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# Taxation of Fringe Benefits Programs

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# Overview

- In offering and designing fringe benefits programs, tax consequences should be considered
- Careful design of such benefits can make them non-taxable to employees and can reduce company exposure for withholding taxes and other tax penalties.
- Tax considerations are especially important now that the IRS is targeting the tax treatment of employee benefits programs for audit. We will outline the background regarding the IRS audit initiatives.

# Overview

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- The way the Internal Revenue Code is structured, every benefit is taxable to the employee unless an exclusion from income/wages covering the benefit can be found.
- We will review the various helpful exclusions and specific examples of how they apply.

# Overview

- If a fringe benefit is provided and there is no basis for exclusion of the amount from taxation, there are consequences both to the employee and to the employer.
- First, the employee is liable for individual income taxes on the value of the benefit.
- Second, the employer is potentially directly liable for the taxes it did not withhold, and there may be additional penalties.
- We will review these tax consequences to the employer.

# I. Failing to Treat Taxable Benefits as Wages: Tax Consequences to Employee

- Employee could be audited by the IRS and could be treated as taxable on benefits that were not reported to him. This would result in increased Federal and state income taxes and, beginning in 2013, potentially more Medicare taxes. Starting in 2013, individuals with wages in excess of \$200,000 (for single filers) or \$250,000 (for joint filers) are liable for an additional .09 percent Medicare tax.
- However, it is much more likely that the issue will arise in an IRS audit of the tax reporting and withholding of the employer's benefit programs.

# I. Failing to Treat Taxable Benefits as Wages: Risks to Employer

- Employer is directly liable (Code 3403) for the employee's taxes that should have been withheld, but were not:
  - Federal Income taxes. Generally, employer is liable to withhold income taxes at a 25% rate (this rate is 35% where the employee has supplemental wages equal or exceeding \$1 million during the year).
  - FICA taxes. Employer is liable to withhold social security taxes at the rate of 6.2% on the employee's first \$106,800 of wages and Medicare taxes at the rate of 1.45% (uncapped). (Medicare taxes on certain employees increase by .09% in 2013)

# I. Failing to Treat Taxable Benefits as Wages: Risks to Employer

- Example: Employer has 10,000 employees, 50% of whom have wages in excess of the \$106,800 social security wage base for 2011 and 50% of whom have wages significantly below the wage base. 500 employees have supplemental wages (e.g., from stock options) in excess of \$1,000,000. Employer provides a fringe benefit or benefits (e.g., gift card, sports tickets) valued at \$400 per employee, and does not report the amount as income. For purposes of the example, assume this position is incorrect and the benefit is properly treated as taxable.

# I. Failing to Treat Taxable Benefits as Wages: Risks to Employer

- Example (cont): Employer is liable for the employees' taxes as follows (total of **\$1,378,000**):
- Employee federal income taxes:
  - 9,500 employees x \$400 x 25% = \$950,000
  - 500 employees x \$400 x 35% = \$ 70,000
  - Total Federal income taxes: \$1,200,000
- Employee FICA:
  - 5,000 employees x \$400 x 7.45% = \$149,000
  - 5,000 employees x \$400 x 1.45% = \$ 29,000
  - Total FICA: \$178,000



# I. Failing to Treat Taxable Benefits as Wages (cont'd)

- Employer also is liable for failing to pay its share of FICA taxes (6.2% OASDI up to annual wage base + 1.45% Medicare) (\$178,000 in our example).
- Employer is liable for 6656 late deposit penalty on *its* share of FICA taxes only (i.e., 10% of FICA taxes it should have paid) (\$17,800, in our example)).
- Information reporting penalties under 6721/6722.
  - Generally, \$100 per incorrect W-2 up to annual maximum of \$1,500,000 (\$1,000,000 in our example).
- Negligence penalty of 20% could also apply under § 6662 (\$311,200 in our example).

## II. Current IRS Audit Environment

- Risk of employer liability is relatively high now with increased IRS scrutiny of fringe benefits issues in IRS employment tax audits.
  - IRS National Research Program (“NRP”) Initiative – auditing 6,000 employers over the course of 2010-2012 on these fringe benefit issues, among other issues. A small percentage of these expected to be large employers.
  - More comprehensive employment tax examinations have occurred outside the NRP Initiative.

## II. Current IRS Audit Environment

- Commissioner's commitment to hire more examiners for payroll tax, information reporting and worker classification examinations – announcement in early 2009
- Coordination with corporate tax exams of deductions
  - No more trading payroll tax assessments for deduction disallowances
- Routine imposition of 20% negligence penalties under 6662
- More frequently require Forms W-2c.
- Employment taxes are a good source of revenue when corporate income is down (or negative).

## II. Current Audit Environment

- Specific fringe benefits we see addressed include:
  - Sky boxes,
  - Prizes, awards and gifts
  - Company cars
  - Use of corporate aircraft
  - Cell phones/computers
  - Club memberships (including airline clubs)
  - Security provided to executives
  - Employee discounts
  - Per diem and other travel policies

# III. Complying with Fringe Benefits Rules

- As noted, in order for a fringe benefit to be excluded from income, there must be an exemption from income that covers the benefit.
- Potential exemptions are as follows:
  - Working condition fringe benefits exclusion
  - De minimis fringe benefit exclusion
  - Qualified employee discount
  - No-additional cost fringe benefit
  - On-site athletic facility fringe benefit
  - Other miscellaneous exclusions (e.g., education assistance)

### III. Complying with Working Condition Fringe Benefit Rules

- In this session, we will focus on the exclusion for working condition fringe benefits. The working condition fringe exclusion generally excludes from income items that an employee needs to perform his job, such as office equipment, business travel, etc.

### III. Complying with Working Condition Fringe Benefit Rules

- The requirements for exclusions are that the property or services be provided to an individual performing services for the employer (IRC § 132(d)), Treas. Reg. § 1.132-5) under the following conditions:
  - the costs would have been deductible by the recipient on his own tax return if the recipient had paid for them;
  - the costs relate to the employer's business;
  - the recipient is a current employee ("EE") for purposes of the exclusion (i.e., is not a retired person or a spouse or child of a current worker);

# III. Complying with Working Condition Fringe Benefit Rules

- Requirements continued:
  - whether or not the benefits are provided on a discriminatory basis; and
  - provided the worker has no choice between cash and the benefit.



### III. Complying with Working Condition Fringe Benefit Rules

- Current Employee Requirement (Reg. sec. 1.132-1(b)(2)):
  - Benefit is allowed to individual who is “currently employed by the employer”
  - Also to partner who performs services for partnership
  - Also to director of the employer
  - Also to an independent contractor who performs services for the employer
  - Directors/independent contractors benefits are limited

### III. Complying with Working Condition Fringe Benefit Rules

- **Business Expense Requirement.** Exclusion from income depends on amount qualifying as a business expense to employee in connection with his/her business of being an employee of the employer (Reg. sec. 1.132-1(b)(2)):
  - Tax recordkeeping rules are applicable, including heightened recordkeeping rules in connection with travel, entertainment, and use of cars, computers, and until recently, cell phones.
  - Expense must relate to employer's business, not other business of employee. Charity Board service example.

### III. Complying with Working Condition Fringe Benefit Rules

- No Cash Choice Requirement (Reg. sec. 1.132-5(a)(1)(i)). There are limits (although they are somewhat vague) on the extent to which an employee can choose between a working condition fringe benefit and cash.
  - This arises when employees are given a choice between business tools, such as office furnishings, subscriptions, etc., and additional cash compensation

# III. Complying with Working Condition Fringe Benefit Rules

Examples of working condition fringe benefits:

- Cell phones and laptops
- Travel expenses and per diem payments
- Flights on company aircraft
- Spousal travel
- Company-provided cars
- Executive physicals
- Home office
- Security protection for executives
- Country club or airline club dues
- Outplacement services
- Use of office supplies and equipment

## IV. Four Hot Working Condition Fringe Topics

- Topic A: Travel expense and per diem issues (Treas. Reg. §§ 1.132-5(a)(1)(v) and 1.62-2(c))
- Topic B: Personal use of the corporate aircraft, including flights provided to spouses
- Topic C: Employer-provided cell phones and cell phone service
- Topic D: Employer-provided cars

## IV. Topic A: Travel Expense Reimbursement Rules

- Travel expense programs generally operate as cash reimbursements to the employee, rather than the direct provision of travel benefits to the employee. This is fine under the working condition fringe rules as long as the employee is required to:
  - use the payment to pay for a specific or pre-arranged activity deductible under §§ 162 or 167;
  - verify that the payment is used for the expense; and
  - return to the employer any unused portion of the payment.

## **IV. Topic A: Travel Expense Reimbursement Rules**

- Travel expense programs also must meet more detailed process rules, called the accountable plan rules.
- These involve specific timing rules for reimbursement.
- Also, strict rules against abusive arrangements.

## **IV. Topic A: Recurring Issues for Travel Expense and Per Diem Arrangements**

- The problem of the bi-coastal executive.
- The problem of the peripatetic employee.



## IV. Topic B: Use of the Corporate Plane and Spousal Travel

- The value of spousal travel benefits that do not qualify as bona fide business travel must be treated as wages.
- It is very difficult to justify spousal travel as bona fide business travel.
- Special favorable valuation rules apply (but often result in an increased deduction disallowance to the employer).
- Mixed business/personal flights present allocation issues.

## **IV. Topic C: Employer-Provided Cell Phones: Substantiation Requirements**

- Cell phones became an issue because IRS auditors were treating them as taxable to employees unless strict business substantiation rules were followed
- Insufficient records of business use resulted in wage treatment
- Cell phones were exempted from these strict substantiation rules by the Small Business Jobs Act of 2010, effective for taxable years ending after December 31, 2009.
- Less strict business substantiation rules still apply.
- Strict business substantiation issue still exists for employer-provided laptops.

## IV. Topic D: Employer-Provided Cars

- Automobiles are subject to strict business substantiation requirements.
  - Employees are generally required to maintain detailed logs regarding the use of the vehicle, or the entire value of the vehicle must be taxed as wages.
  - Allocation of business and personal use.
- Commuting is considered **personal use**. A commute is generally a daily trip between the employee's principal residence and any "regular place of business." See Rev. Rul. 99-7.
- Determination of what constitutes a commute can be tricky!

## IV. Employer-Provided Cars: Special Valuation Rules

- Special favorable valuation rules may apply.
- The employer chooses the valuation rule to apply, and there are consistency rules.

## IV. Topic D: Employer-Provided Cars: Special Rules

- Special exceptions and valuation rules apply in certain circumstances:
  - Qualified Nonpersonal Use Vehicles. Certain types of heavy duty trucks are exempt from recordkeeping requirements.
  - Employer Policy Permitting Commuting Only. If there is a noncompensatory business reason for the employee to have the car at home (e.g., the employee is called out in the middle of the night), a special \$3.00 per day valuation and exemption from recordkeeping applies. Cannot be used for control employees (e.g., highly paid executives).

## V. Conclusion

- Concluding remarks
- Questions?
- Outline of next session

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