



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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Dear _____ :

This letter responds to your request for information dated January 13, 2009. You requested information regarding per diem payments made to certain employees working in the temporary staffing industry. Specifically, you requested information regarding when per diem payments may be treated as non-taxable reimbursements under an accountable plan.

Generally, amounts employers pay as reimbursements for employee business expenses are taxable unless treated as paid under an accountable plan. Amounts treated as paid under an accountable plan are excluded from the employee's gross income, are not reported as wages on the employee's Form W-2, and are exempt from the withholding and payment of employment taxes. In contrast, amounts treated as paid under a nonaccountable plan are included in the employee's gross income, must be reported as wages or other compensation on the employee's Form W-2 and are subject to the withholding and payment of employment taxes. Section 1.62-2(c)(3) and (5) of the Treasury Regulations (the Regulations).

The law treats a reimbursement or other expense allowance arrangement as an accountable plan if it meets the requirements of:

- Business connection
- Substantiation
- Return of excess

Section 62(c) of the Internal Revenue Code (the Code) and section 1.62-2(c) of the Regulations.

Business Connection Requirement

An arrangement meets the business connection requirement if the employer pays advances, allowances (including per diem allowances, allowances only for meals and incidental

expenses, and mileage allowances), or reimbursements only for deductible¹ business expenses that the employee pays or incurs while performing services for the employer.

Section 162 of the Code permits a deduction for traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) paid or incurred while away from home in the pursuit of a trade or business. As such, in order to meet the business connection requirement of an accountable plan, an arrangement that reimburses traveling expenses must reimburse only those expenses that are paid or incurred by an employee while performing services for the employer while away from home.

If an employer pays an employee regardless of whether the employee incurs (or is reasonably expected to incur) bona fide business expenses, the arrangement does not satisfy the business connection requirement. A payor arranges to pay an amount to an employee regardless of whether the employee is reasonably expected to incur bona fide business expenses by supplementing the wages of those employees not receiving the reimbursement (so that the same gross amount is paid regardless of the reasonable expectation to incur expenses), by routinely paying a reimbursement allowance to an employee who has not incurred bona fide business expenses, or by reducing the wage payment in light of expenses incurred or reasonably expected to be incurred only to then increase the wage payment again after the expenses have been reimbursed.

In order to satisfy the business connection requirement, no part of an employee's salary may be recharacterized as being paid under a reimbursement arrangement or other expense allowance arrangement. A plan that recharacterizes amounts that would otherwise be payable as wages as a reimbursement allowance will not be treated as an accountable plan. Such recharacterization violates the business connection requirement because the employee receives the same amount regardless of whether expenses were incurred or reasonably expected to be incurred.

Section 1.62-2(j) example 1 illustrates a recharacterization of wages in violation of the requirement that a reimbursement be paid only when expenses are incurred. The example provides that 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 nontaxable reimbursements for the engineer's travel expenses. On all other days, the engineer receives the full \$200 as taxable wages. Because Employer S pays an engineer \$200 a day regardless of whether the engineer is traveling away from home, the arrangement does not satisfy the business connection requirement. Thus, no part of the \$50 Employer S designated as reimbursement is treated as paid under an accountable plan. Rather, all payments under the arrangement are treated as paid under a nonaccountable plan and

¹ If an arrangement provides advances, allowances, or reimbursements for other bona fide expenses related to the employer's business that are not deductible, the payor is treated as maintaining two arrangements. The portion of the arrangement that provides payments for the deductible employee business expenses is treated as one arrangement that satisfies the business connection requirement; the portion of the arrangement that provides payments for the nondeductible employee expenses is treated as a second arrangement that does not satisfy the business connection requirement and all amounts paid under the second arrangement are treated as paid under a nonaccountable plan. Section 1.62-2(d)(2) of the Regulations.

Employer S must report the entire \$200 as wages or other compensation on the employee's Form W-2 and must withhold and pay employment taxes on the entire \$200 when paid.

The prohibition against wage recharacterization does not preclude an employer's prospective alteration of its compensation structure to include reimbursement of substantiated expenses under an accountable plan, as long as such amount, however identified or denominated, is only paid if bona fide expenses are incurred or reasonably expected to be incurred for the employer, and the employer does not use an alternate method to get the same amount of gross pay to employees when qualifying expenses are not incurred or reasonably expected to be incurred and subsequently substantiated (e.g., increased compensation, bonus, reduction in wages for the reimbursement "amount" with subsequent increase once the "reimbursement" is complete). The presence of wage recharacterization is based on the totality of facts and circumstances.

Substantiation Requirement

To meet the substantiation requirement, an arrangement must require the employee to substantiate each business expense to the payor within a reasonable period of time. For expenses governed by section 162, the employee must submit enough information to allow the employer to identify the specific nature of each expense and attribute the expense to the employer's business activity. Generally, the employee must submit an expense account or other written statement to the employer showing the business nature and amount of each of his or her expenses.

However, for an arrangement that reimburses travel expenses that are governed by section 274(d), the employee must submit to the payor actual substantiation of the amount of their expenses, as well as the time, place and business purpose of such expenses. Section 1.274-5(f)(4) of the Regulations and section 1.274-5T(b)(2) of the Temporary Income Tax Regulations.

We have an optional, simplified method, known as "deemed substantiation," for an employee to substantiate the amount of his or her expenses incurred while traveling away from home when performing services for the employer. This method provides a deemed substantiated amount of expenses but still requires the employee to substantiate the time, place, and business purpose.

Specifically, Revenue Procedure 2008-59² provides rules under which the amount of ordinary and necessary business expenses of an employee for lodging, meal, and incidental expenses, or for meal and incidental expenses, incurred while traveling away from home are deemed substantiated when a payor (the employer, its agent, or a third party) provides a per diem allowance under a reimbursement or other expense allowance arrangement to pay for the expenses. Rev. Proc. 2008-59 defines per diem allowance as a payment under a reimbursement or other expense allowance arrangement that is:

² Rev. Proc. 2008-59 is one of a series of revenue procedures updated yearly.

- paid with respect to ordinary and necessary business expenses incurred, or that the payor 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 in connection with the performance of services as an employee of the employer,
- reasonably calculated not to exceed the amount of the expenses or the anticipated expenses, and
- 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.

We explain this optional substantiation method, and the other accountable plan rules, in Publication 15 (Circular E), Employer's Tax Guide, available on www.irs.gov.

Return of Excess Requirement

To meet the return of excess requirement, the employee must return to the employer within a reasonable period of time any amount the employer paid in excess of the employee's substantiated (or deemed substantiated) expenses. Section 1.62-2(f)(1) of the Regulations. If an employer's arrangement has no mechanism or process to determine when an allowance exceeds the amount that may be deemed substantiated and the arrangement routinely pays allowances in excess of the amount that may be deemed substantiated without requiring actual substantiation of all the expenses or repayment of the excess amount, we will treat the arrangement as a nonaccountable plan and the entire amount of the allowance will be subject to the withholding and payment of employment taxes. Revenue Ruling 2006-56. 2006-46 IRB 874.

This letter has called your attention to certain general principles of the law. It is intended for informational purposes only and does not constitute a ruling. See Rev. Proc. 2009-1, §2.04, 2009-1 IRB 1 (Jan. 5, 2009). If you have any additional questions, please contact our office at

Sincerely,

Janine Cook
Branch Chief, Employment Tax Branch 1 (Exempt
Organizations/Employment Tax/Government Entities)
(Tax Exempt & Government Entities)