Webinar on De Minimis Fringe Benefits, Employee Discounts and on-Site Athletic Facilities

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I. 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 audits.

Overview

- 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 three helpful exclusions and specific examples of how they apply: De Minimis Fringe Benefits, Employee Discounts and On-Site Athletic Facilities.

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 (FICA, FITW) and there may be additional penalties.

Overview

- Tax considerations are particularly important now, given the IRS' heightened audit activity in this area.
- We will outline the background regarding the IRS' audit initiatives.

Part II – Application of the the De Minimis Exclusion

Part III – Application of the Qualified Employee Discount and No Additional Cost Rules

Part IV – Exclusion for On-Site Athletic Facilities

Part II. De Minimis Fringe Benefit Exclusion: Statutory Framework

- The exclusion for “de minimis fringes” is intended to give administrative relief to employers when the benefits being provided to the employee are small in value and are infrequently provided. The definition provided by section 132(e)(1) of the Internal Revenue Code (the “Code”) for de minimis fringes is a syntactical embarrassment, even for the Internal Revenue Code:

  > The term “de minimis fringe” means any property or service the value of which is (after taking into account the frequency with which similar benefits are provided by the employer to the employer’s employees) so small as to make accounting for it unreasonable or administratively impracticable.

De Minimis Fringe Benefit Exclusion: Statutory Framework

- The definition essentially communicates the requirement that the *value* of the benefit must be small when considered within the context of two elements:
  - (1) the frequency with which the benefit and similar benefits are provided, and
  - (2) the level of administrative practicability and costs associated with accounting for the benefits.
- This determination of value is based on all the facts and circumstances.

De Minimis Exclusion: Frequency

- Generally, ***frequency*** must be measured by reference to the frequency with which the benefits are provided to specific individuals ("employee-measured frequency").
- If it would be administratively difficult to determine frequency per-employee, frequency may be measured by reference to the employer's practices in providing benefits to all employees ("employer-measured frequency"), and not the frequency with which individual employees receive them, unless the benefit being provided is occasional meal money or local transportation fare.

De Minimis Exclusion: Frequency

- How often is too often?
- Does “tracking” the frequency defeat the argument that the benefits are de minimis?
- Big issue with –
  - sports, theater, and entertainment-event tickets, and
  - employee meals, group meals and parties

De Minimis Exclusion: Administrative Impracticability

- The second factor governing whether a benefit of small value must be taxed as wages is ***administrability***.
- Treas. Reg. § 1.132-6(c) provides that "[u]nless excluded by a [Code] provision ... other than section 132(a)(4), the value of any fringe benefit that would not be unreasonable or *administratively impracticable* to account for is includible in the employee's gross income."
- It is <u>never</u> administratively impracticable to account for cash or "cash equivalents."

De Minimis Exclusion: Definition of "Employee"

- "Any recipient of a fringe benefit," including family members of employees and clients/business associates. Treas. Reg. § 1.132-1(b)(3).
- Nondiscrimination rules also do not apply to this benefit (except in the limited case of employer-operated eating facilities as defined in Code § 132(e)(2)).

De Minimis Exclusion: Cliff Provision

- The availability of the exclusion operates as a cliff.
- If an employer provides a benefit that exceeds either the value or the frequency limitations for de minimis fringes, the ***entire benefit*** is included in the employee's income, not just the portion that exceeds the de minimis limit. Treas. Reg. § 1.132-6(d)(4).

Value: How much is too much?

- No specific dollar limitation for determining whether a benefit is de minimis is stated in the statute, in IRS regulations, or other formal IRS guidance.
- Examples of various de minimis fringes given in the regulations and in the 1984 legislative history are not limited to items with particular dollar limits.
  - Listed items such as birthday and holiday gifts, flowers, theater tickets and “group meals” typically cost more than $50.

Value: Narrow Interpretation Followed by Shrinking Valuation in IRS Informal Rulings

- PLR 9442003 – the IRS concluded that the value of preparing and filing income tax returns electronically for employees (with a value of approximately $100) was a de minimis fringe benefit.
- TAM 200030001 – the value of meals provided to employees at business conferences, ranging in cost from $109 to $709 per participant were not de minimis fringe benefits.
- CCA 200108042 – the IRS concluded that "non-monetary achievement awards having a fair market value of $100 would not qualify as de minimis fringes."

Special Issues: Gift Cards

- Under the principle that it is never administratively impracticable to account for cash, cash cannot be excluded from income as a de minimis fringe benefit.
- Moreover, a "cash equivalent" is also not eligible for the exclusion as explained in Treas. Reg. § 1.132-6(c):
  - Similarly, except as otherwise provided . . . , a cash equivalent fringe benefit (such as a fringe benefit provided to an employee through the use of a gift certificate or charge or credit card) is generally not excludable under section 132(a) even if the same property or service acquired (if provided in kind) would be excludable as a de minimis fringe benefit.

Special Issues: Gift Cards (Continued)

- TAM 200437030 (April 30, 2004) – the IRS ruled that a $35 employer-provided gift coupon redeemable at grocery stores for a holiday gift is not excludable from gross income and wages as a de minimis fringe benefit.
  - Specifically, the IRS concluded that gift coupons could not qualify for the exception because “cash and cash equivalent fringe benefits like gift certificates have a readily ascertainable value, [and therefore] they do not constitute de minimis fringe benefits because these items are not unreasonable or administratively impracticable to account for.”

Special Issues: Gift Cards (Continued)

- Many taxpayers take the reasonable position that gift certificates that comply with the definition of "tangible personal property," in Treas. Reg. § 1.274-3(b)(2)(iv) (pre-1987 regulations on employee awards) and Prop Treas. Reg. § 1.274-8(c)(2) (post-1986 regulations employee awards) should not be considered cash equivalents.
- Under these rules, a "nonnegotiable certificate conferring only the right to receive tangible personal property" may be treated as tangible personal property for purposes of the employee achievement award rules under Code § 274(j). Prop. Treas. Reg. § 1.274-8(c)(2).
- Softening of IRS Position?

Special Issues: Employee Lotteries/Door Prizes

- Given the statutory prohibition under Code § 102(c) of a gift characterization for employer-provided awards or prizes for an employee, the only practical way to exclude the value of a prize or award from an employee's income is the de minimis exclusion.
- If the value is above a "de minimis amount," how should a door prize at a holiday party be reported?
- What about a door prize at a charity-sponsored event for your workforce?

Special Issues: De Minims Fringe Benefit Exclusion and Reimbursements of Cash

- The IRS is particularly harsh with respect to taxpayer attempts to exclude cash reimbursements as a de minimis fringe benefit.
- For example, in Rev. Proc. 2004-29 (a revenue procedure permitting statistical sampling for identifying meal and entertainment expenses subject to the 50% disallowance), the IRS stressed the ease of tracking reimbursements and concluded that payments under "accountable plans" are never de minimis fringes.
- Are there workarounds for this?

Special Issues: Wellness Plans

- Health plans often offer awards for plan participants engaging in certain types of preventative procedures (e.g., a physical examination) or “healthy activities” (e.g., running a 10K).
- If the health plan is employer-sponsored, absent a specific exclusion, these awards constitute taxable wages.
- Even if the award qualifies as de minimis, the cafeteria plan proposed regulations prohibit offering Code section 132 fringe benefits through a cafeteria plan. See Prop. Treas. Reg. § 1.125-1(q)(1)(iv).

Part III - Qualified Employee Discount Fringe: Statutory Framework

- Section 132(c) of the Code defines a “qualified employee discount” as any employee discount with respect to “qualified property or services” of the employer to the extent that the discount does not exceed certain specified limits.
- Employee for this purpose means a current employee, an employee who retired or terminated due to disability, the widow(er) or child of a deceased employee, and a partner who performs services for a partnership. (Use of discount by spouse or child is treated as use by employee.)
- Nondiscrimination rules apply.

Part III - Qualified Employee Discount Fringe: Statutory Framework

- Specifically, the discount for services cannot exceed 20 percent.
- In the case of qualified property, the employee discount is limited to the price at which the property is offered to customers in the course of the employer's ordinary line of business, multiplied by the employer's "gross profit percentage." Section 132(c)(2); and Treas. Reg. § 1.132-3(c)(1)(i).

Qualified Employee Discount Fringe: Calculation of Gross Profit Percentage

- Gross profit percentage is defined as the excess of the aggregate sales price of the property sold by the employer to customers (including employees) over the employer's aggregate cost of the property, then divided by the aggregate sale price.
- The gross profit percentage must be calculated separately for each line of business based on the aggregate sales price and aggregate cost of property in that line of business over a representative period (typically the prior year). Treas. Reg. § 1.132-3(c)(1)(ii).

Qualified Employee Discount Fringe: Must be Offered for Sale to Customers

- Under Section 132(c)(4) of the Code the term "qualified property or services" means any property (other than real property and other than personal property of a kind held for investment) or services offered for sale to customers in the ordinary course of the line of business of the employer for which the employee is performing services.
- Treas. Reg. § 1.132-1(c) provides that all "employees treated as employed by a single employer under section 414(b), (c), (m) or (o) will be treated as employed by a single employer for purposes of this section."

Qualified Employee Discount Fringe: Line-of-Business Requirement

- Single employer treatment, however, does not automatically result in single line-of-business treatment under section 132(c) of the Code. Treas. Reg. § 1.132(c) provides that the special aggregation rule for controlled groups does not change the line-of-business requirement for purposes of the qualified employee discount exclusion.
- Employees who provide services in one business line of the controlled group are not necessarily eligible for qualified employee discounts furnished to employees in a separate line of business of the controlled group merely because they are treated as employed by a single employer under section 414(b) of the Code.

Qualified Employee Discount Fringe: Line-of-Business Requirement

- Under the regulations, the actual lines of business are identified by reference to the two-digit code classification of the Enterprise Standard Industrial Classification ("ESIC") Manual prepared by the Statistical Policy Division of the U.S. Office of Management and Budget. *See* Treas. Reg. § 1.132-4(a)(2).
- For purposes of the qualified employee discount exclusion, an employer is considered to have more than one line of business if the employer offers for sale to customers property or services in more than one two-digit ESIC code classification.

Qualified Employee Discount Fringe: Limitations of the ESIC Code

- The last version of the ESIC Manual appeared in 1987. Since that time, the North American Industry Classification System (NAICS) has been adopted by the Office of Management and Budget, replacing the ESIC Manual as the economic classification system. *See* 62 Fed. Reg. 17288 (April 9, 1997).
- Since the ESIC Code is dated, many of the classifications, particularly classifications in the Tech industry, fail to identify modern industry sectors and subsectors.

Qualified Employee Discount Fringe: Exceptions to Line-of-Business Requirement

- It is widely recognized that the 99 two-digit (major group) codes established by the ESIC model offer an imperfect measure of what actually constitutes a line of business. In some cases, widely divergent products or services are covered under the same ESIC code. For example, ESIC code 28 applies to agricultural fertilizers, hand soaps, aspirin and explosives.
- In recognition of the restrictive and sometimes arbitrary groupings that this classification system creates, there are statutory and regulatory rules that relax the line-of-business requirement for purposes of the qualified employee discount.

Qualified Employee Discount Fringe: Exceptions to Line-of-Business Requirement

- Performance of services directly benefiting more than one line of business. Treas. Reg. § 1.132-4(a)(1)(iv) provides that employees who provide substantial services benefiting more than one line of business of an employer are treated as performing substantial services in all such lines of business.
- Treas. Reg. § 1.132-4(a)(1)(iv)(A) specifically provides as an example of the performance of services benefiting more than one line of business, "an employee who maintains accounting records for an employer's three lines of business." This rule is typically applied to corporate headquarters personnel who perform services benefiting all the businesses within the affiliated group.

Qualified Employee Discount Fringe: Exceptions to Line-of-Business Requirement

- Aggregation of business lines where uncommon to not operate together. A special aggregation rule applies to companies that typically operate businesses together that have different ESIC codes. Treas. Reg. § 1.132-4(a)(3)(i) provides that separate businesses should be aggregated where "it is uncommon in the industry of the employer for any of the separate lines of business of the employer to be operated without the others."
- In PLR 9025068 (June 22, 1990), the IRS relied on the special rule to combine a motor vehicle company's manufacturing and sales divisions with a separate division that financed sales and leases for motor vehicles, parts and accessories, since it was "common" in the industry for an employer to operate both lines.

Qualified Employee Discount Fringe: Exceptions to Line-of-Business Requirement

- Exception for leased sections of department stores. This special waiver of the single-line-of-business requirement allows employee discounts to be provided by a department store to the employees of a separate employer that sells merchandise or services within the department store under a lease or similar arrangement, provided it appears to the general public that those employees are actually employed by the department store. *See* Treas. Reg. § 1.132-3(d)(1).
- This is a cross-discount exclusion. Thus, not only do employees of the leased section qualify for discounts at the department store, but the employees of the department store qualify for discounts of merchandise sold by the leased section.

Qualified Employee Discount Fringe: Hot Audit Topics

- Excessive discounts
- Providing discounts to individuals other than employees and their spouses and dependents
- Discounts that favor highly compensated employees

No-Additional-Cost Services Fringe Benefit: Statutory Framework

- Under Code section 132(b), a free or reduced charge service provided to an employee (or specified members of the employee's family for personal use) is excluded if:
  1. the employer incurs no substantial additional cost (including foregone revenue and any substantial time spent by the service providers) in providing the service (determined without regard to any amount paid by the employee for such service);
  2. the service is provided by the employer or another business entity with which the employer has a written reciprocal agreement;
  3. the service is of the same type ordinarily offered for sale to nonemployee customers in the same line of business in which the employee is performing substantial services;
  4. the service is provided only to an "employee" (defined in the next slide); and
  5. the nondiscrimination rules applicable to certain highly compensated employees are met.

No-Additional-Cost Services Fringe Benefit: Employee Definition

- Under Code section 132(h), the term employee includes:
  - current employees;
  - spouses of employees;
  - dependent children (including step-children and children of deceased employees);
  - former employees who have left the service of the employer due to retirement or disability; and
  - widows and widowers of employees who died while employed in the line of business or left service due to retirement or disability.
  - Special rule for parents of airline employees. Under a special statutory provision, the use of free or discounted airline passes by a parent of an airline employee is treated as use by the employee. Code § 132(h)(3); Reg. § 1.132-1(b)(1).
  - Partners. Any partner who performs services for a partnership is considered to be an employee of the partnership. Reg. § 1.132-1(b)(1).

No-Additional-Cost Services Fringe Benefit: Line of Business Limitation

- Same line of business requirement and exceptions as qualified employee discount fringe benefit. For example, employees of airline affiliates engaged in "airline related services" (*e.g.*, catering, baggage handling, ticketing, and airport gift shops) are treated as engaged in the airline business. *See* Budget Reconciliation Act of 1985, § 13207(b) and Reg. § 1.132-4(d).

No-Additional-Cost Services Fringe Benefit: Reciprocal Arrangements

- Unlike the qualified employee discount fringe, unrelated employers in the same line of business may enter into written reciprocal agreements so that they can provide no-additional-cost services to each other's employees. Reg. § 1.132-2(b). Example: Airline X and Airline Y have a written agreement permitting their respective airline employees to take personal flights on the other airline at no charge when space is available. Assuming that neither Airline X nor Airline Y incurs any substantial additional cost in providing the service to the employees of the other airline, employees receiving the free flights are eligible for the no-additional-cost service exclusion.

No-Additional-Cost Services Fringe Benefit: Substantial Additional Cost

- Excess capacity services, such as hotel accommodations, transportation, and telephone services, are eligible for treatment as no-additional-cost services, provided the services are, in fact, excess capacity.
- "Cost" includes revenue that is foregone because the service is provided to an employee instead of to a paying customer. Reg. § 1.132-2(a)(5). The amount of time spent by other employees in providing the service to the employee must be considered when computing "cost," even if the employees providing the service provide it after normal business hours or during "idle" time. However, the time spent by employees will not be considered substantial if the services provided to participating employees are merely incidental to the services provided to paying customers.

No-Additional-Cost Services Fringe Benefit: Hot Audit Issues

- Reserved Seating on Airplanes or Reserved Lodging in Hotels

- Use of the No-Additional-Cost Services by Non-qualified individuals (e.g., friends of the employee)

- The use of the service by the employee resulted in foregone revenue (and therefore the service should not qualify as a no-additional-cost service)

Part IV Exclusion for On-Premises Athletic Facilities: Statutory Framework

- Another special rule under Code section 132(j)(4) excludes from gross income the value of any gymnasium or other athletic facility provided to eligible employees that is:
  - located on "premises" of the employer (*i.e.*, not necessarily "business premises," but may not be a "residential use" facility);
  - operated and either owned or leased by the employer;
  - substantially all the use of which is by current or retired employees of the employer (or their spouses and dependent children or widow(er)s or orphaned children).

Part IV - Exclusion for On-Premises Athletic Facilities: Statutory Framework

- Co-ownership or co-leasing with other employers is acceptable, under rules that are explained in more detail in PLR 9029026 (4/20/90); *see also* PLR 9430029 (5/3/94).
- Individuals other than eligible employees (e.g., independent contractors) would be taxed on their receipt of this benefit.
- Nondiscrimination Rules do not apply: Unofficial reason is because if nondiscrimination rules had applied, Senators and Congressmen could not have continued to use their Capitol Hill gymnasiums on a tax-free basis!

Exclusion for On-Premises Athletic Facilities: Special Issues

- It is important to remember that employers can "co-lease" a facility that is not on their actual business premises. This enables employers a lot of flexibility in meeting the requirements of this section.

- With the rise of independent contractors working along side employees, employers with on-site athletic facilities must monitor whether the facility is being used by nonqualified individuals!

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