

Update on the Taxation of Fringe Benefits

American Benefits Council

Marianna G. Dyson

Michael M. Lloyd

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A QUICK TUTORIAL ON FRINGE BENEFITS

What is a Fringe Benefit?

- “Whether it is called a fringe benefit, perquisite, or perk, any property or service (or cash under certain circumstances) that an employee receives from an employer in lieu of or in addition to regular taxable wages is a fringe benefit that may be subject to taxation.” “More Basics: The Basics of Fringe Benefits,” IRS Doc 7977 (Rev. 1-94).
- “A fringe benefit is a form of pay (including property, services, cash or cash equivalent) in addition to stated pay for the performance of services.” Taxable Fringe Benefit Guide for Federal, State and Local Governments (IRS January 2012).
- “Perks frequently cost a company relatively little, but draw considerable criticism as symbols of *irrational largesse*.” Wall Street Journal, April 2007 (emphasis added).

Examples of Fringe Benefits

- airline club memberships
- automobile allowances
- awards or prizes
- back pay awards
- bonuses (cash or noncash)
- cafeteria plans
- cell phones and other telecommunications devices
- chauffeur service
- club memberships
- company aircraft
- company cars
- credit cards (employer-provided)
- dependent care assistance programs
- disability payments
- discounts on property or service
- discounted airline passes
- educational reimbursements
- executive dining rooms
- estate planning
- financial counseling
- financial seminars
- free or subsidized lodging (including campus lodging)
- golden parachute payments
- group-term life insurance over \$50,000
- holiday gifts
- home security systems
- income tax preparation

Examples of Fringe Benefits (cont'd)

- laptop computers
- legal counseling
- loans (low-interest or interest-free)
- local transportation for commuting purposes
- meal money because of overtime
- meal allowances/reimbursements (not away overnight)
- memberships in athletic facilities
- military differential pay
- moving expense reimbursements
- nonqualified stock bonus plans
- nonqualified stock option plans
- outplacement services
- parking
- personal liability insurance
- physical examinations and/or use of health/medical facilities
- qualified stock options
- reimbursements of expenses on sale of personal residence
- retirement gifts
- safety or length of service awards
- severance pay
- scholarships or fellowships
- sick pay
- spousal travel
- uniform allowances
- use of recreation vehicles or boats
- use of vacation homes
- vacations (all expense paid or discounted)

How Do You Determine the Tax Treatment of a Fringe Benefit? Step 1 – Assume It Is Income

- Step 1 – Assume that the **value** of the fringe benefit (“FB”) is taxable, unless there is a statute or regulation that excludes the value from income.
 - § 61 of the Internal Revenue Code – gross income means **all** income from whatever source derived, including compensation provided in the form of fringe benefits.
 - A taxable FB provided by an employer is treated as additional wages subject to FICA taxes and income tax withholding.
 - ***The employer is “secondarily liable” for failing to withhold.***

Step 1 – Fringe Benefits Provided in Connection With the Performance of Services

- A taxable FB is included in the income of the person performing the services. The value of the benefit may be taxable to a person who did not actually receive it.
- The “provider” of the benefit is the person for whom the services are performed, regardless of whether that person actually provides the FB to the recipient.
 - The provider need not be the recipient’s employer – the term “employer” generally includes any provider of a FB in connection with payment for the performance of services.
- Watch out for “**statutory employer**” problem of § 3401(d)(1), in that the entity with control over the payment of the wages (e.g., provision of the fringe benefit) could be held secondarily liable for the payroll taxes!

Step 2 – Determine Whether Any Statutory Exclusions Apply

- After identifying a particular fringe benefit, the Code and underlying regulations should be checked to determine whether there is a statutory exclusion for that fringe benefit.
 - An exclusion may only exclude a portion of the fringe benefit's value.
 - The conditions for excluding the value of a fringe benefit must be met.
 - Special valuation or safe harbor valuation rules may operate as a partial exclusion.

Step 2: Examples of Statutory Exclusions

- § 62(c)—reimbursements under “accountable plan” rules
- § 74—awards for length of service and safety achievement
- § 102—gifts (but under § 102(c), not applicable to common law employees)
- § 105—amounts received under accident and health plans
- § 106—contributions by employer to accident and health plans
- § 107—rental value of parsonages
- § 112—certain combat pay of members of the Armed Forces
- § 117(d)—qualified tuition reductions
- § 119—meals or lodging furnished to an employee for the convenience of the employer
- § 119(d)—qualified campus lodging

Step 2: Examples of Statutory Exclusions

- § 125—cafeteria plans
- § 127—educational assistance
- § 129—benefits provided under a dependent care assistance program
- § 132—certain fringe benefits
- § 134—certain qualified military benefits
- § 137—adoption assistance programs
- §§ 139 and 692—qualified disaster relief payments beginning in taxable years ending on or after 9/11/2001
- § 7872—certain below-market or no-interest loans

But don't forget the regulations, including special valuation rules for certain FBs (e.g., cars, planes, and meals).

Step 2: Section 132–the Workhorse of Statutory Exclusions

Section 132 excludes under certain conditions, the following fringe benefits:

- no-additional-cost services
- qualified employee discounts
- working condition fringe benefits
- de minimis fringes
- on premises athletic facilities
- qualified transportation fringes
- qualified moving expense reimbursements
- qualified retirement planning services

Step 3 – Value the Taxable Portion of a Fringe Benefit

If a FB is not specifically excluded (in whole or in part) from the employee's gross income, the remaining benefit must be valued for inclusion in the gross income of the person who performed the services (i.e., the employee or independent contractor), not the recipient of the benefit (e.g., spouse, child or guest of the employee).

An employee may reimburse the employer for the value of the benefit.

Step 3 – Fair Market Valuation and Election of Special Valuation Rule

General rule of valuation → FMV, i.e., amount that an individual would pay in an arm's-length transaction.

Special valuation rules are available for some commonly provided fringe benefits, such as vehicles and airplanes.

- If the employer elects to use a special valuation rule, the special value is treated as FMV of the benefit for income tax, employment tax and other reporting purposes, as well as for reimbursement purposes.
- Special valuation rule must be correctly and consistently applied to take advantage of favorable valuation.

Step 3 – The Valuation Process

The employer must include in the recipient's gross income the amount by which the FMV of the FB exceeds the sum of

- (1) the amount, if any, paid for the benefit by or on behalf of the recipient, and
- (2) the amount, if any, specifically excluded from gross income by another section of the Code; and
 - in the case of an employee, the amount included in wages must be subjected to FICA taxation and FITW and reported on Form W-2, or
 - in the case of an independent contractor (e.g., board member), the taxable amount must be reported in Box 7 of Form 1099-MISC.

Step 4 – Determining Potential Federal Penalties for Underreporting of Fringe Benefit Wages

- Employer is secondarily liable (§ 3403) for failing to withhold income taxes and will be assessed:
 - 25% (currently) with respect to additional wages paid to employees receiving less than \$1 million in supplemental wages in the aggregate during the year, and
 - 39.6% (currently) for additional supplemental wages in the aggregate equal or exceeding \$1 million during the year.
- Employer is secondarily liable for failing to withhold the employee's share of FICA taxes (6.2% OASDI up to annual wage base + 1.45% Medicare + 0.9% for wages > \$200,000).
- Employer is liable for failing to pay its share of FICA taxes (6.2% OASDI up to annual wage base + 1.45% Medicare).

Step 4 – Determining Potential Federal Penalties for Underreporting Fringe Benefit as Wages

- Employer is liable for FUTA taxes to extent employee's other wages are not over the annual FUTA tax wage base.
- 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).
- Information reporting penalties under § 6721/6722 (\$100 each, but often only one penalty is assessed).
- Negligence penalty of 20% under § 6662 is routinely asserted by Exam but is not often sustained in Appeals.
- Interest, but only if assessment is not paid timely under the interest-free adjustment rules of § 6205.

Step 4 – Example of Potential Federal Penalty Calculation for Underreporting of Wages

- Assume \$1000 in underreported fringe benefits provided to an executive who did not have supplemental wages in excess of \$1M. Executive's other wages are over FUTA and OASDI wage bases for the year.

Fed. Inc. Tax Withholding	25%	250.00
EE's share of Medicare taxes	2.35%	23.50
ER's share of Medicare taxes	1.45%	14.50
§ 6656 late deposit penalty of ER FICA	.145%	1.45
§ 6721/6722 incorrect W-2 penalty	100.00	100.00
(could be doubled to \$200)		
Total		\$389.45

10 ARGUMENTS THAT YOU MIGHT WANT TO THINK TWICE ABOUT MAKING (OR NOT MAKING)

10 (Usually Loser) Arguments in an Attempt to Justify Failing to Treat a Fringe Benefit as Wages

- There is no “cost” to the employer
 - IRS rebuttal: Only no-additional-cost services qualify for this exclusion based on employer cost. § 132(b); Treas. Reg. § 1.132-3. Cost is irrelevant to FMV. § 1.61-21(b)(2)
- The employer did not claim a compensation deduction
 - IRS rebuttal: Irrelevant. Treas. Reg. §1.132-5(c)(1)
- The benefit was not provided, arranged, and/or known by the employer
 - IRS rebuttal: Irrelevant. Treas. Reg. § 1.61-21(a)(5)
- The employer made the employee take the benefit
 - IRS rebuttal: Treas. Reg. § 1.61-21(a) taxes all property and services provided to employees unless an exclusion applies

10 (Usually Loser) Arguments in an Attempt to Justify Failing to Treat a Fringe Benefit as Wages

- Provision of the benefit lowered other tax deductible expenses of the employer. Rev. Rul. 54-597 and PLR 9237014 (Saturday night stayovers)
 - IRS rebuttal: Rev. Rul. 54-597 and PLR 9237014 are limited to facts involving trade-offs between air travel and hotel expenses of traveling employees
- The employee is not having fun
 - IRS rebuttal: The employee's perception of value is not relevant to FMV. Treas. Reg. § 1.61-21(b)(2)
- The benefit is worthless
 - IRS rebuttal: See Treas. Reg. § 1.61-21(b)(2) to determine FMV and Treas. Reg. § 1.132-6 to determine if the de minimis fringe benefit exclusion applies

10 (Usually Loser) Arguments in an Attempt to Justify Failing to Treat a Fringe Benefit as Wages

- Nobody reports this benefit (or government employees don't pay tax on this benefit)
 - IRS rebuttal: Irrelevant
- The IRS issues hundreds of PLRs per year, which have little or no value as precedent, and we only violated one of them
 - IRS rebuttal: Please show us one that you satisfied
- The law is too confusing. See General *Elevator Corporation v. United States*, 20 Cl. Ct. 345 (1990)
 - IRS rebuttal: It's confusing to us, too

WHAT WE HAVE LEARNED FROM RECENT IRS EMPLOYMENT TAX EXAMINATIONS

Update on Employment Tax Examinations

- Random audits initiated in 2009 under National Research Program directed by Chief of Employment Tax (SBSE)
- Focus on reporting of and withholding on payments
- Directive for Agents to assert applicable civil penalties
- IRS employment tax specialists have been reassigned from LB&I to SBSE
- Experience gained by IRS in identifying trends in payroll taxes and executive compensation is revealing itself in the most recent Information Document Requests (“IDRs”)

Categories of Fringe Benefits in Recent IDRs

- Car allowances and reimbursements
- Company cars
- Cell phones/tablets
- Educational assistance
- Meal allowances and reimbursements
- Relocation assistance
- Legal assistance
- Severance payments
- Athletic facility memberships
- Stock options/stock plans
- Free or reduced parking
- Subsidized eating facilities
- Deferred compensation
- Loans

Categories of Fringe Benefits in Recent IDRs (cont'd)

- Aircraft
- Sporting events, tickets and luxury boxes
- Club memberships
- Chauffeured autos
- Spousal travel
- Tax return preparation
- Financial planning services
- Employee loans
- Housing
- Personal living expenses
 - Clothing
 - Tuition
 - Other
- Gift cards
- Discounted meals
- “Any other tangible or intangible benefits provided”

THREE OF FAVORITE AUDIT TARGETS

Update on Cell Phones and Related Services

- Small Business Jobs Act of 2010 (H.R. 5297)
 - Congress “de-listed” cell phones and similar telecommunications equipment, eliminating application of ***detailed*** § 274(d) substantiation requirements
 - Statute did not address § 162 business substantiation requirements for purposes of deducting costs or excluding the value of the business use under §§ 62(c) or 132(d) but footnote in Jt. Committee report provides:
 - ❖ “The provision does not affect Treasury’s authority to determine the appropriate characterization of cell phones as a working condition fringe benefit under § 132(d), or that the personal use of such devices that are provided primarily for business purposes may constitute a *de minimis* fringe benefit, the value of which is so small as to make accounting for it to be administratively impracticable, under § 132(e).”

Update on Cell Phones and Related Services (September 14, 2011)

- Notice 2011-72 deems the § 162 substantiation rules to be satisfied for purposes of the working condition fringe benefit exclusion if the employer provides the cell phone (or other similar telecommunications equipment) for either “noncompensatory business reasons,” or “substantial reasons relating to the employer’s business”
- If the device is provided for noncompensatory business reasons, any personal use of the cell phone will be deemed to be excludable as a de minimis fringe benefit
- Issuance of IRS Field Memo, SBSE-04-0911-083, to field examiners – guidance on **reimbursements** for business use of personal cell phones

Field Memo on Cell Phones and Related Services (September 14, 2011) (Cont'd)

- To qualify as a nontaxable working condition fringe benefit, the cell phone coverage must be “reasonably related to the needs of the employer’s business”
 - The reimbursement must be reasonably calculated so as not to exceed expenses the employee actually incurred in maintaining the cell phone
- Directive to examiners: “reimbursements of unusual or excessive expenses should be examined more closely”
- Best practice: Have a written policy detailing business purpose
- Emerging issues with iPads and other tablets, including dispute as to whether they qualify as “other similar telecommunications equipment”

Spousal Travel: Deduction Disallowance

- § 274(m)(3) disallows deductions (other than moving expenses) for spouse's/guest's travel expenses when traveling with the employee on business travel, unless spouse:
 - Is a bona fide employee of employer
 - Is also traveling for a bona fide business purpose, *and*
 - Would otherwise be able to deduct the expenses under § 162(a)

Spousal Travel: Employer's Election in the Case of Spouse's Business Travel

- Treas. Reg. § 1.132-5(t) concedes that employers have a choice between taxing the employee and absorbing the deduction disallowance for expenses related to any *bona fide business travel* by a spouse
- Alternatively, the employer may elect to treat the value of the spouse's business travel benefits as additional wages, deduct payroll taxes and report the wages on Form W-2, and then deduct the travel expenses
- The value of spousal travel benefits that do not qualify as bona fide business travel must be treated as wages

Accountable Plans under Section 62(c)

EE Business Expense Reimbursement Rules

- Requirements for maintaining a T/E plan that meets “accountable plan requirements” (see Treas. Reg. § 1.62-2)
 - Business connection under § 162
 - Timely substantiation of the expense
 - Allowances reasonably calculated to cover expenses
 - Specific identification of reimbursement or allowance
 - Timely return of “spare change” from advances
- AP function is essentially administering a payroll tax body of law

Accountable Plans

- If the requirements are satisfied, the expense allowance or reimbursement is excluded from the employee's wages
- Prohibition against “abusive arrangements.” (Treas. Reg. § 1.62-2(k))
 - If the employer's expense reimbursement arrangement evidences a “pattern of abusiveness of the rules of § 62(c),” **all** payments under the plan will be treated as nonaccountable (*i.e.*, as wages subject to payroll taxes)
 - IRS can impose payroll taxes retroactively on payments and reimbursements previously treated as nontaxable

Rev. Rul. 2012-25—Recent Guidance on “Wage Recharacterization” under IRC § 62(c)

- The “business connection” requirement of the accountable plan rules will not be satisfied if the employer pays an amount to an employee regardless of whether he incurs or is reasonably expected to incur a deductible business expense.
- Failure to meet this requirement is called “wage recharacterization” because the amount being paid is not an expense reimbursement but instead is a substitute for an amount that would otherwise have been paid as a wage.
(See Ex. 1 of Treas. Reg. § 1.62-2(j); *Moorman*, 26 T.C. 666 (1956); *Lickiss*, T.C. Memo 1994-103.)
- This issue is highly fact-intensive.

Rev. Rul. 2012-25—Three Fact Patterns Describing “Wage Recharacterization” under IRC § 62(c)

- (1) Typical tool reimbursement plan where employer divides technician’s annual tool expenses by expected number of annual work hours to determine an hourly tool rate. The hourly wage is reduced by the hourly tool rate, which is treated as a nontaxable reimbursement. The hourly wage increases for the year once the total tool expenses are reimbursed.
- (2) Nurses working short-term assignments at hospitals receive an hourly rate that does not tend to vary based on location, nurses traveling away from their tax homes receive a portion of their hourly compensation as a nontaxable per diem allowance for travel expenses.
- (3) A flat amount paid to all employees for personal use of car for local transportation treated as nontaxable mileage reimbursement without regard to employee’s business use.

Rev. Rul. 2012-25—Summary of “Wage Recharacterization” under IRC § 62(c)

- Wage recharacterization is usually present when:
 - Compensation is structured so that employee receives same or similar amount whether or not deductible business expenses are incurred;
 - Employer temporarily reduces taxable wages, substitutes reimbursements treated as nontaxable, and then increases wages to the prior level when total expenses have been reimbursed;
 - Employer pays a higher amount to an employee only when he does not receive a nontaxable reimbursement and pays a lower amount as wages only when the employee also receives a nontaxable reimbursement; and
 - Employer routinely pays an amount treated as a nontaxable reimbursement to an employee who has not incurred bona fide business expenses.

Rev. Rul. 2012-25—Prospective Restructuring of Comp Does Not Constitute “Wage Recharacterization”

- Rev. Rul. 2012-25 settles a long-standing debate and holds that an employer can prospectively alter a compensation arrangement (i.e., reduce wages) and establish an accountable plan for expenses:
 - Situation 4: Cleaning services company pays hourly wages to its employees, who are required to provide their own cleaning products and equipment. The employer prospectively alters its compensation structure by reducing the hourly wage rate and establishing a new arrangement for reimbursing business expenses under the accountable plan rules. An employee continues to receive the lower hourly rate if he does not seek reimbursement or his expenses are not substantiated as required under the accountable plan rules.

TOOLS FOR RESOLVING THE CONSEQUENCES OF AN EMPLOYMENT TAX EXAMINATION

Reaching Resolution: Three “Tools” Applicable to Employment Tax Audits

Application of the interest-free adjustment rules:

- § 6205(a)(1), Treas. Reg. § 31.6205-1 and Rev. Rul. 2009-39 provide rules for the adjustments of income tax withholding and FICA taxes without interest
 - ❖ Taxpayers have the opportunity to correct underreporting errors, interest free, if the taxes are paid on or before the due date of the return for the quarter in which the error was ascertained
 - ❖ An interest-free adjustment may be claimed by signing a Form 2504 at the end of the employment tax examination or Appeals process

Reaching Resolution: Interest-Free Adjustment Rules

- An error is deemed to be “ascertained” when a Form 2504 (“Agreement to Assessment and Collection of Additional Tax and Acceptance of Overassessment”) is presented to the taxpayer either at the close of an audit or Appeals review and is signed to indicate agreement with the IRS’s assessment of employment taxes
- No interest accrues for the entire period from the date of the original error through the date that the Form 2504 is signed and becomes effective, provided the taxpayer pays the assessed taxes prior to receiving a notice and demand
- Interest-free adjustments are not available where the issue was raised in a prior examination or where the employer knowingly underreported its employment tax liability

Reaching Resolution: When Should a Gross-Up Apply to an Employment Tax Settlement?

- As a general rule, an employer's payment of an employee's tax obligation results in additional wage income to the employee. However, a different result may be reached depending on the type of tax and the circumstances surrounding the employer's payment
 - **Income Taxes** – The employer can recover from the employee only income tax withholding during the calendar year of the wage payment and cannot recover from the employee income tax withholding after the end of the calendar year. Thus, an employer's payment under the secondary liability provisions does not relieve the employee from liability for income taxes for the prior year. And, the employer's payment of income taxes does not trigger additional wage income for the employee. A gross-up is triggered, however, where the employer: (a) at the time of the wage payment, agrees to pay the employee's income taxes; or (b) where the employer makes a payment directly to the employee in the following year to cover the employee's income tax liability.

Reaching Resolution: When Should a Gross-Up Apply to an Employment Tax Settlement? (cont'd)

- **FICA Taxes** – In contrast to income tax withholding, an employer can correct an underwithholding of FICA taxes in a year following the year of the wage payment
 - The regulations provide that the employer's payment of the employee's FICA tax liability "is a matter of settlement," between the employer and the employee
 - If the employee does not repay this liability to the employer, the employer's payment of FICA taxes results in additional wages for the employee
 - The one exception would be where the employee's statute of limitations has closed (and therefore the employee is not relieved of a liability)
- These procedures are outlined in Field Service Advice 200022004 (February 3, 2000)

Reaching Resolution: An Employer's Obligation to File Forms W-2c

- If the resolution triggers an employment tax assessment, § 6051 and § 6071, and the underlying regulations, require an employer to correct the Forms W-2 (*i.e.*, issue Forms W-2c)
- The filing of Forms W-2c will trigger a corresponding obligation for employees to file Forms 1040-X and may trigger audits for penalties and interest. Employees will often press employers for the reimbursement of the accounting fees and penalties associated with filing amended individual returns
- Depending on the facts and circumstances, the employer may be forced to file one “omnibus Form W-2c” to match the employment tax adjustment, so that a CAWR mismatch penalty is circumvented

For additional information, please contact:

Marianna G. Dyson

(202) 626-5867

mdyson@milchev.com

Michael M. Lloyd

(202) 626-1589

mlloyd@milchev.com

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