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Per Diem in the Staffing Industry

I. Introduction

The way staffing firms reimburse workers for travel-related expenses while they are on assignment away from their "tax homes" has drawn increasing scrutiny from the Internal Revenue Service and the Department of Labor.

This article will examine the legal requirements necessary to establish an accountable per diem plan, substantiation of expenses, the establishment of a tax home, breaks in service, and other issues that are more prevalent in staffing than in direct employment.

II. What Is Per Diem and Why Is it Beneficial?

Per diem is simply an allowance paid to employees by their employer for lodging, meals, and incidental expenses when traveling which is paid in lieu of paying actual travel expenses directly.

Many clients use staffing firms to handle peak loads or when there is insufficient qualified local labor available. Staffing firms are able to provide this labor on a temporary basis to satisfy client labor needs.

It is often the case that temporary assignments require travel to the work site. In order to satisfy employee desire for reimbursement of duplicate living expenses, the payment of tax-free per diem expenses as part of the total compensation is often an attractive alternative for all concerned parties.

The temporary employee gets the benefit of per diem payments without income tax withholdings, and such payments are not reported on the IRS Form W-2. The staffing firm does not pay FICA, FUTA, Medicare, and other payroll deductions for these per diem payments. To the extent per diem is paid as part of an integrated compensation arrangement, the regular rate of pay is sometimes reduced, thereby lowering the overtime premium pay. In other words, sometimes staffing firms pay a total compensation to the employee that includes both wages and per diem payments. This has the effect of reducing the wages paid and therefore the calculation of the "regular rate of pay" computation. This can have the effect of reducing the amount of overtime.

In addition, the staffing firm gets to deduct the per diem amounts paid as a business expense from the company's annual tax return. The full lodging component is deductible, but the meals and incidental component is deductible only to the extent meals are deductible as a business expense.

Finally, per diem effectively allows the client to obtain qualified labor not otherwise available without an increase in cost.

III. Why Is the Staffing Industry at Risk for Noncompliance?

There are a number of unique aspects of the staffing business model which make compliance especially challenging.

In theory, the reimbursement for travel expenses should be a simple matter and should not be related to the payment of wages. However, given the economics of the staffing model, the line between the reimbursement of expenses and the payment of wages is not always clear.

For example, billing arrangements with clients can lead to complications when a client pays a single bill rate for similarly skilled traveling as well as local workers at a work site. This practice can lead the IRS and DOL to view workers with similar skills making different wage rates but the same or similar total compensation, including per diem, as evidence of disguised wages. In such cases, these agencies may characterize the per diem payments to the traveling workers as taxable wages.

IV. Accountable Plans

The IRS requires taxpayers to substantiate business expenses, including travel expenses incurred for a business purpose, in order to obtain a tax deduction by "maintaining adequate records or other sufficient evidence." (1.274-5 Income Tax Regulation.)

The IRS provides an alternate method of substantiation when the employer maintains an "accountable plan" for purposes of making per diem payments.

The following three requirements must be met in order to satisfy the accountable plan requirements.

1. **Business connection.** The expense must be a bona fide business expense related to the employer's business, and deductible by the employer under IRC § 161 to § 198. Per diem payments must be paid separately from wages and are not included on the W-2. (Treasury Regulation § 1.62-2 (d).)

2. **Substantiation.** The employee must submit documentation regarding expenses incurred to substantiate the expense as well as the business purpose. (Treasury Regulation § 1.62 (e).)

3. **Return of payments in excess of expenses incurred.** (Treasury Regulation § 1.62-2 (f).)

Unless all three requirements are met, the plan is nonaccountable and all payments are deemed includable in the gross income of the recipient as wages subject to employment taxes. Stated differently, the term "per diem allowance" means a payment under a reimbursement or other expense allowance arrangement that is

1. Paid for ordinary and necessary business expenses incurred, or that the payer reasonably anticipates will be incurred, by an employee for lodging, meal, and incidental expenses; or for meal and incidental expenses for travel away from home performing services as an employee of the employer in pursuit of a business or trade,

2. Reasonably calculated not to exceed the amount of expenses or the anticipated expenses, and

3. Paid at or below the applicable federal per diem rate, a flat rate, or stated schedule, or in accordance with any other service-specified rate or schedule.

V. Tax Home and Travel Expenses

IRC § 162 (a) (2) permits a tax-free reimbursement for travel expenses only when the employee is away from his or her "tax home" in pursuit of a trade or business. Reimbursement is permitted only when the employee is away from the tax home overnight and incurring duplicate living expenses. Commuting expenses are not deductible and therefore not eligible for per diem payment. [1]

A tax home may be the "principal place of business" or residence that is a "place of abode in a real and substantial sense." As between the two, an individual's "tax home" for purposes of determining the extent to which travel expenses are deductible is generally the location of his or her principal place of employment or business.

Where the individual does not have a principal place of employment, the courts will deem the individual's permanent residence to be his tax home under certain circumstances. The determination of residence or place of abode is dependent on particular facts and circumstances.

There is some tension between the IRS interpretation of these tax home requirements, Revenue Rulings, and a line of court decisions that interpret the regulations. The IRS makes a distinction between the exigencies of business versus the personal necessities and preferences of the traveler. Rev. Rul. 73-529, 1973-2 C.B. 37, sets forth three objective factors to use in determining whether a worker's claimed tax home is the worker's place of abode in a real and substantial sense, or whether the worker is an itinerant worker who cannot legally claim a travel expense deduction.[2]

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[1] There is no safe harbor or published rule that establishes a minimum distance between the tax home and the job assignment, but 50 miles is often used as a rule of thumb.

[2] The IRS defines an itinerant or transient worker as a worker who does not have a regular or main place of business or post of duty and there is no place where he regularly lives, and his tax home is wherever he works. As an itinerant, the worker cannot claim a travel expense deduction because, in the view of the IRS, the employee is never considered to be traveling away from home. (See IRS Publication 463, Travel, Entertainment, Gift and Car Expenses (2015).)

1. Whether the worker performs a portion of his business in the vicinity of his claimed abode and uses such abode (for purposes of his lodging) while performing such business there;

2. Whether the worker's living expenses incurred at his claimed abode are duplicated because his business requires him to be away therefrom; and

3. Whether the worker:

    a. Has not abandoned the vicinity in which his historical place of lodging and his claimed abode are both located,

    b. Has a member or members of his family (marital or lineal only) currently residing at his claimed abode, or

    c. Uses his claimed abode frequently for purposes of his lodging.

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.

There is a division of opinion in cases which address the concept of a "tax home." Some courts take the view that there need not be a link between a permanent residence and a "business site" in order to establish a "tax home" that will qualify for business travel tax deductions. Other courts require maintaining a business interest at the "home" in order to take the travel allowance. (See *Burns v. Gray*, 287 F 2d. 698 (6th Cir. 1961).)

In a case favorable to the taxpayer, the tax court in *Johnson v. Commissioner of Internal Revenue*, 115 T.C. No 16 (2000)[3], did not require a business connection to the residence of the employee for the employee to be eligible for a tax deduction for travel expenses.

Johnson was a merchant seaman with no principal place of employment. The tax court found that his "tax home," for the purpose of determining the extent to which travel expenses were deductible, was the situs of his personal residence where he resided with his wife and children. In so doing, the court rejected the IRS's position that Johnson had no "tax home," which requires maintaining a business interest at the actual "home" in order to take the travel allowance.

According to the *Johnson* court, factors to consider in establishing a tax home at a personal residence include whether the employee-taxpayer:

1. Is primarily financially responsible for maintaining his residence;

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[3] See also *Dowd v. C.I.R.*, 37 T.C. 399 (1961).

2. Has an ownership interest in his personal residence;

3. Contributed to his household in a "valuable and indispensable way";

4. Spent a substantial part of the year at his personal residence;

5. Had a legitimate reason for maintaining a personal residence since his family did not travel with him while he worked.

Critical to the tax court's finding in *Johnson* was the rejection of the IRS position that an employee like Johnson can never have a tax home because he continually travels to different cities in his employment. The tax court reasoned that where a taxpayer financially maintains a "fixed personal residence" it means that he "has a tax home someplace." The purpose of allowing the deduction of living expenses while a taxpayer is "away from home" is to mitigate the burden of the taxpayer who, because of the exigencies of his trade or business, must maintain two places of abode and thereby incur duplicate business expenses. (R*onald D. Kroll*, 49 T.C. 557, 562 (1968).)[4]

The deductions provided by 162 (a) (2) were designed to take the burden off taxpayers who, because of jobs, incur extra expenses for lodging, meals, and incidentals in addition to the expenses of maintaining a family home. (See R*ambo v. Commission of Int. Rev.*, 69 T.C. 920 (1979).)

The IRS, in reliance on a series of cases,[5] takes the positon that, "if the prospects are that work will continue for an 'indefinite' or 'indeterminate' or 'substantially long' period, then the travel deduction should be disallowed." Moreover, "the exigencies of business rather than the personal conveniences and necessities of the traveler must be the motivating factors."[6]

The IRS focuses on the business of the employer and not the business of the employee. If the employer does not care where the services are performed and the taxpayer chooses to move to the situs of the employer's facilities to perform the work, then according to the IRS and a line of cases in support of that view the expenses are not business related and thus the personal expenses of the employee who is merely expressing his personal preference to work someplace other than where he maintains a personal residence.

One court limited the deductibility of travel expenses to situations where "the taxpayer lives one place, works in another, and has business ties to both."[7]

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[4] The court in *Kroll* found that the travel expenses were not deductible because the taxpayer's stay at the work site was not temporary but rather indefinite.

[5] See for example, *Ford v. Commissioner*, 227 F2d 297, 299 (4th Cir. 1955); *Commissioner v. Flowers*, 326 U.S. 465 (1946); *Hantzis v. C.I.R.*, 638 F.2d 248 (1st Cir. 1980); *Wilbert v. C.I.R.*, 553 F.3d 544 (7th Cir. 2009); *Jones v. C.I.R.*, 444 F.2d 508 (1971).

[6] *Hantzis v. Commissioner*, 638 F.2d 248 (1st Cir. 1981).

[7] See *Blatnick v. Commissioner*, 56 T.C. 1344, 1348 (1971); see also *Gen. IRS Counsel Memorandum, Travel Questions*, Number 2000210055, 5/19/2000.

When this line of reasoning is applied to a typical staffing scenario, the IRS view (notwithstanding Rev. Rul. 73-529) is that the employees accept the positions or assignments understanding the temporary nature of the assignments, and the locations of said assignments are known at the time of employment. They are not "required" or "compelled" by the employer to accept such position; rather, they are voluntarily accepting a positon that will take them away from their current tax home.

The IRS view is that the employee, who at this point has no business connection with his residence, has shifted his tax home to a new location in which he regularly lives and pursues a trade or business.

The IRS view can have a significant impact on the ability of staffing firms to establish accountable plans. To the extent an IRS agent relies on this interpretation, there may be a finding that the plan is not accountable, thereby leaving the employer to contest that initial finding at the IRS appeals level, to the tax court, and ultimately through appeals to the federal courts.

VI. One Year Rule

Section 1938 of the Energy Policy Act of 1992 amended section 162 (a)(2) of the Internal Revenue Code to provide that a taxpayer will not be treated as being temporarily away from home if the period of absence exceeds one year.

IRS notice 93-29 states in part:

> "Under § 162 (a) of the Code as amended by the Act, if a tax payer's period of employment away from home in a single location lasts more than one year, no deduction will be allowed for travel expenses paid or incurred after December 31, 1992, for that period of employment. Any reimbursement received by an employee for nondeductible expenses must be included in the employee's gross income. See § 62(c) and § 1.62-2 of income tax regulations."

If a staffing firm's reasonable expectation at the beginning of an assignment is that it will last one year or less, but that expectation later changes, then the change does not cause deductions to be lost retroactively. However, the ability to deduct the travel expenses prospectively ends once the expectation changes to an assignment of greater than one year.

VII. Break in Service

Break in service is yet another issue prevalent in the staffing industry model.

One common question is how long must the employee spend away from the assignment to restart the clock on the one-year rule and still satisfy the temporary assignment requirement.

There is no specific guidance on this issue; however, brief interruptions at work at a particular location do not, standing alone, cause employment which would otherwise be indefinite to become temporary.[8] If during the initial one-year period the employee expects to return to the assignment after the break, the realistic expectation is that the assignment will last more than one year despite the fact that the work is not continuous.

There is no guidance that sets a specific number of days that will constitute a bona fide break in service, but it is worth noting that the IRS requires a seven (7) month break in service for its own employees.[9] Thus, given that there is no bright-line rule, it is important to examine what the employee does when he returns to his tax home. If the employee is working at or near the tax home and looking for employment while home, then there is a greater likelihood that a legitimate break in service will exist.

A second question regarding breaks in service is whether a switch from one staffing firm to another will restart the clock. The answer is that placement on assignment with the client through a second staffing firm, or direct employment by the client, will not restart the clock.[10]

VIII. Business Connection Requirement

In order to satisfy the business connection requirement, the employer must meet the following:

1. Expenses must be ordinary and necessary;
2. The expenses must be incurred while away from home; and
3. The expenses must be incurred in pursuit of a trade or business.

The IRS annually publishes rate tables in order to provide guidance for establishing amounts for per diem reimbursements that are deemed ordinary and necessary. One set of tables are known as CONUS tables, which provide the amounts for different locations within the United States.[11] An optional method is known as the High-Low Substantiation Method, which is used to establish a rate for any high-cost locality and another rate for low-cost localities.[12] An employer may use other means to establish the reasonableness of expenses. However, under certain limited circumstances, the CONUS tables and High-Low amounts may not suffice. For example, the staffing firm may have actual knowledge that the actual expenses at a location may be far less than the tables indicate, in which case the actual expenses should be used.

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8 See *Sohaiby v. Commissioner*, T.C. M. 1965-287.
9 See Gen. Treas. Reg. § 1.62-2. Rev. Ruling 2012-25.
10 Official IRS Local Travel Guide 1.32.1.10.1 (02-07-2012).
11 A CONUS calculator can be found at gsa.gov/portal/content/104877
12 IRB 2015-40 2015-2016 Special Per Diem Rates, irs.gov/irb/2015-40_IRB/ar09.html

The IRS has taken the position that employees may need to provide receipts for lodging, meals, and incidental expenses to establish that they are incurring duplicate living expenses while at the job site. The tax court in *Johnson* rejected the need for the taxpayer to produce receipts since the alternate substantiation methods in an accountable plan were available to the taxpayer.

With respect to the second requirement, there are a number of means that an employer might use to verify the permanent residence of the employee and the existence of duplicate living expenses, including:

1. A copy of a deed or lease indicating permanent residence;
2. Utility and telephone bills;
3. Copy of driver's license;
4. A listing of permanent residence on any medical or benefit forms;
5. Noting the permanent address in the employee's personnel file as part of records kept in the ordinary course of business;
6. Mailing correspondence and notices to the employee at the permanent address;
7. Certification from an employee; and
8. Regularly, at least on a quarterly basis, having employees recertify their permanent residence on the forms provided.

The employee certification is one of the most important factors in determining tax home. It serves the dual purpose of satisfying the employer's IRS reasonable inquiry obligations and impeding an employee from arguing that per diem payments were part of his base wage rate for overtime calculation purposes. It also can substantiate whether family members are at the residence.

In addition, the certification can serve the purpose of having the employee certify that all excess payments for unsubstantiated days have been returned and help satisfy the accountable plan requirement for the employee to return all excess per diem payments.

IX. Wage Re-characterization

Wage re-characterization is the result of a finding that amounts paid for per diem reimbursement are actually wages. Once re-characterized, those wages are subject to employer responsibilities related to wages, including withholding and payroll deductions for FICA.

When the employer pays the same amount to an employee, regardless of whether the employee incurs a travel expense, the reimbursement requirements

necessary to establish a business connection are not satisfied. For example, if a nurse is paid $20.00 an hour while working near her tax home, and $12.00 an hour in wages and $64.00 a day per diem ($64.00 divided by 8 hours is the equivalent of $8.00 per hour. $12.00 plus $8.00 equals $20.00 per hour) while working away from her tax home, it is evidence that the employee is paid the same amount whether or not she incurs a travel expense.

This is a failure to meet the reimbursement requirement because the amount paid is determined to be not an expense reimbursement but rather an amount that would otherwise be paid as wages.[13]

When any payments under an employer's reimbursable plan fail the reimbursement requirement, all such payments are treated as paid under a non-accountable plan.

Where an employee is paid a taxable wage rate that is approximately the same as the taxable wages plus the per diem that would be paid if the employee is traveling, then the per diem amount could be re-characterized as wages. Likewise, if similarly-skilled local workers are paid wages similar to the combined wages and per diem paid to traveling workers, the IRS will seek to re-characterize the per diem payments as wages. Although there does not appear to be regulatory authority on this point, the IRS will also look at Bureau of Labor statistics to assist in determining what constitutes wages. If the traveling employee is paid significantly less wages than the per diem payment, such payment may be considered disguised wages. In the IRS's view, per diem may not be a substitute for wages.

X. Effects of Wage Re-characterization

When wages are re-characterized for failure to establish the business connection requirements of Treas. Reg. § 1.62-2(d), the lodging, meals, and incidental per diem payments are treated as paid under a nonaccountable plan and must be included in the employees' gross income, must be reported on the Form W-2, and are subject to withholding and payment of employment taxes per Treas. Reg. § 1.62-2(c).

There are a number of ways to determine the percentage of withholdings to be paid by the employer, including a 25% flat rate or calculating the withholding for both regular and supplementary wages. The actual amount is dependent on when the supplemental (re-characterized) wages are paid. The employer is responsible for both the employer and employee portions of FICA.

The employer may also be assessed penalties and interest where there is no reasonable belief that the plan is accountable or where a "pattern of abuse" is present.

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[13] *Gagnan v. United Technisource*, 607 F 3rd 1036 (2010) suggests that a case-by-case analysis of relevant facts should be performed.

The IRS takes the position that the withholding taxes are paid on behalf of the employee. As a result, unless that amount is recouped from the employee, it will be considered income and wages paid to the employee subject to new rounds of withholding taxes and payroll taxes that pyramid, as well as the filing of amended W-2 Forms (W-2c).

XI. Split Wage Issue

DOL and IRS regulations prohibit the split of hourly wages into components for actual wages and reimbursable expenses such as per diem payments.[14] Keep in mind, in this "split rate scenario" the employer starts with a wage and "splits out" part of it as a reimbursable per diem expense.[15] This is different than identifying and paying wages, and then separately identifying and paying reimbursable expenses that do not vary by the hour.

If the amount paid to an employee for reimbursement of business expenses varies with the number of hours worked, then ordinarily the amounts paid will constitute wages and will be included within the regular rate of pay.

The regular rate of pay forms the basis for determining the premium overtime rate for nonexempt employees.

If the employer fails to properly include all amounts paid to the employee as regular rate wages and does not pay the premium rate (of at least 1 and 1/2 times the regular rate of pay) on the full amount of wages, it will be in violation of the overtime pay requirements of the Fair Labor Standards Act.

Subject to certain exceptions, an allowance that is computed on a basis similar to that used in computing wages or other compensation does not meet the business connection requirement and is not a per diem allowance. Accordingly, unless the employer can meet the limited exception, which includes a per diem plan in place as of Dec. 12, 1989, per diem should not be paid on an hourly basis. Remember that "per diem" means per day.

XII. Return of Excess

The final requirement to establish an accountable plan is that amounts paid in excess of the allowable per diem must be returned to the employer within a reasonable period of time. This usually happens when, for example, an employee

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[14] The Fair Labor Standards Act permits deductions from the regular rate of pay for "reasonable traveling expenses, or other expenses incurred by the employee in the furtherance of the employer's business and properly reimbursable by the employer and other similar payments which are not made for his hours of employment." 29 CFR § 778.200 et. seq.

[15] There is no definition of "split wage." Federal Register/Vol 55, No 242, 12/17/90, Rules and Regulations, provides an example whereby an employee who generally is paid $200 in wages a day is sent on an assignment and while away is paid $150 a day in wages and $50 in reimbursable expenses. This arrangement does not satisfy the IRS accountable plan requirements.

is paid for five per diem days and only works four days. The extra day of per diem must be returned.

This is different from the requirement to include amounts paid to employees in excess of CONUS or Flat-Rate amounts on the W-2 Form as income.

XIII. Client Responsibility

The general rule is that the "employer" is the person for whom an individual performs services, except when the person or entity for whom the services are performed does not have control over the payment of wages. (See IRS Section 3401(d).)

The IRS takes the position that generally a staffing firm will be responsible for withholding and paying payroll deductions such as FICA.

However, this does not absolve the client company from potential liability—especially if the staffing firm fails to pay employment taxes. If a staffing client is found to be the common law employer of assigned workers, it can be held liable for tax withholdings and overtime.[16]

XIV. Closing Thoughts

While the interpretation of rules and cases surrounding the payment of per diem are complex and sometimes seemingly contradictory, there are a few general guidelines which may be helpful.

1. Pay per diem on a daily basis and not on an hourly basis. The amount of per diem should not vary based on the hours worked.

2. Obtain employee certifications to establish a tax home and duplicate living expenses.

3. Use CONUS tables to determine reasonable lodging, meal, and incidental expenses.

4. Do not split wages.

5. Make sure temporary assignments do not extend beyond the reasonable expectation of one year.

6. Do not make commitments for employees to return to the same assignment after a short break in service.

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[16] See DOL Opinion Letter on Joint Employer Obligations for Minimum Wages and Overtime Pay, U.S. Department of Labor, Opinion Letter No. 874, October 1, 1968–Joint Employer–Duty to Keep Records and Pay Overtime; *Perez v. United Comb and Novelty Corp. et al.*, Case No. 4:16-cv-40047, U.S. District Court for Massachusetts (2016).

7. Obtain documents from employees to substantiate duplicate living expenses.

8. Have a written plan and procedure to establish an accountable plan.