

Fringe Benefits

The most common tax-free fringe benefit employers offer is health insurance. The second most popular tax-free fringe benefit is retirement benefits (e.g., a 401(k) plan). But the tax code contains many other items that may be offered to employees on a tax-free basis. Most of these fringe benefits fall under Section 132 — *de minimis* benefits, qualified employee discounts, no-additional-cost services, qualified transportation fringes, qualified moving expenses, and employer-provided athletic facilities. Other fringe benefits include dependent care assistance and educational assistance. Working condition fringes are separate subsets of fringes that allow you to pay for or reimburse employees for any expense they could deduct under Section 162 (trade or business expenses) and Section 167 (depreciation). Substantiation rules apply to working condition fringes. Fringes that can't be excluded from employees' income are usually valued at their fair market value and are fully taxable.

De minimis fringes must be non-cash, provided to employees infrequently, nominal in value, and administratively difficult to account for. Typical examples include parties and picnics; traditional holiday gifts with a low value (e.g., turkeys, fruit baskets); occasional meal money provided so employees can work late; occasional tickets to the theater or a sporting event; up to \$2,000 in group-term life insurance payable on the death of an employee's spouse or dependent; occasional personal use of the company's photocopying machine; coffee and doughnuts; local phone calls; and fruit, books, or other low-value gifts given to employees on special occasions.

The two most common employee recognition awards — employee-of-the-month and attendance awards — qualify for *de minimis* treatment if awards are limited to mugs, key chains, plaques, certificates, mentions in employee newsletters, etc.

Beware these pitfalls with *de minimis* fringes.

- **Non-cash.** Gift certificates, gift cards, etc., qualify as cash equivalents and therefore cannot be provided as *de minimis* fringe benefits. *What's OK:* You can give employees a holiday turkey (the classic example of a *de minimis* fringe). *What's not OK:* You can't give them a gift certificate to a local supermarket limited to turkeys.
- **Nominal in value.** The IRS has never put a monetary value on *de minimis* fringes.
- **Administrative difficulty.** The bottom line is simple: If you know who got what, then a fringe isn't too difficult to administer. *Hitch:* You can't tailor your accounting procedures to create administrative difficulty. For example, you can't avoid taxing employees on the value of concierge services by not requesting an itemized bill from the service provider.

Employee Recognition Awards

The tax code allows you to exclude length-of-service awards and safety achievement awards from employees' income. Length-of-service awards given in five-year increments are tax-free. Likewise for safety achievement awards, if they're tangible, limited to 10% of eligible employees a year, and exclude managers. Some additional strings are attached to both awards.

- The awards must be part of a meaningful ceremony, but meaningful is flexible.
- The maximum that any employee can receive tax-free depends on whether you have a written plan that doesn't discriminate in favor of upper management (length-of-service awards only, since managers can't qualify for safety achievement awards). If you have a non-discriminatory written plan, you may exclude up to \$1,600 a year from the employee's pay. The average cost per recipient of all awards in a year can't exceed \$400. If you don't have a written non-discriminatory plan, you may exclude up to \$400 from the employee's pay.
- If awards exceed these limits, the greater of the cost or the value is fully taxable.

Qualified Employee Discounts

The value of discounts on merchandise or services provided to employees is a tax-free fringe if the merchandise or services are offered for sale to customers and the following conditions are met.

- The merchandise discount doesn't exceed the **gross profit percentage** multiplied by the sale price to customers. The gross profit percentage is the gross profit (gross receipts minus the cost of goods sold) divided by gross receipts. The gross profit percentage must be figured for a representative period, which is usually the preceding taxable year. *Upshot:* The gross profit percentage must be refigured every year, and may go up or down, depending on business.
- The discount on services doesn't exceed 20% of the sale price to customers.

No-Additional-Cost Services

Employers in service businesses can offer employees — 100% tax-free — the same services they provide to the public if no *additional* costs are incurred in offering the services to employees (i.e., the service is the result of excess capacity). *Key:* Employees can't displace regular, paying customers. *Typical examples:* airline employees who fly standby, or hotel rooms for hotel employees when spare rooms are available.

Employer-Provided Athletic Facilities

The value of employer-provided athletic facilities may be excluded from employees' income if:

- the gym is located on your premises or property;
- you operate the gym directly or contract with another firm to operate it; and
- the gym's use is limited to employees, spouses, and dependents.

Educational Assistance

Under tax code Section 127, you can pay for or reimburse employees for their educational expenses, up to \$5,250 a year. Employees can use this educational assistance for personal or business-related pursuits, including undergraduate or graduate degrees, and certifications. Employees can take courses that will allow them to meet the minimum requirements of their current jobs or courses needed for promotion.

Section 127 educational assistance plans must be written, limited to employees, not discriminate in favor of executives, and can't be used to pay for sports, games, or hobbies. You also can't give employees cash. Common strings attached to Section 127 benefits include:

- limiting participation to employees with six months of service who work a certain number of hours a week;
- requiring employees to submit requests at least 30 days before course registration;
- requiring employees to provide receipts for items for which reimbursements are sought; and
- requiring that employees earn at least a grade of C before reimbursements are made.

Regardless of cost, education related to employees' *current* jobs may be paid for or reimbursed tax-free under tax regulation 1.162-5. The trade off is that "job-related" is defined narrowly. Tax-free payments or reimbursements must be limited to education that maintains or improves employees' current skills, and doesn't qualify them for new jobs. It includes education that's required by law or by you. However, you must tax payments or reimbursements if the education allows employees to meet the minimum requirements of their current jobs or qualifies them for new jobs, *even if* the education maintains or improves skills currently required in your business. Employees must provide you with proof of the amount, time, place, and business purpose of the expenses within a reasonable period of time.

Moving And Relocation Expenses

The tax code allows you to pay or reimburse employees' qualified moving expenses (i.e., expenses employees could deduct on their 1040s) on a tax-free basis. For moving expenses to be deductible, the new job location must be at least 50 miles farther from the old home than the old job location was to the old home, and employees must work for at least 39 weeks at the new location. Qualified moving expenses are limited to expenses employees incurred for moving household goods from the old home to the new home, and traveling expenses incurred (including lodging, but not meals) from the old home to the new home. Employees must account to you for those expenses.

All other expenses are non-qualified expenses; employer reimbursements, therefore, are taxable. Examples: expenses incurred for house-hunting trips and return trips to the old home; payments covering out-of-pocket expenses, including expenses for trash removal, carpet cleaning, drapery installation, and cable-TV hook-ups; and drivers license/vehicle registration fees.

Because it's not always possible to determine whether employees can deduct their moving expenses by the

time they're reimbursed, the tax code provides a withholding break. Provided you *reasonably* believe employees are entitled to the deduction when you cut checks, no withholding is required. Your belief can be reasonable, even if it turns out to be wrong. *Flip side:* If you don't reasonably believe that the expenses are deductible, your payments are fully taxable; withhold when employees are paid. [Special W-2](#) rules apply to moving expenses.

Employers that assist employees in selling their old homes by hiring commercial relocation companies may be able to exclude the employer-paid fees paid to those companies from employees' income. To keep the fees out of the relocating employee's income, the contract between the employer and the relocation company should require the employee to sell his/her home to the relocation company, which, in turn, sells it to a third party. Key: Who has the benefits and burdens of ownership. Factors tending toward tax-free treatment include:

- title to the property passing to the employer through the relocation company; and
- the employer paying property taxes, bearing the risk of loss or damage to the property, and receiving the profits from the sale of the property

Qualified Transportation Fringe Benefits

Transportation to/from work in a car pool or van pool; transit passes, tokens, fare cards, vouchers, and other items that enable employees to commute via public transportation; and paid parking at or near the workplace qualify as tax-free transportation fringe benefits. Qualified transportation fringes can be offered on a pre-tax basis, but can't be part of a cafeteria plan. Mass transit transportation fringes can be offered through debit cards, provided IRS procedures are satisfied.

The amount that employees can exclude from their income is figured monthly, and can't exceed amount established by the IRS (the IRS releases the monthly figures for the next year every fall). Employees must account to you for their expenses. Employees who want to revoke their pre-tax elections must do so on a going-forward basis only. Finally, if unused pre-tax deductions are carried over into later months (including months in subsequent calendar years), they must be used to fund additional transportation fringes.

Dependent Care Assistance

You can exclude up to \$5,000 a year from employees' income as dependent care benefits. These benefits are popular candidates for flexible spending accounts. Dependent care benefits may be provided through debit cards, provided IRS procedures are satisfied.

Dependent care benefits must be provided under a written, non-discriminatory plan. To qualify as dependent care assistance, employees' expenses must be work-related. The IRS interprets work-related expenses broadly to include baby sitter fees; day camp expenses; fees for pre-school, nursery school, or other pre-k programs; before-or after-school care of a child in kindergarten or a higher grade; transportation provided by the care provider; and indirect expenses, including application fees, agency fees, and deposits, but not forfeited deposits.

Expenses must be incurred for qualified dependents. Qualified dependents are children under the age of 13, spouses who are physically or mentally incapable for caring for themselves, and other adult dependents (e.g., elderly parents) who are physically or mentally incapacitated.

Working Condition Fringes

Working condition fringes are any property or services employees could deduct on their personal tax returns if they had to pay for them themselves. Employees' deductions must be for trade or business expenses (Section 162), or depreciation (Section 167). Since employees must be able to deduct their expenses, were they not to be reimbursed, they must substantiate those expenses to you prior to reimbursement. Typical examples of working condition fringes include the following.

- **Company cars.** The value of business miles can be excluded from employees' income; the value of personal miles is taxable. There are three ways to value personal use: the standard mileage rate, the lease valuation rate, and the general valuation rate.
- **Meals and entertainment.** The value of business-related meals and entertainment provided to employees may be reimbursed tax-free if the expenses are ordinary and necessary, not lavish, and are directly related to or associated with business. *Example:* taking clients out to dinner after a business meeting. Note that while employees can be reimbursed 100%, business deductions are limited to 50%.
- **Outplacement assistance.** The value of in-kind outplacement assistance is excludable as a working condition fringe benefit. Services must be based on employees' needs. This means that provided all employees have access to some services, terminated executives can be provided with a greater level of assistance. Cash allowances are taxable.
- **Everyday business expenses.** These expenses include reimbursing employees who drive their own cars on business, make business calls on personal cell phones, purchase company supplies with their own money, etc.
- **Travel expenses.** These expenses include overnight travel expenses, and lodging, meals, entertainment, and incidental expenses employees incur on the company's behalf.
- **Dues and subscriptions.** Amounts you pay for employees' professional dues and subscriptions to business periodicals can be excluded from their income. This exclusion doesn't apply to dues for a membership in an exclusive alumni club.
- **Spousal travel.** Amounts paid for employees' spouses to travel with them may be excluded from employees' income if employees can show that their spouses' presence has a *bona fide* business purpose. If you treat spousal travel as a working condition fringe, you sacrifice your corporate deduction.
- **Club dues.** Amounts you pay for employees' memberships in clubs organized for business, pleasure, recreation, or other social purposes can be excluded from their income. Tax-free treatment extends only to the portion of the club dues attributed to business use; amounts attributed to personal use are taxable. If you treat club dues as a working condition fringe, you sacrifice your corporate deduction.

FAQs About Fringe Benefits

1. *The company will be taking its top salespeople on a five-day retreat to a resort. Business meetings are scheduled for one hour a day for three days, during the late afternoon. Mainly, however, the plan is for employees to relax and go fishing. Is this a tax-free working condition fringe benefit, or must we include the value of the trip in employees' income?*

This can go either way. It could be considered a tax-free working condition fringe (i.e., a business trip) if the company has a realistic expectation of gaining concrete future benefits from the trip. For example, employees could be brainstorming new business opportunities or trading sales techniques. On the other hand, if recreation is the primary focus, the trip would be personal and the value would have to be included in employees' income. To back up the company's claim that the trip is business-related, have documentation showing what was accomplished.

2. *An employee suffered a house fire and lost everything. We gave her \$5,000 to help her reestablish her household. Is this emergency assistance taxable?*

Yes. If the employer's payment is a gift, it's taxable and must be included in gross income. The payment should be reported on Form 1099-MISC as "other income."

3. *Regulations exclude de minimis fringe benefits, such as occasional tickets to sporting events or the theater, from employees' income. Our company buys \$10,000 worth of professional basketball tickets, which the president distributes at her discretion. Each pair costs \$400, and no employee receives them more frequently than others. Are the tickets tax-free de minimis fringe benefits?*

No. The three keys to *de minimis* fringes are that employees receive them infrequently, they're of low value, and they're difficult to administer. These tickets, although they're given to employees infrequently, are too expensive to be considered *de minimis*.

4. *Employees must wear special protective gear consisting of safety glasses and shoes. Provided they submit receipts, we reimburse them up to \$65. Does the reimbursement qualify as a working condition fringe benefit?*

Maybe. Since employees can deduct uniforms as a working condition fringe, employers may reimburse employees tax-free. The general rule regarding deductibility is that employer-provided work clothes are tax-free if the items can't be worn on the street. So you can reimburse employees tax-free for the safety glasses. The shoes are a different matter. If employees change into their shoes at work, (e.g., you require sterile booties), you'll have a more compelling case that reimbursement should be tax-free. On the other hand, you'll have more of a problem making a case for tax-free reimbursement if you're referring to run-of-the-mill steel-tipped work boots, since they are advertised as all-purpose items.

5. *We give employees turkeys at holiday time. That, however, wasn't good enough for one manager, who bought his most outstanding employee an expensive jacket. Unbeknownst to Payroll, Accounts Payable reimbursed the manager. How do we sort out the taxes?*

The manager's reimbursement is fully taxable. In addition, the value of the jacket is fully taxable to the employee.

6. *Our top salesperson just won a vendor-paid trip for two to next year's Super Bowl. Is the value of the tickets (plus hotel, meals, etc.) taxable, and if so, who's responsible for what?*

Yes, the value is taxable to the employee. The company must include the value of the prize on the employee's W-2 if it distributed the vendor-supplied prize (e.g., at the company holiday party or picnic). The vendor must provide a 1099-MISC form if it handled the distribution.

7. *The company operates several miniature golf courses. To express management's appreciation, some employees were given comps for rounds of play anytime we're open. I've been told that under tax code Section 102, employers can't make gifts to employees, so they must be taxed on the value of the golf games. But isn't this a Section 132 fringe benefit, instead?*

Yes. Under Section 132, this perk is a no-additional-cost service. Employers in service businesses can offer employees the same service, tax-free, that they provide to the public. But, as its name implies, you can't incur any additional cost. That means that regular, paying customers can't be displaced. Non-discrimination rules also apply, so that services offered to upper management are on substantially the same terms as services available to the rest of the workforce.

8. *My company collects all the frequent flyer miles for our employees' business travel. Sometimes, as an incentive award, it will provide a free round-trip ticket to an employee "purchased" with these frequent flyer milers. Is this taxable? If so, how should it be valued?*

Yes, since it's compensation paid in the form of miles. The value is the fair market value of the trip.

9. *We're trying to streamline the company's employee awards program. Instead of allowing employees to choose a 10-year length-of-service award from a catalog, we want to substitute \$100 in cash. Is this OK? If the cash is taxable, how about a \$100 gift certificate?*

The tax code is specific and doesn't allow for streamlining. Cash is always taxable. Gift certificates are taxable, as well. Non-cash length-of-service awards are tax-free if you have a qualified length-of-service award plan; the maximum excludable from employees' pay is \$1,600 and the average cost of all awards in a year doesn't exceed \$400; presentations are part of a meaningful ceremony; and the awards are limited to five-year increments.

10. *We want to offer employees \$500 a year they could use for conferences, courses, or certification tests; to buy a computer; or for professional memberships. Is any of this taxable, and if it is, how can we change that?*

Giving employees \$500 in cash is taxable. Regardless of cost, short courses (e.g., seminars) related to employees' current jobs may be paid for or reimbursed tax-free under tax reg. section 1.162-5. *Caution:* Courses that lead to undergraduate degrees, certifications, and, in most instances, graduate degrees can be reimbursed tax-free under Section 127 of the tax code only. Generally, Section 127 plans are written; don't discriminate in favor of upper management; can't be used to pay for sports, games, or hobbies; and have an annual limit of \$5,250 per employee.

Employer-financed computers and professional dues could be working condition fringe benefits. Those are any business-related property or services employees could deduct on their 1040s, if they paid for them themselves. Professional dues clearly qualify. As for computers, to keep the company's payments tax-free, you would have to show that employees were required to work from home, and not that working from home was merely an accommodation to them.

11. Employees have been working late finishing up several important projects. Those who work up to four hours of overtime get \$7 per hour in meal money. The company reimburses employees in full for their meals if they work longer than that. Is any of this taxable?

Yes, the \$7 per hour you're providing employees in the first group is fully taxable. For occasional meal money to be tax-free, employees must either be reimbursed for the cost of their meals, as the company is doing with employees who log more overtime, or given a pre-determined amount each time they work overtime. You could, for example, give employees who work up to four hours overtime a flat \$7. But you can't give them an hourly amount in meal money for each overtime hour they work.

12. Under the company's proposed educational assistance plan, instead of reimbursing employees, they would be allowed to borrow money to cover their grad school expenses, up to \$5,250 a year. Once they graduate, the company will forgive the debt. Employees would also receive additional salary equal to the interest and principal due on their loans each year. Does this plan qualify as a Section 127 educational assistance plan, and what's includable in income?

Yes, the plan would qualify under Section 127. Debt forgiveness is an interesting twist but not relevant to the analysis. Therefore, forgiven debt, up to \$5,250 a year, could be excluded from employees' incomes tax-free. Salary in excess of \$5,250 remains fully taxable. Key to keeping the plan tax-free: Under Section 127, you can't provide employees with a choice between receiving educational assistance benefits and another taxable benefit, say, the same amount in additional salary, without the burden of going to school.

13. An employee said she heard that she could enroll her child in sleep-away camp for the summer and be reimbursed through the company's dependent care assistance program. Is she correct?

No. The tax code specifies that only day camp expenses may be defrayed through dependent care assistance plans. Expenses employees incur to send their children to day camp qualify for the dependent care credit if the children are under 13 and they incur those expenses to enable them to work. Generally, whatever qualifies for the dependent care credit also qualifies as an expense under an employer-sponsored dependent care assistance program, up to the \$5,000 annual limit, of course. Employees can change their dependent care flexible spending accounts mid-year to accommodate day camp expenses.

-