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State of California
Franchise Tax Board

CLASSIFICATION AND
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COMPENSATION DIVISION

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Thomas Dazell, Chairman
California Citizens Compensation Commission
c/o IBEW Local 1245
30 Orange Tree Circle
Vacaville, CA 95687

Chairman, California Citizens Compensation Commission
Department of Personnel Administration
1515 S St., North Building, Suite 400
Sacramento, CA 95811-7258

Dear Mr. Dzell:

This is in response to your correspondence dated May 10, 2011, requesting legal opinions from the Franchise Tax Board regarding the taxability of per diem paid to California legislators. Please find enclosed a summary of the tax treatment of per diem paid to legislators under current federal and California law. I hope it is helpful.

Your correspondence also sought our views concerning whether the tax treatment of per diem paid to California legislators should be revised. While the Franchise Tax Board is responsible for administration of California income tax laws, tax policy matters are within the province of the Congress and the California Legislature. For similar reasons, we also feel compelled to refrain from expressing any views with respect to the circumstances for which per diem should or should not be paid.

Please feel free to contact me or Assistant Chief Counsel Patrick Kusiak of my Legal Division at 916.845.6479 or patrick.kusiak@ftb.ca.gov if you have any further questions.

Sincerely,



Selvi Stanislaus
Executive Officer

Enclosure

Tax Treatment of Per Diem Paid to State Legislators Under Federal and California Law

Federal and California Law

An individual is allowed a deduction for traveling expenses (including amounts expended for meals and lodging) while away from home overnight in pursuit of a trade or business (Internal Revenue Code (IRC) sec. 162(a)(2)). In addition, except as expressly allowed under the Code, a deduction is not allowed for personal, living, and family expenses (IRC sec. 262). These provisions of federal law are also applicable for California tax purposes.

Moreover, deductible "away from home" expenses exclude commuting costs. A taxpayer's "home", for purposes of the deduction of traveling expenses, generally means the taxpayer's principal place of business or employment. If a taxpayer has more than one trade or business, or a single trade or business which requires spending a substantial amount of time at two or more localities, "home" is the taxpayer's principal place of business. A taxpayer's principal place of business is determined on an objective basis, taking into account the facts and circumstances in each case. The more important factors considered in determining the taxpayer's principal place of business (or tax home) are: (1) the total time ordinarily spent by the taxpayer at each of his or her business posts, (2) the degree of business activity at each location, (3) the amount of income derived from each location, and (4) other significant contacts of the taxpayer at each location. One factor is not determinative.

An employer's payments to employees generally are included in the employee's gross income and are treated as wages subject to employment taxes (IRC sec. 61). However, if an employer reimburses deductible business expenses and meets the other requirements of an accountable plan, the reimbursement is not wages and is not included in income or subject to employment taxes (See Treas. Reg. § 1.62-2.).

As noted above, in order to exclude the reimbursements for deductible travel expenses from gross income the reimbursement arrangement must be an accountable plan (Treas. Reg. § 1.62-2(c)(4)). An accountable plan generally requires the employee to substantiate the amount of the expense and the business purpose for the expense to the employer and to return amounts exceeding expenses (Treas. Reg. § 1.62-2(c)(1)).

The Commissioner of Internal Revenue is authorized to prescribe rules under which an arrangement providing per diem allowances will be treated as an accountable plan, even though the arrangement does not require the employee to substantiate actual expenses, or to return amounts exceeding expenses. The allowance must be reasonably calculated not to exceed the employee's anticipated expenses. The employee must substantiate that he or she was traveling on a particular day and must return any allowance for days of travel not substantiated (Treas. Reg. § 1.62-2(f)(2)).

Under this authority, the Commissioner annually publishes a revenue procedure (currently Rev. Proc. 2010-39, 2010-42 I.R.B. 459). This revenue procedure provides that per diem allowances set at or below the federal per diem rates will satisfy the substantiation requirements for amounts of ordinary

and necessary business expenses of an employee for lodging, meal, and incidental expenses incurred while traveling away from home under IRC section 274, and therefore, will satisfy the requirement of returning amounts exceeding expenses (Treas. Reg. § 1.62-2(f)(2)).

An employer may choose to pay a travel allowance greater than the federal per diem rate, but the excess is generally treated as wages, which would be subject to employment taxes and included in the employee's gross income.

Federal Tax Law for State Legislators

Background. Prior to the Tax Reform Act of 1976, there was no special rule for ascertaining the location of a State legislator's tax home. As a result, the generally applicable rules, described above, determined the location of a State legislator's tax home. The Tax Reform Act of 1976 provided an election for the tax treatment of State legislators for taxable years beginning before January 1, 1976. Under this election, a State legislator could treat his or her place of residence within the legislative district as his or her tax home for purposes of computing the deduction for living expenses. If this election was made, the legislator was treated as having expended for living expenses an amount equal to the sum of the daily amount for per diem generally allowed to employees of the U.S. Government for traveling away from home, multiplied by the numbers of days during that year that the State legislature was in session, including any day in which the legislature was in recess for a period of four or fewer consecutive days. For this purpose, the rate of per diem to be used was to be the rate that was in effect during the period for which the deduction was claimed. If the State legislature was in recess for more than four consecutive days, a State legislator could count each day in which his or her physical presence was formally recorded at a meeting of a committee of the State legislature.

The State legislator provision of the 1976 Act was construed by the U.S. Tax Court in *Eugene A. Chappie v. Commissioner*, 73 T.C. 823 (1980). In that case, the Tax Court held that the generally applicable business deduction rules (sec. 162) required a California Assemblyman to be away from home overnight in order to be entitled to a business deduction for traveling and living expenses. Because section 604 of the Tax Reform Act of 1976 made no change in this rule for State legislators, the Tax Court held that no deduction was available as to days when a legislator actually was not away from his tax home (i.e., his place of residence in the district represented) overnight. The Court explained that the rules pertaining to business deductions and commuting expenses (IRC secs. 162 and 262) precluded a deduction for expenditures incurred in the legislator's travels to and from Sacramento.

In the Economic Recovery Act of 1981, the State legislator provisions were modified and made permanent. Under the 1981 Act, an electing State legislator is deemed to have expended for business purposes an amount equal to the appropriate per diem times the legislator's legislative days for the taxable year. In addition, an electing legislator is deemed to be away from home in the pursuit of a trade or business on each legislative day. This is an exception to the general rules of section 162. As a result, an electing legislator is entitled to a deduction equal to that computed under the statutory formula. Because such an individual is deemed to be away from home in the pursuit of a trade or business while incurring the deemed expenses, such an electing legislator is not required to be present at the legislature for that day (or for any day in a legislative recess of four or

fewer consecutive days), or away from home overnight. This change in effect reversed the Tax Court decision in *Chappie v. Commissioner*, 73 T.C. 823 (1980), as to electing State legislators. This language is codified as IRC sec. 162(h).

Current Federal Law. IRC section 162(h)(1) provides that any individual that is a state legislator during the taxable year who makes an election under IRC section 162(h) shall (A) have his or her place of residence within the represented legislative district treated as their home for tax purposes, (B) be deemed to have expended for living expenses (in connection with his/her trade or business as a legislator) an amount equal to the sum of the amounts determined by multiplying each legislative day during the taxable year by the greater of (i) the amount allowed to such legislator by a state's per diem rules (so long as it does not exceed 110 percent of the federal amount) or (ii) the federal per diem amount allowable to employees of the executive branch of the federal government¹, and (C) be deemed to be away from home in the pursuit of a trade or business on each legislative day. IRC section 162(h)(2) defines legislative days as any day during the taxable year on which (A) the Legislature was in session (including any day in which the Legislature was not in session for a period of 4 consecutive days or less), or (B) the Legislature was not in session but the physical presence of the legislator was formally recorded at a meeting of a committee of the Legislature.² However, under IRC 162(h)(4), the State legislator rules are not available to any legislator whose place of residency within the legislative district is 50 or fewer miles from the capitol building of the state. The 50 miles is determined by measuring the actual distance a legislator would be required to travel by surface transportation between his or her district residence and the State capitol building.

The federal per diem rate is: the sum of the federal lodging expense rate plus the federal meal and incidental expense (M&IE) rate for the day and locality of travel. The rates for localities within the continental United States are set by the General Services Administration. These rates can be found in:

- The Federal Travel Regulations, Appendix A of 41 C.F.R. § 301
- Internal Revenue Service Publication 1542, Per Diem Rates

If a legislator does not, or is not entitled to make the election, any travel expense reimbursement is subject to the general rules for determining the legislator's tax home, substantiation, (IRC sec. 274(d)), and accountable plans (IRC sec. 62) discussed above.

Effective December 7, 2010, the per diem rate paid to California legislators is \$141.86³ and the federal per diem amount for Sacramento for the period from October 1, 2010, to September 30,

¹ See IRS Publication 1542, Per Diem Rates, <http://www.irs.gov/pub/irs-pdf/p1542.pdf>.

² Treas. Reg. § 1.162-24(b)(4) also defines a legislative day as any day that the taxpayer is a state legislator and the taxpayer's attendance at any session of the legislature that only a limited number of members are expected to attend (such as a pro forma session) is formally recorded. Treas. Reg. § 1.162-24(d) provides that the legislature of which a taxpayer is a member is in session on any day if, at any time during that day, the members of the legislature are expected to attend and participate as an assembled body of the legislature.

³ California Citizens Compensation Commission Resolution of June 16, 2010.
<http://www.dpa.ca.gov/cccc/resolutions/pdf/20100616-salary-and-benefit.pdf>

2011 is \$162 (\$101 for lodging and \$61 for meals and incidentals).⁴ Since the amount of the payment under California law for travel expenses of state legislators is less than the allowable federal rate of per diem for Sacramento, the substantiation requirements of Rev. Proc. 2010-39 have been satisfied and the amounts paid for legislative days are not included in the gross income of a legislator.

If, however, the legislator incurs expenses in excess of the per diem reimbursement rate received, deductions for those excess amounts would be limited in certain respects as a result of federal laws enacted in 1986 and 1993 that limit the deductibility of certain business-related expenses, including travel expenses while away from home. With respect to travel expense deductions of state legislators, Treas. Reg. sec. 1.62-1T(e)(4) prescribes how these limitations apply to State legislators.

Unreimbursed expenses of State legislators. For taxable years beginning after December 31, 1986, any portion of the amount allowed as a deduction to State legislators pursuant to section 162(h)(1)(B) that is not reimbursed by the State or a third party shall be allocated between lodging and meals in the same ratio as the amounts allowable for lodging and meals under the Federal per diem applicable to the legislator's State capital at the end of the legislator's taxable year[.] For purposes of this paragraph (e)(4), the amount allowable for meals under the Federal per diem shall be the amount of the Federal per diem allowable for meals and incidental expenses reduced by \$2⁵ per legislative day[.] The unreimbursed portion of each type of expense is deductible from adjusted gross income in determining the State legislator's taxable income subject to the limitations applicable to such expenses. For example, the unreimbursed portion allocable to meals shall be reduced by 20 percent⁶ pursuant to section 274(n) before being subjected to the 2-percent floor of section 67 for purposes of computing the taxable income of a State legislator. See §1.67-1T(a)(2).

California Tax Law

California specifically does not conform to IRC section 162(h) under Revenue and Taxation Code (RTC) section 17270, so that California legislators, for state income tax purposes, are not entitled to use the election provided under that federal law section. Instead, under RTC section 17201, California conforms to IRC section 162(a)(2), as discussed above. However, under RTC section 17270(a)(1), California law further provides that the place of residence of a member of the Legislature within the district represented shall be considered the tax home of the legislator for

⁴ Federal per diem rates apply on the basis of the federal fiscal year, which runs from October 1 and continues until September 30 of the following year. The federal per diem amount for Sacramento is \$170 for the period from October 1, 2009, through September 30, 2010, and is \$162 for the period from October 1, 2010, through September 30, 2011. Taxpayers are allowed to use the per diem rates in effect for the first nine months of 2010 for expenses of all travel while away from home that were paid or incurred during the calendar year 2010 in lieu of the updated rates, but taxpayers are required to consistently use either the rates in effect for the first nine months of 2010, or the updated rates, for the period from October 1, 2010, to December 31, 2010, inclusive. (Sec. 3.02(1)(a), Rev. Proc. 2010-39 (2010-42 I.R.B. 459). See also IRS Publication 1542, note 1.

⁵ The amount allocated to incidental expenses is now \$5 (41 C.F.R. § 301-11.18; Sec. 4.05, Rev. Proc. 2010-39 (2010-42 I.R.B. 459)), .

⁶ Treas. Reg. § 1.62-1T(e)(4) has not been amended to reflect the changes made to IRC sec. 274(n) by the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66) that reduced the deductible portion of meals and entertainment expenses from 80 percent to 50 percent for taxable years beginning after December 31, 1993.

purposes of applying the "travel expense" rules of IRC section 162(a)(2). As a result, in order for travel expenses to be deductible and per diem to be excluded, a legislator must be "away from home" overnight. (See *Chappie v. Commissioner, supra.*)

Under California tax law the legislator's residence within the district is the legislator's tax home for purposes of determining the deductibility travel expenses, just as it is for state legislators that make an election under IRC sec. 162(h) for federal purposes. However, unlike the federal rules under IRC sec. 162(h), the traditional rules for determining the deductibility of travel expenses apply for determining the deductibility of travel expenses while away from home overnight for California tax purposes. In addition, the federal rules with respect to substantiation requirements for an accountable plan also apply. If a legislator is away from his or her residence within the district represented overnight, amounts expended for ordinary and necessary would be deductible.

The amount deductible/excludable for each night away from home overnight would be subject to the same rules related to substantiation and accountable plans described above.