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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Should You Be Withholding On Per Diems Paid To Employees?

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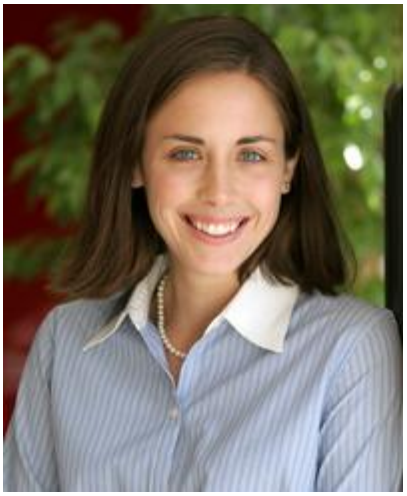
Two Tax Court cases released last week highlight the importance — and the difficulty — of determining where a traveling worker "lives" for tax purposes. The concept of "tax home" has long been a source of confusion and uncertainty for employees that travel frequently or for extended periods. Such an employee may not have a tax home in the same location as his personal home, and in fact may not have a tax home at all.



Jennifer A. Ray

As the Tax Court noted in Jacobs v. Commissioner, an employee must have a tax home, and must travel away from that tax home, to deduct travel expenses or receive tax-free reimbursement of travel expenses. On the other hand, as discussed in Evans v. Commissioner, if an employee is sent overseas and wants to take advantage of the foreign-earned income exclusion, the employee's tax home must move with him outside of the United States.

Both cases arose from audits of individual workers, and both workers lost. The stakes are magnified, however, for employers that provide cash allowances for travel expenses or per diem amounts to their traveling employees. An employer with a mobile workforce — for example, contract engineers, construction workers, transportation workers, academics or oil workers — should ensure that it has adequate procedures in place to determine whether its workers are eligible for tax-free per diems or a reduced rate of withholding on foreign-earned income. Failure to do so could subject the employer to liability for withholding taxes and penalties, including with respect to expense reimbursements that would otherwise be tax-free.

The Tax Turtle

At issue in Jacobs v. Commissioner was whether a long-haul truck driver had a tax home such that he could deduct expenses with respect to his travel. Travel expenses are only deductible under Internal Revenue Code Section 162 if they are incurred in the ordinary course of business and while a person is traveling away from his tax home.

A tax home is generally a person's "regular and principal" place of business. If a person does not have a regular and principal place of business (as may be the case for a person who travels frequently for work), then the person's tax home is his "regular place of abode in a real and substantial sense." A person who has neither a principal place of business nor a regular place of abode is considered to be in "itinerant" whose tax home is wherever he happens to work. Since an itinerant is never "away from home," he cannot deduct travel expenses.

Jacobs spent a number of weeks on the road each year. When he was not traveling, Jacobs stayed at a friend's house in Cottage Grove, Minnesota, and considered that to be his home. Accordingly, Jacobs' position was that when he was on the road in his truck, he was traveling away from home, and he took deductions for per diem meal expenses on those days.

The Tax Court disagreed. It held that Jacobs did not have a tax home, but rather was an itinerant for tax purposes — a "tax turtle" — who carried his home with him on his back. Since Jacobs did not have a regular and principal place of business, the question was whether he had a "regular place of abode." Courts and the IRS have generally examined three factors in making this determination: whether the individual has a business connection to the claimed home, whether he duplicated living expenses by traveling and maintaining the claimed home, and whether he had significant personal ties in that area.

The Tax Court found that Jacobs met none of these factors with respect to the Minnesota home. He had no business reason to live in Minnesota while he was not on the road, but rather visited there to see his friends. Jacobs had no evidence that he contributed financially, let alone significantly, to the home. Finally, he did not have significant personal ties to the area. In particular, the court noted that Jacobs stayed in the guest room when he visited the Minnesota house, as did all other guests.

While each case is heavily fact-dependent, the court's holding and reasoning is consistent with other decisions. Courts frequently hold that where a person does not have a business reason to maintain the claimed tax home and does not incur substantial continuing living expenses there, the taxpayer does not have a tax home in a location even if the taxpayer maintains an address, bank account and driver's license at a location and stores personal belongings there. Courts emphasize that the purpose of the travel expense exclusion is to help people who are incurring significant duplicate living expenses necessitated by business travel.

The Tax Goose

On the other hand, the taxpayer in Evans v. Commissioner apparently had too much of a connection to his personal home. Evans worked in the oil industry and migrated between his personal home in Louisiana and his work in Russia, on a 30 days on, 30 days off schedule. He excluded his salary earned in Russia from his income under the Section 911 foreign-earned income exclusion.

Section 911 is an exception to the general rule that a U.S. citizen is subject to tax on worldwide income. It allows a taxpayer to exclude from his taxable income "foreign-earned income" as well as foreign housing expenses if he satisfies certain requirements. One of those requirements is that he must have his tax home in a foreign country. For this purpose, Section 911(d)(3) provides that a taxpayer will not be considered to have a foreign tax home if he has an "abode" in the United States. That is, even if a taxpayer has a principal place of business in a foreign country (and therefore a tax home under the Section 162 standard), he will be deemed not to have a tax home in the foreign country for purposes of Section 911 if he has too many personal ties to the United States.

Evans (like many oil rig workers before him) fell into this trap. Evans grew up in Louisiana. He began working in the oil industry in 1988 and was regularly posted to drilling locations overseas, but on breaks he returned to visit his parents and later, his wife and child, in Louisiana. In 2007, he began working in

Russia. While in Russia, he lived in employer-provided housing. Throughout this period, he maintained his Louisiana home, made monthly mortgage payments and paid other expenses, and did not attempt to rent the house to offset his expenses. He spent his monthly leave time at his house in Louisiana, often with his daughter.

The Tax Court did not take a position on whether Evans had a tax home in Russia under the Section 162 test discussed above. Rather, it focused on whether he had an "abode" in the United States. Interestingly, the court seemed to apply a more liberal standard in determining that Evans had an abode than the court applied in finding that Jacobs (the tax turtle) did not have an abode.

Evans did not necessarily have any business connection to Louisiana (a factor that courts have emphasized in determining whether an abode is a tax home in the Section 162 context). His personal ties were sufficient to create an abode and deny Evans the Section 911 exclusion for his Russian wages. A worker sent overseas and hoping to qualify for the Section 911 exclusion should carefully consider his level of personal connection to the United States and whether it rises to an "abode."

The Stakes are Even Higher for Employers

Both of these cases focus on the individual worker, but the consequences for an employer could be even more drastic. Employers with mobile workforces frequently provide a per diem to employees to cover meals and incidental expenses and reimburse other travel expenses. Providing these cash allowances to employees who are not traveling (for tax purposes) could cause the employer's entire reimbursement plan to become taxable. As a result, the employer could be required to withhold taxes from all per diems and other cash allowances paid to employees.

This harsh result could occur because the IRS has placed strict limits on cash allowances that can be made to employees tax-free. Generally, employee expenses reimbursed by an employer in cash (including per diems) are subject to tax withholding and reporting, unless the amounts are paid pursuant to an "accountable plan." Expenses reimbursed under an accountable plan are not considered to be wages and are not subject to withholding.

In order to qualify as an accountable plan, a reimbursement plan must meet certain requirements, including that it must provide allowances (including per diems) only for deductible business expenses that are paid or incurred by the employee in connection with the employer's business. As discussed above, an employee's travel expenses are only deductible business expenses if the employee is traveling away from a tax home.

If a plan fails the business connection requirement, generally all amounts paid under the arrangement (including those amounts that would otherwise be excludible) are treated as paid under a "nonaccountable plan" and subject to withholding. That is, improperly providing cash reimbursements to one tax turtle could potentially require an employer to withhold on and report as wages all travel expense reimbursements paid to all employees. An employer that does not withhold as required would be liable for the withholding taxes and, potentially, penalties.

In certain cases, the regulations provide a favorable proration rule that the employer's plan is only considered to be "nonaccountable" for the tax turtles (and other employees that are traveling for business but whose travel expenses are not deductible) and can continue to qualify as an accountable plan for the employees whose travel expenses qualify under Section 162. In order to take advantage of this proration rule, the employer must be careful not to reimburse any "personal" expenses, including meal expenses of an employee that is not traveling at all.

To avoid these results, employers with a mobile workforce should do some amount of due diligence to determine whether their employees qualify for tax-free travel expense reimbursements and per diems, and in particular should ensure that they do not reimburse personal expenses. In an audit, the burden of proof would be on the employer to show that employees who received travel expense reimbursements were traveling away from a “tax home” in the course of the employer’s business.

—By Jennifer A. Ray, Crowell & Moring LLP

Jennifer Ray is a Washington, D.C.-based partner in Crowell & Moring's tax group.