to meet the substantiation requirements of section 274 and section 62(c) for two types of per diem allowance arrangements which may be used:

(1) a per diem allowance for an employee's meals and incidental expenses only ("M&IE-only"); or

(2) a per diem allowance for an employee's lodging, meals and incidental expenses ("Lodging-plus-M&IE").

The revenue procedures apply to expenses incurred or paid after 1989 only if the employer's reimbursement or other expense allowance arrangement meets the "accountable plan" criteria (i.e., the "three requirements") and the per diem allowance under the arrangement:

(a) is paid for ordinary and necessary business expenses incurred, or which the employer reasonably expects will be incurred, by an employee for lodging, meals and incidentals in connection with the employee's business travel away from home,
(b) is reasonably calculated not to exceed the amount of the expenses or anticipated expenses, and
(c) is paid at the applicable federal per diem rate (or other IRS-specified rate or schedule) or is paid under a "flat rate or schedule."

The "applicable federal per diem rate" depends on the locality of travel. Charts reflecting the federal per diem rates are published in Appendix A of 41 C.F.R., Chapter 301.

A "flat rate or schedule" refers to any uniform and objective basis for computing travel allowances, such as the number of days away from home or any other basis that is in accordance with normal business practices. Generally, however, an allowance that is computed on a basis similar to that used in computing the employee's wages or other compensation (e.g., number of hours worked, miles traveled, or pieces produced) does not meet the business connection requirement of Treas. Reg. section 1.62-2(d), is not a per diem allowance, and is not paid at a flat rate or stated schedule unless the allowance was correctly in use as of 12/12/89 as specified in rules contained in section 3.03(2) of each of the revenue procedures.

Currently, sections 4.01 and 5.01 of Rev. Proc. 2001-47 provide that, if a payor pays a per diem allowance in lieu of reimbursing actual lodging, meal and incidental expenses incurred or to be incurred by an employee for travel away from home, the amount of such expenses that is deemed substantiated for each calendar day is equal to the lesser of the per diem allowance for such day or the amount computed at any of the following rates:

(i) the federal maximum per diem rate for the locality as published in Appendix A of 41 C.F.R., Chapter 301 or

(ii) the maximum per diem rate using the high-low method for the locality.

Rev. Proc. 2001-47, section 6.02 provides that no receipt for lodging expenses is required in order to apply the federal per diem rate for the locality of travel.

Under the high-low method, IRS publishes a list of localities that are classified as high-cost areas (see revenue procedures listed above). All other areas within the continental U.S. ("CONUS") are classified as low-cost areas. A per diem rate is then established for the two types of localities. This method may only be used for travel within CONUS, and is subject to other limitations in section 5.05 of the revenue procedure.

To qualify as a per diem allowance under Rev. Proc. 2001-47, section 3.01 requires that the payment be paid with respect to ordinary and necessary business expenses incurred, or which the payor reasonably anticipates will be incurred, by an employee for lodging, and/or meals, and incidental expenses for travel away from home. Under section 4.02 of Rev. Proc. 2001-47, if the employer provides lodging in-kind, pays the cost of lodging directly, reasonably believes that the employee will not incur any lodging costs, pays the employee for actual expenses of lodging, or (after 1994) computes the allowance on a basis similar to that used in computing the employee's wages or other compensation, the per diem allowance is treated as paid only for meal and incidental expenses and is deemed substantiated only for the portion of the allowance that does not exceed the federal M&IE rate for the locality of travel for such day. Hence, if the employee substantiates the other elements of the travel expenses to the payor, (i.e., time, place, and business purpose) and the reimbursement arrangement meets the other requirements of an accountable plan (i.e., business connection and return of excess) the per diem payments are treated as paid under an accountable plan.

For partial days of travel, the federal M&IE rate must be prorated to reflect times that an employee is not in travel status. This is done either in accordance with the Federal Travel Regulations (FTR) or on any other consistently applied basis that is in accordance with reasonable business practice.

Although a single amount represents the per diem for Lodging-plus-M&IE, the M&IE portion of the per diem allowance must be prorated to reflect times that an employee is not in travel status. Also, the M&IE portion of the rate (or, at the employer's option, 40 percent of the allowances less than the federal per diem rate) is treated as an expense for food and beverages and is subject to the 80% limitation (50% after 12/31/93) on deductions for meal and entertainment expenses.

If a per diem allowance under either the M&IE-only method or the Lodging-plus-M&IE method exceeds the federal rates for M&IE or Lodging-plus-M&IE, the employee is required to include and report in gross income the portion of the per diem allowance exceeding the amount computed using the federal rates. The excess portion is treated as paid under a nonaccountable plan (i.e., as wages) and must be reported on the employee's Form W-2.

Requirement 3: Return of Amounts in Excess of Expenses

The general rule of Treas. Reg. section 1.62-2(f)(1) provides that the requirement for the employee to return amounts in excess of expenses to the payor is satisfied if the arrangement requires the employee to return within a reasonable time any amount paid under the arrangement that is in excess of expenses substantiated.

An exception to the general rule, however, is authorized by Treas. Reg. section 1.62-2(f)(2) for per diem and mileage allowances. Under this provision, a per diem allowance arrangement (as described in Rev. Proc. 2001-47) will be treated as meeting the requirement to return amounts in excess of expenses if (l) the allowance is paid at a daily rate that is reasonably calculated not to exceed the amount of the employee's expenses or reasonably anticipated expenses and (2) the employee is required to return within a reasonable period of time any portion of the allowance which relates to days not substantiated in accordance with the requirements of section 274(d) and Treas. Reg. section 1.62-2(e).

Generally, under Treas. Reg. section 1.62-2(c)(2)(ii), if an arrangement (whether a per diem allowance or some other type arrangement) meets the "three requirements" but the employee, in fact, fails to return, within a reasonable period of time, any amount in excess of the amount of the expenses substantiated in accordance with Treas. Reg. section 1.62-2(e), only the amounts paid under the arrangement that are substantiated are treated as paid under an accountable plan. The excess amounts are treated as paid under a nonaccountable plan. See Treas. Reg. section 1.62-2(c)(3)(ii).

The regulations establish safe harbors for purposes of the "reasonable period of time" requirement discussed above. An advance made within 30 days of when an expense is paid or incurred, or substantiated to the payor within 60 days after it is paid or incurred, or an amount returned to the payor within 120 days after an expense is paid or incurred, will be treated as having occurred within a reasonable period of time. Treas. Reg. section 1.62-2(g).

Advances, allowances, or reimbursements deemed paid under a nonaccountable plan are included in the employee's gross income, are reported on the Form W-2, and are subject to the withholding and payment of employment taxes per Treas. Reg. section 1.62-2(c)(5). The employee may claim itemized deductions for expenses attributable to amounts received under a nonaccountable plan or expenses in excess of amounts substantiated under an accountable plan. The deduction is shown on the employee's Schedule A as miscellaneous itemized deductions subject to both the 2% floor of section 67 and the 80% limitation (50% after 12/31/93) on deductions for meals and entertainment expenses of section 274(n).

If it is determined upon examination of a payor's reimbursement or other expense allowance arrangement that there is a pattern of abuse of the rules under section 62(c) regarding reimbursement and other expense allowance arrangements, the Service will treat all payments made under the arrangement as made under a nonaccountable plan and will also impose the appropriate penalties.

CONCLUSION - ISSUE 1

The determination whether an employer's expense allowance payments to "temporary" technical services employees are treated as made under an accountable plan is made on a case-by-case (i.e., employee by employee) basis. The expense allowance arrangement must satisfy the three requirements of an accountable plan. Thus, if the arrangement fails to satisfy one or more of the requirements, payments under the arrangement are treated as made under a nonaccountable plan.

Under the facts stated above, the employer has not established an accountable plan and, thus, the $50 daily allowance is included in the employee's gross income. The employer's plan is considered a nonaccountable plan because the employer does the following: (1) pays the amount without regard to whether bona fide expenses related to the employer's business are incurred; (2) does not require the employee to substantiate the expenses; and (3) does not require the return of the excess if any of the allowance is over expenses substantiated.

Whether the employee is, in fact, away from home in the pursuit of business does not alter this result. If such is the case, however, the employee may deduct the expense as an itemized deduction. The itemized deduction is subject to the substantiation requirements of section 274(d), the limitation on meal and entertainment expenses provided in section 274(n), and the 2-percent floor on miscellaneous itemized deductions provided in section 67.

LAW & ANALYSIS - ISSUE 2

Relevant "employment taxes" include Federal Insurance Contributions Act (FICA), Federal Unemployment Tax Act (FUTA), Railroad Retirement Tax Act (RRTA), and income tax withholding. For federal income tax withholding purposes, section 3402(a) of the Code requires every employer making payment of wages to an employee to deduct and withhold federal income taxes from such payments. The RRTA imposes an employee tax on employee compensation under section 3201 of the Code and an employer tax on employee compensation under section 3221. Section 3202(a) requires employers to deduct the employee RRTA tax from the compensation paid to employees. Similarly, FICA imposes an employee tax on wages under section 3101 of the Code and an employer tax on wages under section 3111. Section 3102(a) requires employers to deduct the employee FICA tax from wages paid to employees. FUTA imposes a tax on employers with respect to wages under section 3301 of the Code.

For FICA, FUTA, and federal income tax withholding, the term "wages," and "compensation" under RRTA, is generally defined as all remuneration for services performed by an employee for an employer, unless specifically excluded. See I.R.C. sections 3121(a), 3231(e), 3306(b), and 3401(a). There is no statutory exception from wages for FICA, FUTA, and income tax withholding for amounts paid by employers to employees for employee business expenses. However, amounts paid under an accountable plan are excluded from an employee's gross income, are not required to be reported on the employees' Form W-2, and are exempt from withholding and payment of

employment taxes. Treas. Reg. section 1.62-2(c)(4); See also Treas. Reg. sections 31.3121(a)-3, 31.3231(e)-1(a)(5), 31.3306(b)-2, 31.3401(a)-4, and 1.6041.3-(h)(1).

For FICA taxes, FUTA tax, and income tax withholding purposes, payments made under an arrangement that meets the requirements of section 62(c) of the Code and Treas. Reg. section 1.62-2 are not wages. However, the reimbursement or other expense allowance must be identified either by making a separate payment or, if both wages and the reimbursement or other expense allowance are combined in a single payment, by specifically identifying the amount of the reimbursement or other expense allowance. Treas. Reg. sections 31.3121(a)-3(a), 31.3306(b)-2(a), and 31.3401(a)-4(a). If the plan does not meet the requirements of section 62(c) of the Code and Treas. Reg. section 1.62-2, then all amounts paid under the plan must be included in wages and are subject to withholding and payment of employment taxes when paid. Treas. Reg. sections 31.3121(a)-3(b)(2), 31.3306(b)-2(b)(2), and 31.3401(a)-4(b)(2). As for per diem and mileage allowances, amounts that exceed what is deemed substantiated for the day or miles of travel are treated as paid under a nonaccountable plan and are treated as wages, the excess being subject to withholding and employment taxes when paid. If paid as an advance, the excess amount is subject to withholding and payment of employment taxes no later than the first payroll period following the payroll period in which the related expenses are substantiated. Treas. Reg. section 31.3121(a)-3(b)(1)(ii), 31.3306(b)-2(b)(1)(ii) and 31.3401(a)-4(b)(1)(ii).

For RRTA tax purposes, RRTA Tax 31.3231(e)-1(a)(5), refers to and adopts the FICA tax regulations regarding reimbursement and other expense allowance amounts at Treas. Reg. section 31.3121(a)-3.

The guidelines for determining when per diem allowances or other types of expense reimbursement payments are considered to be wages and subject to employment taxes are found in the following Treasury Regulations:

FICA Tax 31.3121(a)-3
RRTA Tax 31.3231(e)-1(a)(5)
FUTA Tax 31.3306(b)-2
Federal Income Tax Withholding 31.3401(a)-4

These regulations are similarly worded and generally apply to payments received by an employee on or after July 1, 1990, with respect to expenses paid or incurred on or after July 1, 1990.

Under the terms of the above employment tax regulations, if a reimbursement or other expense allowance arrangement meets the requirements of section 62(c) and Treas. Reg. section 1.62-2, and the expenses are substantiated within a reasonable period of time, payments made thereunder that do not exceed the substantiated amounts are treated as paid under an accountable plan and are not wages.

Treas. Reg. section 1.62-2(h)(2)(i)(A) provides that if the arrangement meets the requirements of an accountable plan, but expenses are not substantiated within a reasonable period or unsubstantiated amounts are not returned to the payor within a

reasonable period, the unsubstantiated and unreturned amounts will be treated as paid under a nonaccountable plan, subject to withholding and payment of employment taxes. The withholding and payment of employment taxes is to occur no later than the first payroll period following the end of the "reasonable period," defined as the periods specified in Treas. Reg. section 1.62-2(g)(2).

Treas. Reg. section 1.62-2(h)(2)(i)(B) provides that if a per diem allowance meets the requirements of an accountable plan but is paid at a rate that exceeds the amount of the employee's expenses deemed substantiated, the excess portion is wages subject to withholding and payment of employment taxes in the payroll period in which the payor reimburses the substantiated expenses. However, if the per diem allowance is paid as an advance at a rate for each day that exceeds the amount of the employee's expenses deemed substantiated, the excess portion is wages subject to withholding and payment of employment taxes no later than the first payroll period following the payroll period in which the expenses for which the advance was paid are substantiated. Substantiation must occur within a reasonable period of time as specified in Treas. Reg. section 1.62-2(g)(2).

If the arrangement does not satisfy the requirements of section 62(c) and Treas. Reg. section 1.62-2, all amounts paid under the arrangement are treated as paid under a nonaccountable plan, are included in wages, and are subject to withholding and payment of employment taxes when paid.

Additionally, Treas. Reg. section 1.62-2(k) provides that if a payor's reimbursement or other expense allowance arrangement evidences a pattern of abuse of the rules of section 62(c) of the Code and the underlying regulations, all payments made under the arrangement will be treated as made under a nonaccountable plan.

CONCLUSION - ISSUE 2

As the $50 daily allowance is a payment under a nonaccountable plan, the payments are includible in the employee's gross income, the payments are wages subject to federal employment taxes and must be reported on Form W-2.

SETTLEMENT GUIDELINES

The factual scenario outlined in the Examination Coordinated Issue Paper, and recited herein, illustrates a situation where the per diem allowance or expense reimbursements paid to technical services employees fails to satisfy the three requirements of an "accountable plan". Based upon the facts provided, the daily allowances for travel expenses paid to technical services employees were paid under a "nonaccountable plan" and, therefore should be included as wages on the employees' W-2's, subject to withholding and employment taxes.

To qualify as an "accountable plan", the payment must meet all three of the tests set forth in Treas. Reg. sections 1.62-2(d), (e) and (f), which include:

- Business Connection – Treas. Reg. section 1.62-2(d)
- Substantiation – Treas. Reg. section 1.62-2(e), and
- Return of Amounts in Excess of Substantiated Expenses – Treas. Reg. section 1.62-2(f)

The plan is deemed a "nonaccountable plan" because the employer:

1. pays the amount without regard to whether bona fide expenses related to the employer's business are incurred;
2. does not require the employee to substantiate the expenses; and
3. does not require the return of the excess of the allowance over expenses substantiated.

Therefore, the $50 per diem paid to the temporary technical services employees is:

1. paid under a "nonaccountable plan" per Treas. Reg. section 1.62-2(c)(3), and

2. treated as wages which must be included on the employees W-2, subject to income tax withholding as well as withholding and payment of employment taxes (FICA, FUTA and RRTA) per Treas. Reg. section 1.62-2(c)(5).

This is true regardless of whether the employee is considered to be "away from home" in pursuit of business. However, to the extent that the employee does qualify as "away from home" in pursuit of business, the employee may deduct the qualifying employee business expenses on Schedule A, subject to the limitation on meal and entertainment expenses

provided in section 274(n) and the 2-percent floor on miscellaneous itemized deductions provided in section 67.

The per diem payments described in this paper clearly do not satisfy the “accountable plan” requirements outlined in Treas. Reg. sections 1.62-2(d), (e), and (f). Accordingly, with respect to a factual pattern similar to the one described in this paper, the government would have little or no litigating hazards in asserting that such payments constitute a “nonaccountable plan”.