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1.01 Working-Condition Fringe Benefits

According to the Internal Revenue Code, compensation for services includes "fees, commissions, fringe benefits, and similar items." The term "fringe benefits" is often used to refer to any benefit given employees. However, the term is not specifically defined anywhere in the IRC or the Treasury Regulations. Regulations only provide examples of fringe benefits and a list of specific benefits referred to as excludable or not excludable from income. Fringe benefits offered under IRC §132 may be excluded from an employee's income, FITW, FICA, and FUTA. If these benefits are provided in the form of reimbursements of employee expenses, such payments must be made by employers under an accountable plan (*see* ¶5.17[1]). Under such a plan, employees must keep adequate records and substantiate the business purpose of the expenses. IRC §132 fringe benefits include:

- no-additional-cost services,
- qualified employee discounts,
- de minimis fringes, and
- working-condition fringes.

A "working-condition fringe" is an employer-provided benefit in the form of property or services that would be deductible by the employee under IRC §162 as an ordinary and necessary business expense if the employee paid for the item him or herself.

Working-condition fringes include:

- use of **employer-provided** vehicles for business purposes (*see* ¶2.01),
- product-testing goods,
- job-related educational expenses (*see* ¶3.01),
- **uniform** expenses,
- equipment allowances, and
- security services such as a bodyguard or chauffeur.

Note. The IRS considers qualified retirement planning services — advice on retirement income planning for employees and their spouses — to be an excludable fringe benefit. This does not include the preparation of tax returns IRC §132(a)(7) ; IRS Fringe Benefits Audit Techniques Guide (02-2005).

An amount that would be deductible by an employee under any IRC section other than §162 is *not* a working-condition fringe benefit, although this amount may still be excluded under another IRC provision. For example, a company-paid physical examination does not qualify as a working-condition fringe, even if the employer makes the examination mandatory. However, according to the IRS, these exams are still exempt from FITW, FICA, and FUTA under IRC §105(b) and IRC §106 (*see* ¶7.01) IRS Reg §1.105-11(g) ; IRS Reg §1.132-5(a) .

Other items not entitled to exclusion as working-condition fringes include cash payments from employers and benefits purchased through a flexible spending account.

Cash Payments, Services, or Property. Cash payments qualify as working-condition fringes *only* if:

- the employer requires the employee to use the cash in connection with a specific or pre-arranged activity that qualifies for a business-expense or depreciation deduction,
- the employee verifies the payment of the expenses, and
- any unused payment is returned to the employer IRS Reg §1.132-5(a)(1)(v) .

Services or property offered as part of a flexible spending account cannot be excluded as a working-condition fringe.

If an employee would be able to deduct only the costs of property or services received from an employer in connection with a trade or business other than that of the employer, the property or services do not qualify as a working-condition fringe IRS Reg §1.132-5(a)(2)(i) .

EXAMPLE: Jane is an employee of Alpha Corp and is also a member of the board of directors of Beta Corp. Alpha and Beta are unrelated entities. Jane's services as director of Beta are unrelated to her duties as an employee of Alpha. Alpha provides Jane with air transportation so that she may attend a meeting of Beta's board of directors. The air transportation does not qualify as a working-condition fringe because the benefit is provided by Alpha but is not related to the business of Alpha. Jane could exclude this expense as a working-condition fringe, however, if she can demonstrate that the transportation is legitimately related to Alpha's business. Thus, if Beta was a major purchaser of goods and services from Alpha, Jane's membership on the board of directors of Beta would be related to the business of Alpha, and she could exclude the air transportation as a working-condition fringe.

Substantiation requirements. The value of goods or services provided to an employee may not be excluded from the employee's gross income as a working condition fringe by either the employee or the employer, unless the applicable substantiation requirements of IRC §274(d) or IRC §162, and the applicable regulations, are satisfied IRC §274(d) ; IRC §162 .

Under IRC §274(d), "listed property" such as automobiles and computers (*see* IRC §280F(d)(4)) may only be excluded if expenses are properly substantiated by adequate records or by sufficient evidence corroborating: (1) the amount of the expenses; (2) the time and place of the expenses; (3) the business purpose of the expenses; and (4) the business relationship of the employee to the persons involved in the expenses IRC §274(d) ; IRC §280F(d)(4) .

Cell phones. For tax years beginning after Dec. 31, 2009, the Small Business Lending Fund Act (the Act, P.L. 111-400 removes cellular telephones (cell phones) and other similar telecommunications equipment from the categories of “listed property” under IRC §280F . Thus, the heightened substantiation requirements that apply to listed property don't apply to cell phones.

Under IRS guidance, effective for *tax years beginning after Dec. 31, 2009,* the value of the business use of an employer-provided cell phone is excludable from an employee's income as a working condition fringe to the extent that, if employees paid for the use of the cell phone themselves, the payment would be allowable as a deduction under IRC §162 . If an employer provides an employee with a cell phone primarily for noncompensatory business reasons, the IRS will treat the employee's use of the cell phone for reasons related to the employer's trade or business as a working condition fringe benefit, the value of which is excludable from the employee's income. In addition, solely for purposes of determining whether the working condition fringe benefit provision in IRC §132(d) applies, the substantiation requirements that the employee would have to meet in order for a deduction under IRC §162 to be allowable are deemed to be satisfied (i.e., employees will not have to provide records to support their business use of the cell phone). The IRS will also treat the value of any personal use of a cell phone provided by the employer primarily for noncompensatory business purposes as excludable from the employee's income as a de minimis fringe benefit IRS Notice 2011-72, 2011-38 IRB 407 .

An employer is considered to have provided an employee with a cell phone primarily for noncompensatory business purposes if there are substantial reasons related to the employer's business, other than providing compensation to the employee, for providing the employee with a cell phone. For example, the employer's need to contact the employee at all times for work-related emergencies, the employer's requirement that the employee be available to speak with clients at times when the employee is away from the office, and the employee's need to speak with clients located in other time zones at times outside of the employee's normal work day are possible substantial noncompensatory business reasons. A cell phone is not provided primarily for noncompensatory business purposes if it is provided to promote the morale or goodwill of an

employee, or to attract a prospective employee. It may also not be used as a means of furnishing additional compensation to an employee IRS Notice 2011-72, 2011-38 IRB 407 .

Use of personal cell phones. The IRS has also issued a memo to its examiners that provides a similar administrative approach with respect to arrangements common to small businesses that provide cash allowances and reimbursements for work-related use of personally-owned cell phones. Under this approach, employers that require employees, primarily for noncompensatory business reasons, to use their personal cell phones for business purposes may treat reimbursements of the employees' expenses for reasonable cell phone coverage as nontaxable. This treatment does not apply to reimbursements of unusual or excessive expenses or to reimbursements made as a substitute for a portion of the employee's regular wages. The IRS provided the following examples to its examiners of reimbursement arrangements that may need to be examined more closely because they may not be reasonably related to the needs of the employer's business: (1) reimbursement for international or satellite cell phone coverage to a service technician whose business clients and other business contacts are all in the local geographic area where the technician works; or (2) a pattern of reimbursements that deviates significantly from a normal course of cell phone use in the employer's business (i.e., an employee received reimbursements for cell phone use of $100 per quarter in quarters 1 through 3, but received a reimbursement of $500 in quarter 4) [IRS Interim Guidance on Reimbursement of Employee Personal Cell Phone Usage in Light of Notice 2011-72, 9/14/11].

None of the above guidance applies to cell phone reimbursements that are not primarily business related, as such arrangements are generally taxable.

Click here to view the IRS Interim Guidance on Reimbursement of Employee Personal Cell Phone Usage.

Nondiscrimination. Nondiscrimination rules do not apply to working-condition fringes, except those associated with product-testing programs. Therefore, employers may offer working-condition fringe benefits to certain employees and not others in a discriminatory manner IRC §132(d) ; IRS Reg §1.132-5(q) .

> **EXAMPLE:** Fields Services provides automobiles and personal computers for the business use of its executive officers, but not for any other employees. The officers may exclude such fringe benefits as working-condition fringes whether or not the executives are highly compensated employees since the vehicles and computers are not provided as part of a product-testing program.

1.01[1] Employee Status

For purposes of the working-condition fringe, an “employee” is:

- a current employee;

- any partner who performs services for a partnership;
- any director of the employer, except where the working-condition fringe consists of the use of consumer products primarily for testing purposes; and
- any independent contractor who performs services for the employer, except where the working-condition fringe consists of parking or the use of consumer products primarily for testing purposes IRS Reg §1.132-1(b)(2) .

1.01[1][a] Employee Exclusion

The determination of the amount of the working-condition fringe is made without considering the 2% floor on itemized deductions under IRC §67(a) . Thus, if an amount is treated as a working-condition fringe benefit, the entire amount is excludable from income. If the amount does not qualify as a working-condition fringe, however, the entire amount is includable in the employee's gross income even if it is deductible by the employee as an itemized deduction IRS Reg §1.132-5(a)(1)(vi) .

1.01[2] Excludable Benefits

Excludable working-condition fringe benefits include the following:

- Product testing — the fair market value of the use of consumer goods manufactured for sale to nonemployee customers that are provided to employees for product testing outside the office may be excluded from an employee's gross income as a working-condition fringe.
- Dues and subscriptions — payment of professional association dues (*e.g.*, bar association dues by a law firm) and the subscription costs of business periodicals directly related to an employee's work are excludable as working-condition fringe benefits IRS Reg §1.132-1(f)(1) ; IRS Reg §1.132-5 .
- Qualified nonpersonal use vehicle — the value of the use of a qualified nonpersonal use vehicle is excludable as a working-condition fringe benefit (*see* ¶2.01).
- Qualified automobile demonstration use — the fair market value of the use of a qualified demonstration automobile by a full-time auto salesperson is excludable as a working-condition fringe benefit (*see* ¶2.01).
- Business travel expenses — the value of the business use of a company vehicle (*see* ¶2.01) or an **employer**-**provided** aircraft flight (*see* ¶2.04) is excluded from income as a working-condition fringe benefit.
- **Uniform** allowances — the value of a **uniform** that is specifically required as a condition of employment and is not adaptable for general usage is excluded from income as a working-condition fringe benefit.

- Volunteer benefits — bona fide volunteers may exclude working-condition fringe benefits (*e.g.*, directors' and officers' liability insurance protection) if the total value of the benefits is substantially less than the value of the services provided by the volunteer IRS Reg §1.132-5(r) .

Note. The payment of a real estate broker's commission by the employer on the sale of an employee's house to help the employee relocate is not a working-condition fringe because direct payment of the commission expenses by the employee would not have been a deductible business expense. However, a real estate broker's commission may be deductible as an indirect moving cost incurred because of a job relocation (*see* ¶5.15).

1.01[2][a] Product-Testing Programs

One product evaluation method used by employers is employee testing of consumer products. By allowing employees free use of the employer's or a competitor's products, employers benefit from the convenience of immediate feedback on the products and employees benefit from the free use of the products.

A consumer-product-testing program must meet all the following requirements to qualify as a working-condition fringe:

- Consumer testing and evaluation of the product must be an ordinary and necessary business expense of the employer.
- Off-premises testing and evaluation by employees must be required by business reasons.
- The item must be provided to the employee for testing and evaluation.
- The item must not be made available to the employee for longer than necessary to test and evaluate its performance.
- The employee must return the item to the employer at the conclusion of the testing period if the item has not been used up.
- The employee must make detailed reports to the employer on the testing and evaluation.
- The length of the testing and evaluation period must be reasonable IRS Reg §1.132-5(n)(1) .

Employer Limitations. The employer must impose limitations on the product's use that significantly restrict the value of the personal benefit to the employee. This requirement is satisfied if:

- the employer limits the employee's ability to select among different models or varieties of the product furnished for testing and evaluation;
- the employer's policy provides for the employee, in appropriate cases, to buy or lease at his or her own expense the same type of item as that being tested so that personal use by the employee's family will be limited; and

- the employer generally prohibits use of the item by persons other than the employee IRS Reg §1.132-5(n)(2) .

Highly Compensated Employees. Product-testing programs may not discriminate in favor of highly compensated employees. If products are furnished under a product-testing and evaluation program only to certain classes of employees, such as highly compensated employees, this fact may be considered in determining whether the goods are furnished for testing and evaluation purposes or for compensation purposes unless the employer can demonstrate a legitimate business reason for the classification of the employees to whom the products are furnished. Thus, the practice of an automobile manufacturer that furnishes automobiles to its design engineers and supervisory mechanics for testing and evaluation is probably not discriminatory in favor of its highly compensated employees IRS Reg §1.132-5(n)(3) .

1.01[2][b] Security Programs

Some businesses or professions are inherently dangerous. In other businesses, certain positions carry a high risk of harm to employees. Employers may take security measures to protect employees by providing them with bodyguards, alarms, bulletproof vehicles, metal detectors, or company aircraft.

The value of property or services provided to an employee by an employer as a security measure generally is excludable from income as a working-condition fringe. For the value of transportation provided by the employer for security reasons to be excluded, bona fide business-oriented security concerns must exist, documented by an independent security study (*see* ¶2.02). Only the excess of the higher security transportation over the employee's normal costs for transportation is excludable under this rule. If a bona fide business-oriented security concern exists with respect to an employee (such as a threat made on the life of the employee), the bona fide business-oriented security concern is also deemed to extend to the employee's spouse and dependents IRS Reg §1.132-5(m)(2) ; IRS Reg §1.132-5(m)(1) ; IRS Reg §1.132-5(m)(3) .

1.01[2][c] Employee Uniforms

The acquisition and maintenance of employee **uniforms** are tax-deductible or tax-exempt as ordinary and necessary business expenses only if: (1) the **uniforms** are specifically required as a condition of employment and (2) they are of a distinctive nature and not of a type that is adaptable to general or continued use (*i.e.*, can be worn as ordinary “street” clothing). An **employer's** expense, direct or through reimbursement, in **providing** employee **uniforms** that fit this definition is considered a working-condition fringe benefit and is not includable in employee wages Rev Rul 70-474, 1970-2 CB 34 .

Both parts of the definition must be met for the exemption to be allowed. It is not enough that the clothing be distinctive (*e.g.,* bearing the employer's logo); it also must be required by the employer. Similarly, the requirement that a uniform be worn as a condition of employment is not in itself sufficient to allow its exclusion from income. The uniform also must be unsuitable for off-the-job wear. For example, exclusions are usually not allowed for a painter's white cap, shirt, and overalls; a welder's blue work clothes; and a machine operator's work shirt and pants.

If the clothing is work-specific, the employee will be entitled either to exclude the clothing costs from gross income or to recognize the extra income but then receive an offsetting deduction for it. For example, a deduction is allowed for the cost of the purchase and maintenance of **uniforms** that are not suitable for ordinary wear in the case of police officers, firefighters, letter carriers, nurses, bus drivers, and railroad workers who are required to wear distinctive types of **uniforms** while at work. If the **employer provides** an allowance to purchase and maintain **uniforms**, the employee must include that allowance in gross income, but may then reduce that income by the amount personally spent on the **uniforms** Rev Rul 70-475, 1970-2 CB 35 .

To the extent that an **employer provides** or pays for a nonexcludable **uniform** (one that is not specifically required for employment or can be worn as ordinary clothing) at no or partial cost to an employee, the amount of the benefit must be included in the employee's gross income and is subject to FITW, FICA, and FUTA.

An **employer** that requires employees to wear **uniforms**, the cost of which is not excludable from income, can handle the tax consequences in one of three ways:

- it may allow employees to purchase and/or maintain their **uniforms** themselves, either through weekly payroll deductions or through individual contracts with **uniform** companies, eliminating tax liability altogether;
- it may purchase the **uniforms** for employees, directly or through reimbursement, input the value on a weekly or other basis, and include the amount as wages in box 1 of employees' Forms W-2; or
- it may purchase the **uniforms**, input the income, and pay the taxes for the employees by grossing up the costs of the benefit through a weekly or other period calculation (*see* ¶5.08).

1.01[2][d] Equipment Allowances

Amounts paid by **employers** to reimburse employees for **providing** their own tools, supplies, and equipment to perform work are considered wages subject to withholding, unless they are paid under an accountable plan. A reimbursement or expense allowance arrangement can satisfy the requirements of an accountable plan if it meets all of the following requirements: (1) the reimbursed expense must be allowable as a deduction and must be paid or incurred in connection with performing services as an employee of the employer (business connection); (2) each reimbursed expense must be adequately accounted for to the employer within a reasonable period of time (substantiation); and (3) any amounts in excess of expenses must be returned within a reasonable period of time (return of excess expense requirement) Rev Rul 2002-35, 2002-1 CB 1067 .

> **IRS ruling** In 2005, the IRS ruled that an arrangement failed to meet both the substantiation and the return of excess expense requirements because it did not require employees to substantiate their actual expenses. As a result, the arrangement was a nonaccountable plan and all tool allowances paid under the arrangement were required to be reported as wages on the employees' Forms W-2, and were subject to withholding and payment of federal employment taxes Rev Rul 2005-52, 2005-2 CB 423 .

Caution In 2008, the IRS established a cross-divisional team to address concerns with certain employee tool and equipment expense reimbursement plans that it believes are being falsely marketed as qualifying for tax-favored treatment [IRS Employee Tool & Equipment Alert, 1/30/08].

EXAMPLE: Carpenter Construction Co. furnished all heavy tools and complete sets of hand tools to its employees, but many workers preferred to use their own hand tools. Under the terms of a union contract, Carpenter paid a tool allowance to all union employees even if they used the company's tools. Since the allowance is not reimbursement for tool use in all cases, it is part of the employee's compensation for services rendered and subject to FITW, FICA, and FUTA.

Pipeline workers. There is an optional deemed-substantiation rule for mechanics or welding rig payments made by eligible employers in the pipeline industry. For calendar years 2009 through 2012, payments up to $16 per hour for these rigs (considered qualifying non personal use vehicles) are deemed substantiated and treated as made under an accountable plan if made to employee rig welders and heavy equipment mechanics required to provide their own rigs. The amount deemed substantiated for use of these rigs will be reduced to up to $10 per hour in 2009 through 2012 if the employer provides fuel for the rig or separately reimburses fuel costs. Any reimbursements exceeding these amounts are treated as made under a nonaccountable plan Rev Proc 2011-52, 2011-45 IRB .

1.01[3] Partnerships and S Corporations

Although partnerships, LLCs treated as partnerships, and S corporations have distinct tax and nontax advantages, some of the tax-free and tax-favored fringe benefits available to shareholder-employees of C corporations are not available to owner-entrepreneurs of “passthroughs.”

Note. The statutory rules granting or denying fringe benefits to owners of passthroughs are stated explicitly only with respect to partners and partnerships. However, under the default classification rules of IRS Reg §301.7701-3(b)(1)(i) , a domestic eligible entity automatically is treated as a partnership if it has two or more members, unless it elects to be taxed as an association (*i.e.*, as a corporation). Additionally, under IRC §1372 , for fringe benefit purposes, more-than-2% S corporation shareholder-employees are subject to the rules that apply to partners, and S corporations are treated as partnerships. As a result, unless otherwise noted, the tax consequences of fringe benefits for members of LLCs taxed as partnerships and for more-than-2% S shareholder-employees are the same as they are for partners.

For working-condition fringes, property or services supplied by an employer to an employee qualify as tax-free fringe benefits if the employee would be entitled to a business expense deduction under IRC §162 or IRC §167 for the item had the employee paid for it him or herself. And, the term employee, for purposes of the working-condition fringe, includes partners who perform services for a partnership (*see* ¶1.01[1] above). Thus, partners may receive the following working-condition fringes tax-free:

- business-related use of a company vehicle, if properly substantiated (personal use must be treated as income);
- business-use portion of company paid country club dues, even if the dues are completely nondeductible;
- employer-paid job-related education expenses; and
- job placement assistance.

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