

Can Our Company Let Employees Use Our Services Tax-Free?

EBIA Weekly (April 25, 2024)

QUESTION: Our company operates several hotels. If we let employees use rooms that would otherwise go unused, is that a taxable fringe benefit?

ANSWER: Many employers that sell services—such as airlines, hotels, telephone companies, and event sponsors—allow their employees to obtain those services for free or at discounted prices. Even if those services or discounts have significant value, employees can exclude that value for federal income tax purposes and from the wage base for income tax withholding and employment tax purposes, if the services qualify as “no-additional-cost services” under Code § 132(b). The exclusion for no-additional-cost services applies to services provided in-kind, and to partial or total cash rebates of any amount the employee paid for the service. The exclusion may be applied to current employees, and to certain family members and former employees.

A no-additional-cost service is a service that—

- the employer offers to its customers (and not primarily to employees) in the ordinary course of business;
- the employer also offers to its employees for their personal use;
- is offered by the same line of business in which the employee provides services; and
- does not cause the employer to incur substantial additional costs when it is provided to the employee.

Not every service that meets this definition qualifies. Some services (such as education) are the subject of specific Code provisions that dictate the extent to which those services are excludable. The existence of those other specific Code provisions may make the no-additional-cost fringe unavailable. And even if the exclusion is otherwise available, the value of the service will not be excludable if the employee is a highly compensated employee (HCE), and the benefit is discriminatory.

IRS regulations provide that eligible services may include excess-capacity services such as hotel accommodations, transportation (by aircraft, train, bus, subway, or cruise line), and telephone services. Other guidance has applied the exclusion to entertainment or recreational facilities (such as golf courses) and tickets to baseball games. The regulations suggest that some tangible items (e.g., in-flight meals) can be provided without loss of the exclusion, so long as the goods are incidental to the primary service. If non-employee customers must pay separately for items that are arguably incidental, those items are less likely to be excludable.

If your company operates multiple lines of business, you will need to determine which employees can be treated as providing substantial services to your hotel line of business. The line of business rules for no-additional-cost service fringe benefits are like those used under the qualified employee discount rules.

When deciding whether a service causes the employer to incur substantial additional costs, any amount paid by the employee is ignored. (For example, the employee could pay 99% of the cost, and the service

might still fail to qualify.) “Cost” in this context includes revenue that is lost because an employee receives the service instead of a non-employee. No revenue is lost when employees take advantage of truly unused or excess capacity. But if the employer has limited capacity and employees can reserve some of that capacity in advance, revenue will be considered lost. Labor costs incurred in providing services to employees must also be considered. Consequently, even if the employer incurs no non-labor costs, substantial additional costs are deemed incurred if either the employer or its employees spend a substantial amount of time to provide the service. Time spent by employees must be counted even if they would otherwise be idle or if they perform the services outside of their regular work hours, but such time may be ignored if the labor is “merely incidental” to providing the primary service. Examples of such incidental services include the in-flight services of a flight attendant, and housekeeper services provided to employees who use their employer’s hotel rooms on a space-available basis.

HCEs can benefit from the no-additional-cost service exclusion only if the service is available on “substantially the same terms” to all the employer’s employees or to a group of the employer’s employees that does not discriminate in favor of “highly compensated employees.” These rules apply to the no-additional-cost service exclusion in essentially the same manner as the exclusion for qualified employee discounts.

For more information, see EBIA’s Fringe Benefits manual at Sections IX (“Qualified Employee Discount Programs”) and XXIV.B (“No-Additional-Cost Services”).

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